

# TAX MANAGEMENT PORTFOLIOS™

## U.S. INCOME

### Employee Fringe Benefits

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# TAX MANAGEMENT PORTFOLIOS™

U.S. INCOME

## Employee Fringe Benefits

### PORTFOLIO DESCRIPTION

Tax Management Portfolio, *Employee Fringe Benefits*, No. 394-5th, discusses the substantive rules pertaining to various fringe benefits provided by an employer to employees, including the statutory framework for exclusion created by the 1984 Tax Reform Act and subsequent legislative changes and additions.

This Portfolio discusses in detail the various categories of fringe benefits specifically addressed under §132 — working condition fringes, no-additional cost services, qualified employee discounts, de minimis fringe benefits, qualified transportation fringes, qualified moving expense reimbursements, qualified retirement planning services, and qualified military base realignment and closure fringe payments. It also considers the tax status of certain benefits addressed by specific statutory provisions such as §127 educational assistance programs and §129 dependent care assistance programs. Supplemental unemployment benefit trusts under §501(c)(17) also are covered. The Portfolio discusses the organizational and operational requirements for plans or programs providing these benefits, including the rules on withholding and employment taxes, as well as the “separate line of business” rules of §414(r).

This Portfolio may be cited as Elwood, and Moore, 394-5th T.M., *Employee Fringe Benefits*.

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## DETAILED ANALYSIS

### I. Introduction and Overview

#### A. Types of Fringe Benefits

Fringe benefits, in the broadest sense, include all benefits provided by an employer to its employees (or others performing services for the employer) other than cash salary or wages for services rendered. Such benefits may take many forms, including current cash payments (e.g., advances or reimbursements for employee expenses) or future cash payments (e.g., retirement benefits); providing privileges, goods, services or facilities to employees at a discount or without charge; allowing employees to use employer property; providing intangible benefits (e.g., a choice office location); or giving employees investment opportunities, including opportunities to receive stock of the employer. Conceptually, fringe benefits may be divided into three categories:

- benefits provided currently, including property made available, job-related working conditions, and incidental benefits;
- benefits provided as future cash payments or property rights; and
- benefits provided in the form of insurance.

##### 1. Current Provision of Property, Services or Cash

Many benefits can be provided to an employee currently on a continuing or as-needed basis. Such benefits are most often provided in the form of services or property obtained for or made available to the employee at the employer's expense.

Current benefits may take the form of employee expense reimbursements or the provision of services or the use of facilities.<sup>1</sup> For example, an employer may reimburse its employees for, or pay directly on their behalf, such items as:

- moving expenses;
- educational expenses;
- legal or investment expenses;
- transportation expenses;
- expenses of food and lodging;
- expenses of caring for an employee's dependents;
- medical expenses;

<sup>1</sup>The TCJA (Pub. L. No. 115-97) alters several fringe benefit provisions after 2017. As discussed below, it suspends temporarily exclusions from gross income for qualified bicycle commuting reimbursements and qualified moving expense reimbursements (except for certain military moves), expands the 50% food and beverage deduction limit, and disallows deductions for expenses associated with providing qualified transportation fringe to employees, expenses incurred for providing transportation for commuting between the employee's residence and place of employment (except for ensuring employee safety), and certain expenses paid or incurred after 2025 that are associated with meals provided for the employer's convenience through an employer-operated facility.

- professional dues; and
- prizes, awards and other special payments.<sup>2</sup>

The employer may also allow the employee to use the employer's property or provide a direct service or facility to the employee. Commonly employer-provided services and facilities include:

- day care services;
- dinner money and taxi fare for late evening work;
- use of an employer cafeteria or dining room;
- personal use of company airplanes or cars;
- free or reduced rate travel on employer transportation;
- discounts on employer goods or services;
- gifts or awards;
- use of employer athletic or recreational facilities or activities;
- counseling on various personal matters; and
- low interest or interest-free loans.

Most of the foregoing current benefits involve formal employer plans, while a few, such as dinner money, are merely incidentally provided, often as part of particular employment circumstances. Whenever possible, these arrangements are set up so that the employee will not be taxed on the benefit provided. However, in cases where the benefit is taxable, the employee is ordinarily taxed currently. Correspondingly, the employer will ordinarily be entitled to take a current deduction for the cost of providing the benefit.

##### 2. Future Cash Payments or Property Rights

###### a. Qualified Plans

One of the more common fringe benefits is the provision of cash benefits to employees at retirement under qualified pension or profit-sharing plans. Under such plans, an employer contributes cash to a trust for the benefit of its employees. The employees (or their beneficiaries) receive payments when they retire, leave the employer's employ, become disabled or die.

Noncash benefits also may be provided to employees upon their retirement under a stock bonus or employee stock ownership plan (ESOP). Under these plans, an employer contributes to a trust. The contributions are then used to buy stock in the employer, giving the employees a share of ownership in the employer.

<sup>2</sup>In IRS News Release IR-2006-112, the IRS announced that cash incentives or "rebates" that some companies offer to employees in select areas to offset the purchase price of environmentally friendly hybrid cars are taxable compensation just like other forms of compensation. Employers should include the cash incentive amounts in employees' compensation reported on year-end Form W-2 earnings statements. The cash incentives are also subject to income tax withholding and employment taxes.

All of these plans are geared toward providing an employee with a benefit at retirement that will not be taxed until received. These plans are usually referred to as qualified deferred compensation plans because they have “qualified” to be tax-exempt under the tests of the applicable sections of the Internal Revenue Code of 1986, as amended (I.R.C.),<sup>3</sup> relating to such plans.

Deferred compensation benefits also may be provided through a number of alternative vehicles, discussed below.

#### *b. Nonqualified Deferred Compensation Arrangements*

Nonqualified deferred compensation arrangements are plans under which the employer contractually agrees to provide an employee certain benefits (usually cash) at a later date (ordinarily upon retirement, but occasionally after a fixed number of years or a particular event), but the obligation is subject to the risk that the employer or a responsible successor will continue to exist and be able to provide the benefit as well as the rights of the employer’s general creditors. Although early case law and IRS administrative decisions formed the initial foundation for use of some nonqualified arrangements without current tax recognition, many are now subject to the specific statutory requirements and restrictions of §409A.<sup>4</sup>

#### *c. Statutory Cash or Deferred Compensation Arrangements*

These are plans under which an employee is permitted an election to either receive currently or defer receipt of cash or a benefit under an otherwise qualifying profit-sharing or stock bonus plan.

#### *d. Stock or Equity Option Plans*

These are plans under which an employee is given options to purchase stock, LLC membership units or other equity interests in the employer at a future date for a specified price.

#### *e. Restricted Stock or Equity Plans*

These are plans under which an employee is given stock, LLC membership units or other equity interests of the employer to which such employee will not have clear title until the employee fulfills some subsequent condition or conditions, such as working a number of years for the employer and/or not violating a non-compete agreement.

#### *f. Phantom Stock or Unit Stock Plans*

These are plans under which an employee is credited with a number of units of employer stock, LLC membership units or other equity interests and the equity principal (together with the dividends or distributions earned thereon) is made available to the employee after a specified number of years or when the employee retires.

#### *g. Stock or Equity Appreciation Rights*

These are plans under which an employee is given a right to receive a payment equal to the excess of the fair market value

of a certain number of shares or units of the employer’s stock, LLC membership units or other equity interests on the date the employee exercises such right, over such equity’s fair market value on the date the right was provided to the employee.

The above arrangements are ordinarily set up so that the employee will not be taxed until the employee receives the cash provided under the plan or until such employee acquires the unrestricted right to the property provided under the plan. However, the time when an employer may take a deduction for the benefits provided under such plans or arrangements may vary depending upon whether the plan or arrangement is qualified under the I.R.C.

If the benefit is provided under a qualified pension, profit sharing or stock bonus plan, the employer ordinarily will receive a deduction for contributions made to the plan’s trust in the year when the contributions are made or accrued, whether or not those contributions are made available to the particular employees taken into account in determining the amount of the contribution in the year the contributions are made (if ever). In all other instances, the employer can expect a deduction only when the cash or property is made available to the employee or the employee’s rights to the property become either: (1) transferable; or (2) not subject to a substantial risk of forfeiture. For further discussion of the taxation of these benefits, see I.B.

### *3. Benefits Provided Through Insurance*

A benefit may be provided to an employee in the form of premium payments on insurance for the benefit or protection of the employee or his/her beneficiaries. An employee (or the employee’s beneficiaries) will receive an actual payment only if the condition or event that the insurance covers occurs or a covered type of expense is incurred. The employee also receives the intangible benefit of knowing that he or she is protected in case the condition or event occurs or a covered expense is incurred. Common forms of insurance premiums paid by employers for the benefit of employees are for:

- insurance on the employee’s life;
- medical insurance covering the medical and hospitalization costs of the employee and the employee’s family;
- disability insurance providing a benefit to the employee upon disability;
- directors’, officers’ and key employees’ liability insurance; and
- legal services insurance that reimburse certain legal costs incurred by the employee and the employee’s family.

In most instances, the employer is able to currently deduct the cost of premiums paid on such insurance policies and the employee does not have to include the premium costs in income. However, the benefits provided under the insurance policy may/may not be includible in the income of the employee or of a member of the employee’s family.<sup>5</sup>

<sup>3</sup> All section references herein are to the Internal Revenue Code of 1986, as amended, and the regulations thereunder (Reg.), unless otherwise stated.

<sup>4</sup> See generally 385 T.M., *Deferred Compensation Arrangements*.

<sup>5</sup> For example, benefits provided under employer-paid medical insurance generally are not includible in an employee’s income pursuant to §105(b), while benefits provided under an employer-provided disability income policy are included in the employee’s income pursuant to §104(a)(3). See generally 330 T.M., *Tax and ERISA Implications of Employer-Provided Medical and Disability Benefits*.

## B. Tax Consequences of Fringe Benefits

### 1. Objectives

#### a. Current Benefits

The employee would like to exclude from income the value of all noncash benefits made available to such employee and the amounts paid to such employee or on the employee's behalf. The employer would like to receive a current deduction for the cost of the goods, services or facilities made available to the employee, or any cash paid to the employee.

#### b. Deferred Benefits

The employee would like to defer taxation of the cash or property until receipt of the right to the cash or unfettered rights to the property. The employer would like to receive a deduction at the earlier of the time the cash or property is either paid into an account or trust for the benefit of the employee (or employees) or paid or provided directly to the employee or made available without restrictions.

#### c. Insurance Benefits

The employee would like to exclude from income the value of the employer's premium cost and also to exclude (or at least defer until occurrence of an insured event) tax on the value of benefits paid or provided pursuant to the insurance arrangement. The employer would like to receive a deduction when the premium cost is incurred.

### 2. Income Tax Consequences to the Employee

#### a. Inclusion in Income — General Rule and Exclusions

The federal income tax law has contemplated from the earliest tax act that part of an individual's taxable income might be compensation paid in a form other than in cash.<sup>6</sup> Thus, under §61(a),<sup>7</sup> "gross income means all income from whatever source derived, including ... (1) Compensation for services, including fees, commissions, *fringe benefits*, and similar items."<sup>8</sup> This result has likewise always been stated to be the rule under case law.<sup>9</sup> Therefore, the general rule is that an employee's gross income potentially includes not only all payments of cash but

also the value of all awards of property and all provision of goods, services or facilities arising out of an employee's employment relationship with the employer.

However, notwithstanding the general rule of inclusion, the I.R.C. specifically provides that certain cash and noncash benefits made available to employees are not included in their gross income. The I.R.C. provisions that exclude incidental fringe benefits and certain other statutory fringe benefits from an employee's income are discussed in II. and III.

#### b. Time of Inclusion

For a benefit to be included in an employee's income, the taxable year of the employee in which the value of the benefit is includible must be determined. Because the individual income tax rates under the I.R.C. are progressive,<sup>10</sup> increasing as an individual's taxable income increases, the year in which an employee includes a particular benefit in income can make a material difference in the amount of tax the employee has to pay on such income. Further, if an employee is able to defer payment of tax on a cash benefit until a later year, the employee will effectively have interest-free use of funds equal to the tax on such benefit until such time as the employee is required to pay the tax.

#### (1) Current Inclusion Rule

Section 451(a) provides that "[t]he amount of any item of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under the method of accounting used in computing taxable income, such amount is to be properly accounted for as of a different period." The regulations under §451 provide that the year in which a taxpayer includes compensation for services (including a taxable benefit) in gross income depends on whether the taxpayer is on the accrual or cash method of accounting.<sup>11</sup> An accrual method taxpayer must include an item in gross income when all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy (all events test).<sup>12</sup> However, most employees use the cash receipts and disbursements method of accounting, under which an item is included in income only when it is actually or constructively received. Cash or property constituting income is deemed to be constructively received by a cash method taxpayer in the taxable year during which such income is credited to the taxpayer's account, set apart for the taxpayer, or oth-

<sup>6</sup> Section 11B of the Revenue Act of 1913 provided that:

Net income of a taxable person shall include ... income derived from salaries, wages, or compensation for personal service of whatever kind and in whatever form paid. (Emphasis added.)

This language was successively re-enacted and carried into the 1939 I.R.C. as §22(a), and with minor wording changes, the gloss of this language was carried into the predecessor to the current I.R.C. as §61(a)(1). See S. Rep. No. 1622, 83d Cong., 2d Sess. 168 (1954).

<sup>7</sup> As amended by the Deficit Reduction Act of 1984, Pub. L. No. 98-369 (1984 Act), and included the Tax Reform Act of 1984 as Division A, and by Pub. L. No. 115-97, §11051(b)(1)(A).

<sup>8</sup> Emphasis added. The 1984 Act amended §61(a)(1) to specifically include "fringe benefits" in the enumeration in that subsection of the compensation items specifically includible in gross income.

<sup>9</sup> For example, in *Commissioner v. LoBue*, 351 U.S. 243 (1956), involving an employee stock option, the U.S. Supreme Court noted the absence of the kind of "detached and disinterested generosity" that would characterize the stock transfer as a "gift," and ruled that the employee realized compensation, formulating the applicable legal principle very broadly:

[T]hat in defining "gross income" as broadly as it did in §22(a) Congress intended to "tax all gains except those specifically exempted." [and that] When assets are transferred by an employer to an employee to secure better services they are plainly compensation. (Emphasis added.) See also *Commissioner v. Duberstein*, 363 U.S. 278 (1960); *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 429-30 (1955); *Commissioner v. Smith*, 324 U.S. 177, 181 (1945).

<sup>10</sup> See generally §1.

<sup>11</sup> Reg. §1.451-1(a).

<sup>12</sup> Reg. §1.451-1(a). For taxable years beginning after December 31, 2017, see §451(b), added by Pub. L. No. 115-97, §13221(a) (generally requiring income recognition under the all events test in the taxable year in which the item is taken into account on a financial statement). See also Reg. §1.451-1(b) and Reg. §1.451-3, discussed at 570 T.M., *Accounting Methods — General Principles*.

erwise made available so that the taxpayer may draw upon it during the taxable year.<sup>13</sup>

### (2) *Exceptions Permitting Deferred Inclusion*

There are three principal exceptions to the rule of current inclusion.

#### (a) *Unsecured Promise to Pay*

Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. If an employee receives an unsecured promise that he or she will be paid compensation in a later year, which promise is subject to the general creditors of the employer, the mere promise to pay the employee cash at a future date does not constitute constructive receipt.<sup>14</sup> Similarly, if an employer credits an employee's account with bonus stock, LLC membership units or other equity, but such equity interest is not available to the employee until some future date, the mere crediting on the books of the employer does not constitute receipt.<sup>15</sup> An employer may even agree to have amounts to be paid later to an employee placed in a separate trust, a so-called "rabbi trust." As long as the trust is subject to the employer's creditors, the employee does not recognize income currently.<sup>16</sup> Benefit plans based on deferral of constructive receipt enjoyed a surge in popularity after the reduction in the maximum compensation that could be considered in making contributions to qualified plans by the Revenue Reconciliation Act of 1993 (1993 RRA).<sup>17</sup> However, the enactment of §409A as part of the American Jobs Creation Act of 2004<sup>18</sup> imposed an entirely new layer of complex requirements and restrictions on nonqualified deferred compensation plans, which has tempered some of the enthusiasm for this approach.

#### (b) *Income Recognition Statutorily Deferred*

In many cases, the amounts credited to an employee's account in a qualified plan are fully or partially vested. However, in general under §402, an employee is not taxed on amounts contributed by an employer on such employee's behalf to a tax-exempt trust that is part of a qualified pension, profit sharing or stock ownership plan until distributions are made to the employee from the plan. Similar special deferral rules defer recognition with respect to arrangements qualified under §401(k).<sup>19</sup> Section 402 also provides for further deferral on amounts withdrawn from such plans and transferred to another plan in a qualifying rollover.<sup>20</sup> Thus, Congress has statutorily limited the constructive receipt doctrine and Reg. §1.451-1 and §1.451-2

for qualified deferred compensation plans so that an employee need not include the contributions made under such plans in current income until received (even though such contributions may be nonforfeitable and are ordinarily secured by a trust).

#### (c) *Property Subject to Substantial Risk of Forfeiture*

A third exception applies to property (other than money) transferred to an employee that is not freely transferable by the employee and is subject to a substantial risk of forfeiture. For example, an employer may transfer a restricted equity interest (stock, an LLC capital interest or other equity) to an employee that (1) the employee is not able to sell to another person until the employee completes a certain number of years of service with the employer or (2) is subject to forfeiture if the employee violates a non-compete covenant during such period. In such instances, an employee has a statutory choice under §83 as to when to include the value of such property in income<sup>21</sup> and may choose to include the value of the property in income as of the date it either becomes nonforfeitable or transferable or as of the date received.<sup>22</sup>

In summary, the general rule of inclusion requires an employee to include in income the value of all goods, services, facilities or property provided, to such employee, and the amount of cash paid to such employee, or on the employee's behalf, unless a specific I.R.C. provision allows the employee to exclude the value of such services, facilities, goods, property or cash from income. If the value of a fringe benefit paid or provided to an employee is not excluded from income, the time when the employee must include it in income is the earlier of the year it is actually paid or provided to the employee or the year in which it is constructively paid or made available unless: (1) the benefit is an unfunded promise to pay cash or property in the future; (2) the benefit is a payment to a trust that is part of a qualified plan; or (3) the benefit is nontransferable property subject to a substantial risk of forfeiture (and the employee does not make an election under §83(b) to recognize income in the year the property is transferred to such employee).

### 3. *Income Tax Consequences for the Employer*

#### a. *Amount Deductible*

Pursuant to §162(a), an employer may deduct all ordinary and necessary expenses it pays or incurs during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered.<sup>23</sup> Thus, except as otherwise limited by other applicable I.R.C. provisions, an employer may deduct all money paid to its employees reasonable as compensation for

<sup>13</sup> Reg. §1.451-1(a), §1.451-2(a).

<sup>14</sup> Rev. Rul. 71-1, amplified by Rev. Proc. 92-65, Rev. Rul. 69-649, and Rev. Rul. 60-31.

<sup>15</sup> See Reg. §1.451-2(a). See also Rev. Rul. 80-300 and PLR 8618031 (IRS ruled that there was no constructive receipt of amounts credited in phantom stock plan).

<sup>16</sup> See GCM 39230 (Jan. 20, 1984); Rev. Proc. 92-64; PLR 8634031. See also PLR 8113107 (IRS first approved such an arrangement in the context of a congregation's funding of its retirement obligations to its rabbi).

<sup>17</sup> Pub. L. No. 103-66, §13212, enacted as Chapter 1 of Title XIII of the Omnibus Reconciliation Act of 1993.

<sup>18</sup> Pub. L. No. 108-357. For more information on the impact of §409A, see 385 T.M., *Deferred Compensation Arrangements*.

<sup>19</sup> See generally §402(c)(3); Reg. §1.401(k)-1(a)(4)(iii).

<sup>20</sup> §402(c).

<sup>21</sup> Under §83, the employee may either include the fair market value of the property less the amount paid for the property in income in the year the employee receives it, or in the year in which the property first either becomes transferable or is no longer subject to a substantial risk of forfeiture. The election to include the value of the property in income in the year received must be made within 30 days of the property's transfer and cannot be revoked without the IRS's consent.

<sup>22</sup> §83(a). In some cases, employees of certain start-up companies may elect special timing rules under §83(i) for qualified stock that is attributable to options exercised after 2017. See Pub. L. No. 115-97, §13603(a). For further discussion of the provisions of §83, see 384 T.M., *Restricted Property — Section 83*.

<sup>23</sup> Reg. §1.162-7.

personal services, and an employer may also deduct the cost or value of goods, services and facilities provided or made available to its employees as fringe benefits in connection with such employment.

#### *b. Time of Deduction*

Section 461(a) provides that “[t]he amount of any deduction ... shall be taken for the taxable year which is the proper taxable year under the method of accounting used in computing taxable income.” Accordingly, under Reg. §1.461-1, the year in which an employer would expect to deduct current compensation items depends initially on whether the employer itself is on the accrual or cash method of accounting.

##### *(1) Current Deduction Rule*

If an item of compensation currently is includible in income by the employee, under the general accounting rules, a cash basis employer ordinarily will deduct that item of current compensation when it is actually paid.<sup>24</sup> Similarly, an accrual basis employer generally is able to deduct an item of current compensation when all the events have occurred that determine the fact of the liability and the amount can be determined with reasonable accuracy.<sup>25</sup> In addition, accrual basis employers must satisfy the test under §461(h). For this purpose, the employer may not treat an amount as incurred before there has been “economic performance” with respect to that item. This limitation ordinarily is not a problem in connection with payments for employee services because the economic performance rules provide that economic performance generally occurs as an employee renders services to the employer.<sup>26</sup>

##### *(2) Exceptions and Special Rules*

There are a number of exceptions to the general rule of current deductibility, as well as certain special rules that, in appropriate cases, give the employer the benefit of realizing a deduction in advance of the time when the employees realize income.

##### *(a) Unsecured Promise to Pay*

If an employer makes an unsecured promise to pay an employee compensation that will be deferred until a later year, then, notwithstanding that the employer may use an accrual method of accounting, the employer’s deduction for the compensation statutorily is deferred until it is actually paid or made available to the employee.<sup>27</sup>

<sup>24</sup> Reg. §1.461-1(a)(1).

<sup>25</sup> Reg. §1.461-1(a)(2). See Rev. Rul. 2011-29 (employer can establish “fact of the liability” under §461 for bonuses paid to group of employees even though employer does not know identity of any particular bonus recipient and amount payable to that recipient until after end of taxable year). See also FAA 20134301F (IRS stated that accrual basis employer not entitled to deduct cash bonuses paid to employees in the year in which the employees performed the work giving rise to the bonuses, concluding that neither the fact of liability nor the amount of liability prong of the all events test was met because employer retained the right to modify or eliminate the bonuses, the bonuses were subject to committee approval and subjective determinations were needed to calculate the amounts of the bonuses).

<sup>26</sup> §461(h)(2)(A)(i).

<sup>27</sup> §404(a)(5); Reg. §1.404(a)-12.

##### *(b) Property Subject to Substantial Risk of Forfeiture*

A similar deferred deduction rule applies in the case of property transferred to an employee in return for the employee’s service, under which property either is subject to a substantial risk of forfeiture or is nontransferable. The employer may not deduct the value of the transferred property until the employer’s taxable year in which or within which ends the taxable year in which such amount is included in the employee’s gross income.<sup>28</sup>

##### *(c) Special Rules*

One of two special rules may allow an employer a current deduction for a compensation item independent of the general pattern of linking such deduction to the time of employee income inclusion. First, if the value of the property, goods, services or facilities made available (or the cash paid to the employee) is excluded altogether from the employee’s gross income, the employer may still deduct the cost of the benefit in the year it is made available or paid to the employee.<sup>29</sup> This is the rule generally operable with respect to the “incidental” fringe benefits discussed in II., as well as for the other statutorily excluded benefits discussed in III.

Second, under §404, an employer may deduct amounts paid to a trust exempt from income tax under §501(a) that forms part of a qualified pension, profit sharing or stock ownership plan in the taxable year contributions are made to the trust, subject to the various limitations applicable to such plans, including limitations on the amounts that may be contributed.<sup>30</sup>

### **C. Tax Policy and Fringe Benefits**

Because fringe benefits are generally includible in income, when certain fringe benefits have been statutorily exempted from federal taxation or when the incidence of such taxation has been postponed, Congress’s purpose generally has been to provide a tax incentive to encourage employers to provide those benefits to their employees.<sup>31</sup> The motivation for this generally is the view that such benefits are appropriate to encour-

<sup>28</sup> §83(h). For example, if an employer transferred stock, an LLC capital interest or other equity to an employee that was nontransferable and that would be forfeited by the employee if the employee did not continue to work for the employer for the following five years or violated a non-compete agreement, the value of such equity interest would not be deductible by the employer until the employee completed five years of service. However, if the employee elected under §83(b) to include the value of the equity interest in income in the year received, the employer could deduct the equity interest’s value in that year. The deduction must be reduced by any amount paid by the employee for the property. See 384 T.M., *Restricted Property — Section 83*.

<sup>29</sup> This result is not specifically provided for in the I.R.C., but a failure to allow the deduction at that time could effectively preclude the deduction because no subsequent event offers a more appropriate time for allowance of the deduction. However, see generally Reg. §1.162-7, §1.162-10.

<sup>30</sup> For further discussion of the restrictions provided under §404, see 371 T.M., *Employee Plans — Deductions, Contributions, and Funding*.

<sup>31</sup> Note that Congress has deviated somewhat from this purpose in the TC-JA (Pub. L. No. 115-97). For example, although it retains employee income exclusions for employer-provided food and beverages through an eating facility on or near the employer’s premises that meet de minimis fringe requirements, it limits the employer deduction to 50% of expenses for 2018 through 2025 and allows no employer deduction beginning in 2026. Also, beginning in 2018, Congress continues to allow most employee exclusions related to qualified transportation fringe benefits for travel between home and work but disallows employer deductions for those expenses. See II.B.

age employers to provide them because such items are not otherwise provided by the government.<sup>32</sup> By excluding these benefits from gross income, or deferring taxation of such benefits until paid, the government incurs part of the benefit's cost. For example, the United States has no system that provides universal medical care to its citizens.<sup>33</sup> To help provide adequate medical care, the I.R.C. exempts from tax both the cost of medical care insurance provided by employers to their employees and benefits paid thereunder.<sup>34</sup> Similar policy reasons support the exemption from federal tax of premiums paid by employers for life and disability insurance and other statutory benefits.

However, broad social welfare concerns have played a less significant role in regard to incidental fringe benefits. Many of

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<sup>32</sup> See Report of the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, *Summary, Analysis and Justification of H.R. 3525* (Oct. 3, 1986) at pp. 4–6.

<sup>33</sup> No law requires employers to provide health plan coverage to employees. However, numerous rules and penalties apply to employers and group health plans that do not offer coverage at a certain level (i.e., “minimum essential coverage”) or offer coverage that is unaffordable or does not provide minimum value. See The Patient Protection and Affordable Care Act, Pub. L. No. 111-148.

<sup>34</sup> §105(b), §106.

these benefits historically have been excluded from employee income for various administrative reasons, including the difficulty of placing a value on such benefits, recognition of the fact that taxation of particular benefits would impose excessive recordkeeping burdens on employers, recognition that the value of certain benefits was so small as to make the revenue gain from taxing them minimal and realization of the inappropriateness of taxing benefits provided or utilized either to enable or facilitate the employee's performance of services. Thus, the overall policy focus of excluding incidental benefits appears, in part, to be grounded in minimizing governmental intrusion into employment relationships, at least when that goal can be accomplished without undue risk of encouraging discriminatory compensation practices or eroding the tax base through excessive provision of compensation in the form of nontaxable benefits.<sup>35</sup>

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<sup>35</sup> See Supplemental Report on H.R. 4170, H.R. Rep. No. 432, Part 2, 98th Cong., 2d Sess. (1984) (the “Supplemental House Report”) at pp. 1591–92; General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, Staff of the Joint Committee on Taxation, JCS 41-84 (1984) (the “1984 Act Bluebook”) at pp. 840–43. See also *The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity*, May 1985, Summary at p. 23.

## II. Statutory Rules for Incidental Benefits

### A. Background

Until the passage of the Tax Reform Act of 1984 (1984 Act),<sup>36</sup> there was no statutory framework for determining the taxability of the numerous incidental items or benefits provided by employers under varying circumstances to their employees. Such benefits, referred to as “incidental” fringe benefits and also commonly referred to as perquisites or “perks,” include meal allowances, theatre or sports tickets, discounts, use of employer transportation, facilities and services, and numerous other items.

As discussed previously, the federal income tax *can* reach all cash and noncash compensation items.<sup>37</sup> Nonetheless, application of these principles to incidental fringe benefits had not been consistent. Many such benefits came to be perceived as nontaxable because they were not individually consequential. In addition, early decisions and long-standing administrative practices produced an expectation of exclusion for certain significant incidental fringe benefits while others had been subject to inclusion.

#### 1. Attempts to Establish Uniform Rules

The Department of the Treasury (Treasury) initially attempted to establish uniform rules for the income tax treatment of incidental fringe benefits without legislation, through two successive sets of proposed regulations. However, each set, as well as an attempted legislative solution, failed, in part due to various administrative problems and because they were perceived to raise questions of consistency with current law.<sup>38</sup>

##### a. First Discussion Draft Regulations

Treasury first attempted to establish general rules for the treatment of incidental fringe benefits in 1975 by publication of proposed regulations in an unusual “discussion draft” format.<sup>39</sup> The proposed rules (First Discussion Draft) sanctioned tax free treatment of certain common incidental fringe benefits, but proposed to tax others, and drew arbitrary distinctions between comparable government and private industry benefits. The First Discussion Draft provoked extensive public controversy and comment,<sup>40</sup> and even the IRS disagreed with the proposed regulations.<sup>41</sup> As a result, the First Discussion Draft proposed regulations were withdrawn by Treasury in a little over a year.<sup>42</sup>

<sup>36</sup>Division A of the Deficit Reduction Act of 1984, Pub. L. No. 98-369, §531.

<sup>37</sup>See discussion at I.B.2.

<sup>38</sup>See Elwood, *Fringe Benefit Regulations*, 81 Tax Mgmt. Memo. 11 (June 1, 1981) for a detailed comparison of the three proposals.

<sup>39</sup>Prop. Reg. §1.61-16, 40 Fed. Reg. 41,118 (Sept. 5, 1972).

<sup>40</sup>See, e.g., Note, *Federal Income Taxation of Employee Fringe Benefits*, 89 Harv. L. Rev. 1141 (April 1976); Elwood, *The Treasury Proposal for Regulation of Incidental Fringe Benefits*, 3 Exec. Comp. J. 4 (March 1976).

<sup>41</sup>See Statement of Jerome Kurtz, Commissioner of Internal Revenue, Hearings Before a Task Force on Employee Fringe Benefits, Committee on Ways and Means, 95th Cong., 2d Sess., Serial 95-109 at p. 12 (Aug. 14, 1978).

<sup>42</sup>Treas. News Release, 41 Fed. Reg. 56,334 (Dec. 17, 1976).

### b. Initial Legislative Response

Although Treasury withdrew the First Discussion Draft proposed regulations, the resulting controversy aroused Congress to impose a statutory moratorium on the issuance of new fringe benefit regulations before January 1, 1980, to give itself the opportunity to establish the general rules for taxation of fringe benefits.<sup>43</sup>

Congress then began a serious effort to address the problem. A special task force was established and held hearings in August and September of 1978.<sup>44</sup> To further the process, the IRS submitted a summary of existing law with respect to fringe benefit taxation,<sup>45</sup> and Treasury submitted a statement of policy implications.<sup>46</sup> The Staff of the Joint Committee also prepared a Summary of Current Law for the Task Force’s use.<sup>47</sup> Following the hearings, the Staff of the Task Force prepared a report and discussion draft bill,<sup>48</sup> although the initiative did not result in legislation before the expiration of the 95th Congress.

Congress, however, remained firm in the view that any change in the taxation of incidental fringe benefits should be legislative. Thus, it extended the moratorium on new fringe benefit regulations twice more.<sup>49</sup>

### c. Second Discussion Draft Regulations and Administrative Activities

Constrained by the congressional moratorium, Treasury made one further attempt to regain the initiative. In early 1981, it released a second set of proposed regulations.<sup>50</sup> However, the proposed regulations (Second Discussion Draft) were not embraced by the following administration and were ultimately overtaken by legislative events. During this period, the IRS generally adhered to the congressional moratorium, although in at least one case taxpayers alleged, unsuccessfully, that the assertion of deficiencies violated the congressional restrictions; however the Tax Court held that it lacked jurisdiction to enforce the moratorium.<sup>51</sup>

<sup>43</sup>Pub. L. No. 95-427.

<sup>44</sup>See Tax Treatment of Employee Fringe Benefits: Written Comments and Hearings Before a Task Force of the House Committee on Ways and Means, 95th Cong., 2d Sess., Ways and Means Committee Print, Serial 95-109 (Aug. 14, Sept. 22 and 23, 1978).

<sup>45</sup>Tax Treatment of Employee Fringe Benefits: Written Comments and Hearings Before a Task Force of the House Committee on Ways and Means, at pp. 9-18.

<sup>46</sup>Tax Treatment of Employee Fringe Benefits: Written Comments and Hearings Before a Task Force of the House Committee on Ways and Means, at pp. 19-29. See also Statement of Donald C. Lubick, Assistant Secretary of the Treasury for Tax Policy (Aug. 14, 1978).

<sup>47</sup>See Staff of the Joint Committee on Taxation, Taxation of Fringe Benefits, Statement of Current Law, Prepared for the Use of the Task Force on Employee Fringe Benefits, 95th Cong., 2d Sess., Ways and Means Committee Print, Serial 33-78 (Aug. 11, 1978) (Joint Committee Summary).

<sup>48</sup>Staff of Task Force on Employee Fringe Benefits, Discussion Draft Bill and Report on Employee Fringe Benefits, House Committee on Ways and Means, 96th Cong., 1st Sess., Ways and Means Committee Print, Serial 96-8 (Feb. 15, 1979) (Task Force Staff Report).

<sup>49</sup>Pub. L. No. 96-167 and ERTA §801.

<sup>50</sup>Prop. Reg. §1.61-17 through §1.61-20, §1.83-1(a)(33), and §1.117-3(a). The proposed regulations were not published in the Federal Register but were widely reported. See, e.g., *BNA Daily Exec. Rep.* (Jan. 16, 1981) at p. J-14 et seq.

<sup>51</sup>*Knapp v. Commissioner*, 90 T.C. 430 (1988).

## 2. The Tax Reform Act of 1984

Legislative efforts continued during the period of the congressional moratoriums, aided by the success of a new administration in resolving the earlier public policy differences between Treasury and IRS.<sup>52</sup> In particular, H.R. 3525, “Permanent Tax Treatment of Fringe Benefits Act of 1983”<sup>53</sup> was introduced. It provided the basic conceptual framework for, and made significant contributions to, the language of §132 and the related provisions eventually adopted in the 1984 Act.<sup>54</sup>

### 3. Effect of Pre-1984 Act Authorities

Congress recognized that the approach of the 1984 Act was to codify much of what had been historical practice and existing law.<sup>55</sup> Thus, the body of prior case law and rulings retains substantial vitality as a guide to interpreting the current codified statutory structure, particularly with respect to the treatment of specific items not considered during the legislative process or addressed by the Final Regulations, or subsequent legislation, regulations, cases or rulings.

## B. Excluded Incidental Fringe Benefits — §132

### 1. Overview

#### a. General Rule of Inclusion

The approach of the 1984 Act was straightforward. Section 61 was specifically amended to clarify that the general rule of inclusion in gross income<sup>56</sup> applied to incidental fringe benefits in the form of any property, service or facility furnished by an employer to (or for the benefit of) an employee in consideration for the employee’s performance of services.<sup>57</sup> The amount to be included in income is the excess of a benefit’s fair market value over any amount paid by the employee for the benefit.<sup>58</sup> Thus, fair market value continues as the base point for determining the amount to be included in gross income.<sup>59</sup> However, because application of this standard to noncash benefits

<sup>52</sup> See Statement of John E. Chapoton, Assistant Secretary for Tax Policy, and Roscoe L. Egger, Jr., Commissioner of Internal Revenue, Hearings Before the Subcommittee on Select Revenue Measures at p. 4 (May 13, 1981) (Chapoton and Egger Joint Statement) Treasury Department News Release R-2461 (Dec. 20, 1983).

<sup>53</sup> Introduced by Representatives Stark and Conable, 98th Cong., 1st Sess. on July 12, 1983.

<sup>54</sup> 1984 Act, Title V, Subtitle C, §531 and §532.

<sup>55</sup> See Supplemental House Report at pp. 1591–92 and 1610; Report on H.R. 4170, H.R. Rep. No. 98, 98th Cong., 2d Sess. (Oct. 21, 1983) (First House Report) at pp. 286–87 and 305.

<sup>56</sup> See discussion at I.B.2.a.

<sup>57</sup> 1984 Act, §531(c) amending §61(a)(1). That section now provides: “[G]ross income means all income from whatever source derived, including... (1) Compensation for services, including fees, commissions, *fringe benefits*, and similar items.” (Emphasis added.) The term “fringe benefits” had not been previously included in the list.

<sup>58</sup> This formulation is not specifically set out in the 1984 Act or in the I.R.C. It is consistent with long-standing practice and was endorsed as the applicable approach in both the Supplemental House Report at p. 1593 and in the Conference Report to Accompany H.R. 4170, H.R. Rep. No. 98-861, 98th Cong., 2d Sess. (1984) (Conference Report), at p. 1169. The requirement of a netting of amounts paid by the employee is consistent with and derives support from the employment tax regulations. See, e.g., Reg. §31.3121(a)-1(e), Notice 94-3, Q&A-2 at Answer I.

<sup>59</sup> Conf. Rep. at p. 1169; Supplemental House Report at p. 1593.

was one of the most difficult problems in developing generalized rules for the taxation of incidental fringe benefits, Treasury responded to congressional directives during the consideration of the 1984 Act by providing detailed regulations addressing many of the most frequently encountered valuation issues, including personal use of employer vehicles and aircraft.

#### b. Statutory Exclusions

The general rule of inclusion under §61 is limited by §132, which provides the framework for permissible exclusion of certain fringe benefits from gross income. Section 132 as enacted established four broad categories of excludible benefits and a number of special exclusionary rules. Four additional categories of exclusion have been added by subsequent legislation. Accordingly, the eight excluded types of benefits are: (1) non-additional cost services;<sup>60</sup> (2) qualified employee discounts;<sup>61</sup> (3) working condition fringes;<sup>62</sup> (4) de minimis fringes;<sup>63</sup> (5) qualified transportation fringes;<sup>64</sup> (6) qualified moving expense reimbursements (suspended beginning after 2017 except for certain active military duty and, after 2025, certain employees or new appointees of the intelligence community);<sup>65</sup> (7) qualified retirement planning services;<sup>66</sup> and (8) qualified military base realignment and closure payments.<sup>67</sup> Additionally, there are special rule exclusions for eating facilities,<sup>68</sup> athletic facilities<sup>69</sup> and certain use of demonstrator autos.<sup>70</sup> Finally, §132 completes the I.R.C. framework by recognizing the exclusion from income of those fringe benefits subject to other explicit statutory provisions such as educational assistance benefits and dependent care assistance programs discussed below in III.A. and III.B.<sup>71</sup>

As discussed below, TCJA,<sup>72</sup> legislation enacted in 2017, suspended the exclusions from gross income for qualified bicy-

<sup>60</sup> §132(a)(1).

<sup>61</sup> §132(a)(2).

<sup>62</sup> §132(a)(3).

<sup>63</sup> §132(a)(4).

<sup>64</sup> §132(a)(5), added by Pub. L. No. 102-486, the Comprehensive National Energy Policy Act of 1992 (Energy Act) as discussed at I.B.2.e.

<sup>65</sup> §132(a)(6), added by 1993 RRA §13213(d). See §132(g)(2), added by TCJA, Pub. L. No. 115-97, §11048, (exclusion suspended for taxable years beginning after December 31, 2017, and before January 1, 2026), and amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70113(c)–(d) (suspension extended for taxable years beginning after December 31, 2025, with added exception for certain employees or new appointees of the intelligence community). See also Notice 2018-75 (suspension of the exclusion applies only to payments or reimbursements for expenses incurred in connection with a move that occurred after December 31, 2017).

<sup>66</sup> §132(a)(7), added by The Economic Growth and Tax Relief and Reconciliation Act of 2001 (EGTRRA), Pub. L. No. 107-16, §665(a), effective for years beginning after 2001 as discussed in I.B.2.g.

<sup>67</sup> See §132(a)(8), §132(n), added by the Military Family Tax Relief Act of 2003, Pub. L. No. 108-121, effective for payments made after November 11, 2003. Section 132(n) was amended by the Worker, Homeownership, and Business Act of 2009, Pub. L. No. 111-92, §14(a), effective for payments made after February 17, 2009, so that these payments to military personnel under the Defense Department’s Homeowners Assistance Program are excludible. Such payments are not generally thought of as incidental fringe benefits, but rather are payments under 42 U.S.C. §3374 to compensate for the adverse effect on housing values resulting from a military base realignment or closure.

<sup>68</sup> §132(e)(2). See I.B.3.a.(1).

<sup>69</sup> §132(j)(4).

<sup>70</sup> §132(j)(3).

<sup>71</sup> §132(i).

<sup>72</sup> Pub. L. No. 115-97.

cle commuting reimbursements and qualified moving expense reimbursements (with limited exception) for employees. For employers, the TCJA expanded the 50% food and beverage deduction limit, and disallowed deductions for expenses associated with providing qualified transportation fringe to employees, expenses incurred for providing transportation for commuting between the employee's residence and place of employment (except for ensuring employee safety), and certain expenses paid or incurred after 2025 that are associated with meals provided for the employer's convenience through an employer-operated facility.

### c. Regulations and Regulatory Authority

Section 132(o) directed the IRS to prescribe regulations to carry out the purposes of §132.<sup>73</sup> Although the regulatory grant of authority is quite broad, it is limited by the fact that Congress intended §132 to operate in significant part as a codification of the pre-statutory rules.<sup>74</sup> Moreover, the legislative history imposes the notable and unusual constraint that any benefit stated to be exempt in the legislative history must be ported in the §132 regulations.<sup>75</sup> Accordingly, citations in this portfolio include dual references to both the regulations and legislative or case law history where appropriate.

Treasury acted quickly following passage of the 1984 Act to exercise its authority and published initial temporary and proposed regulations in January 1985<sup>76</sup> to assist taxpayers faced with compliance with the 1984 Act's general effective date of January 1, 1985.<sup>77</sup> Following extensive taxpayer comment, those regulations were withdrawn and replaced in large part by temporary and proposed regulations issued at the end of 1985,<sup>78</sup> although certain sections of the initial temporary regulations remain in effect.<sup>79</sup> Final regulations were issued in July 1989 and became effective January 1, 1989.<sup>80</sup>

With respect to most benefits, the statutory rules, the final regulations and the older authorities reach a common result. Thus, the treatment of numerous incidental fringe benefit items is regarded as well-settled. For some specific benefits only limited authority exists with respect to the proper federal tax treatment, and certainty of tax treatment will have to wait for IRS rulings or court decisions. Certain benefits may, in addition, continue to be subject to either special substantiation requirements or limitations on deduction under §274.<sup>81</sup>

<sup>73</sup> §132(o). Section 132(o) was designated as §132(m) prior to its redesignation by Pub. L. No. 108-121, §103(b).

<sup>74</sup> See discussion at II.A.3.

<sup>75</sup> Supplemental House Report at p. 1609; First House Report at p. 303; 1984 Act Bluebook at pp. 864-65.

<sup>76</sup> T.D. 8004, 50 Fed. Reg. 836 (Jan. 7, 1985).

<sup>77</sup> 1984 Act, §531(h).

<sup>78</sup> T.D. 8063, 50 Fed. Reg. 52,281 (Dec. 23, 1985) (temporary regulations).

<sup>79</sup> Principally those sections dealing with employment taxes, which are discussed at V.A.1.

<sup>80</sup> T.D. 8256, 54 Fed. Reg. 28,576 (July 6, 1989).

<sup>81</sup> See, e.g., Reg. §1.132-5(c); Supplemental House Report at p. 1605. This is fully consistent with prior law. See, e.g., *Walliser v. Commissioner*, 72 T.C. 433 (1979) (expressly holding certain employee expenses deductible under the standards of §162 but nondeductible under §274). See generally 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses*.

## 2. General Rules for Excludible Fringe Benefits

### a. Working Condition Fringes

The most important of the eight specific exceptions to the rule of inclusion is the exclusion for items furnished by an employer to an employee as a "working condition fringe."<sup>82</sup> Under §132(a)(3), the entire value of a qualifying working condition fringe benefit is entitled to exclusion from the employee's income.

#### (1) Working Conditions Covered

The working condition exclusion recognizes that there are numerous elements to an employee's work environment directly related to the employee's ability to perform the job required. A working condition fringe is defined to mean "any property or services provided to an employee to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction under §162 or 167."<sup>83</sup> Thus, the definition effectively sets the scope of included benefits in terms of the established body of law with respect to deductibility of employee business expenses. Typically, under §162, items such as a car used for business, an office, a secretary, support staff and office supplies are deductible. Therefore, to the extent that such items have been provided by the employer instead of by the employee but still serve the purpose of getting the employee's job done, they will fall within the exclusion.

*Note:* Miscellaneous itemized deductions are disallowed for taxable years beginning after December 31, 2017.<sup>84</sup> The disallowance of this deduction, which under the TCJA would have applied only through taxable years beginning before 2026, was not accompanied by an amendment to the definition of "working condition fringe." Due to the interplay of the trade or business expense deduction under §162 with these provisions, the question arises whether the loss of the deduction might be interpreted to also suspend the exclusion for working condition fringe benefits. IRS Publication 15-B, as revised after the enactment of the TCJA, does not limit the availability of the working condition exclusion based on this suspension.

The exclusion does not depend on demonstrating that the employee does not also incidentally enjoy or benefit from the working condition, because in most cases the employee has no choice as to whether to accept its availability. Thus, for example, an employee who enjoys horseback riding would not realize income from the necessary working out of horses owned by his or her employer<sup>85</sup> or from spending an extra Saturday night at the location of a desirable out-of-town assignment to allow

<sup>82</sup> This exception appears to have been derived from the "convenience of the employer" exclusion developed under prior case law. See *Commissioner v. Kowalski*, 434 U.S. 77 (1977) (Supreme Court extensively reviewed the development of the "convenience of the employer" rule).

<sup>83</sup> §132(d).

<sup>84</sup> §67(h), added by TCJA, Pub. L. No. 115-97, §11045 (added as §67(g) to suspend miscellaneous itemized deductions through 2025), effective for taxable years beginning after December 31, 2017, as redesignated and amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70110(a) and §70110(b)(2) (permanently disallowing miscellaneous itemized deductions), effective for taxable years beginning after December 31, 2025.

<sup>85</sup> *Dean v. Commissioner*, 9 T.C.M. 246 (1947), *aff'd*, 187 F.2d 1019 (3d Cir. 1951). See also *Lang Chevrolet Co. v. Commissioner*, T.C. Memo 1967-212.

the employer to obtain a reduced airfare,<sup>86</sup> or even a sufficiently business-related fishing trip.<sup>87</sup>

### (2) Requirements for Exclusion

For property or services provided to an employee by an employer to qualify as a working condition fringe benefit, the cost of the property or the service must be a cost that would have been deductible under §162 or §167 if incurred by the employee. Thus, the expense must be one that would be an ordinary and necessary expense if the employee purchased the property or services directly (or one which would have been depreciable or amortizable under §167 to the extent the expense was a capital expenditure). However, this standard ignores particular employee personal circumstances that might cause that expense to be partly or wholly nondeductible, i.e. it does not preclude exclusion for nonitemizers, nor does it take into account the extent that such deductions could be limited by the 2% of adjusted gross income threshold for miscellaneous itemized deductions for taxable years beginning before 2018 or the partial disallowance of deductions under §68.<sup>88</sup> Likewise, the limitations under §280F are ignored. Thus, an employee's actual ability to take a deduction is not determinative, rather it is the character of the expense as an expense that *could* qualify for deduction under §162 or §167 that is determinative.

*Note:* Although miscellaneous itemized deductions are disallowed for taxable years beginning after 2017, the definition of “working condition fringe” was not changed by the TCJA. The interplay with the deduction under §162 creates the question of whether the temporary loss of the deduction could be interpreted to also suspend the exclusion for working condition fringe benefits. IRS Publication 15-B, as revised after the enactment of the TCJA, does not limit the availability of the working condition exclusion based on this suspension.

*Note:* In determining whether an educational benefit qualifies as a working condition fringe under Reg. §1.132-5(a)(2), it is not sufficient that the tuition, if paid by the employee, would be deductible under §162 as a trade or business expense. Excludibility under §132 generally is based on all the facts and circumstances. Given the inherently factual nature of such determinations, the IRS generally will not rule on the excludibility of a given fringe benefit as a working condition fringe.<sup>89</sup>

The deductibility test also is subject to the limitation that it must be applied on an employer-by-employer basis. The regulations provide the example of an executive employed by one company who is also a director of a second (and presumably nonaffiliated) company and note that payment by the first com-

pany of the executive's travel to a board meeting of the second company would not qualify for exclusion by the employee.<sup>90</sup> If, however, there is a business relationship between the first and second companies, such that the executive is attending in his/her capacity as an employee of the first company, the executive would be able to exclude the cost of the travel as a working condition fringe. The regulations cite as examples circumstances in which the second company regularly purchases a significant amount of goods and services from the first company; or when the second company is a charitable organization and the executive's service as a director is substantially related to the first company's business.<sup>91</sup>

Finally, use of the §162 deductibility standard denies a deduction under the working condition classification for certain benefits that cannot meet the employee deductibility standard, but before the 1984 Act generally had been regarded to be excludible under the predecessor convenience of the employer rule — e.g., employer meal allowances or taxi money given in connection with overtime work. This benefit would not appear to qualify under the §162 deductibility standard because an employee's meal expenses (even for overtime meals) are not ordinarily deductible absent travel away from home.<sup>92</sup> However, exclusion for most long-standing fringe benefits is specifically provided for under the alternative general exclusion for de minimis fringe benefits.<sup>93</sup>

### (3) Permissible Recipients and Discrimination

The character of the working condition exclusion logically limits its scope to current employees (including for this purpose, directors, independent contractors and partners who perform services for a partnership).<sup>94</sup> The exclusion generally is unavailable for benefits provided to nonemployee family members or former employees; however, volunteers who do not have a profit motive for purposes of §162 also are entitled to exclude working condition fringes from income.<sup>95</sup> For similar reasons, working condition fringe benefits generally are not subject to the nondiscrimination requirements or line-of-business requirements.<sup>96</sup>

### (4) Special Rules and Specific Benefits

*Note:* Miscellaneous itemized deductions are prohibited for taxable years beginning after December 31, 2017.<sup>97</sup> Neither TCJA, which temporarily suspended these deductions, nor OBBBA, which made the suspension permanent, amended the definition of “working condition fringe.” Due to the interplay of the deduction under §162 with these provisions, the question arises whether the temporary loss of the deduction might be in-

<sup>86</sup> PLR 9237014.

<sup>87</sup> *Townsend Indus. v. Commissioner*, 342 F.3d 890 (8th Cir. 2003).

<sup>88</sup> See §62, §67, §68; Reg. §1.132-5(a)(1)(vi). For taxable years beginning after 2017 and before 2026, §68 does not apply to limit itemized deductions. Pre-OBBBA §68(f), added by TCJA, Pub. L. No. 115-97, §11046, and amended by OBBBA, Pub. L. No. 119-21, §70111(a). For taxable years beginning after 2025, §68(a), as amended by the OBBBA, Pub. L. No. 119-21, §70111(a), reduces itemized deductions for all taxpayers by 2/37 of the lesser of (i) the aggregate amount of itemized deductions or (ii) taxable income exceeding the §1(j) threshold for the 37% tax bracket. This calculation replaces the pre-2018 so-called Pease formula under which the total amount of itemized deductions, with specified exceptions, was limited for certain higher-income taxpayers.

<sup>89</sup> See, e.g., PLR 200337004 (plan qualifies as §127 plan but IRS declines to rule on excludibility of payments exceeding §127 dollar limit by employees under §132(d)).

<sup>90</sup> Reg. §1.132-5(a)(2)(ii) *Ex.* (1).

<sup>91</sup> Reg. §1.132-5(a)(2)(ii) *Exs.* (2), (3).

<sup>92</sup> 1984 Act Bluebook at p. 856.

<sup>93</sup> See discussion at II.B.2.d.(4)(b).

<sup>94</sup> IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits* (“Employer's Guide”).

<sup>95</sup> See discussion of permissible recipients at II.B.4.a.

<sup>96</sup> See discussion of nondiscrimination rules at II.B.5.

<sup>97</sup> §67(h), added by TCJA, Pub. L. No. 115-97, §11045 (added as §67(g) to suspend miscellaneous itemized deductions through 2025), effective for taxable years beginning after December 31, 2017, and redesignated and amended by OBBBA, Pub. L. No. 119-21, §70110(a) and §70110(b)(2) (permanent disallowance), effective for taxable years beginning after December 31, 2025.

interpreted to also suspend the exclusion for working condition fringe benefits. IRS Publication 15-B, as revised after the enactment of TCJA, does not limit the availability of the working condition exclusion based on this suspension.

(a) *Employer-Provided Transportation*

The pervasiveness of employer-provided transportation makes the tax treatment of such benefits one of the single most significant incidental fringe benefit issues. In particular, the proper tax treatment of the ubiquitous company car has been of long-standing concern to the IRS, and the issue, as discussed below, was often litigated in the period before the 1984 Act and subsequent regulations.<sup>98</sup>

Both the 1984 Act legislative history and the subsequent regulations confirm that transportation provided to an employee may be a working condition just as much as an office or employer equipment used in performing the employee's job. Accordingly, when it so qualifies, the benefit of employer-provided transportation is excluded from employee income.<sup>99</sup>

(i) *Company Car*

An employee does not realize income from the use of an employer's vehicle in the discharge of employment duties regardless of the fact that the car may be a luxury make.<sup>100</sup>

Moreover, mere incidental personal use of a company car provided by the employer primarily for business use does not render the value of the incidental use includible in the employee's income, although the exclusion is provided by the general exception for de minimis fringe benefits rather than under the working condition exclusion.<sup>101</sup> An example of incidental use is an employee's stopping for lunch at a restaurant or detouring for a brief personal errand during a day of driving between customers.<sup>102</sup> However, incidental use does not include commuting between the employee's residence and business location more than once a month.<sup>103</sup> The IRS has long regarded commuting to be personal use, and, under the general inclusion rule, such use of an employer's vehicle constitutes a taxable fringe benefit.<sup>104</sup> Employees may, however, be able to value the commuting benefit according to a special valuation rule, discussed below.

An employee also may exclude the value of a "qualified non-personal use vehicle" from gross income as a working condition fringe. A qualified non-personal use vehicle means any vehicle that, by reason of its nature, is not likely to be used more than a minimal amount for personal purposes. A list of

such vehicles, some of which are subject to certain usage or other conditions, is included in Reg. §1.274-5(k)(2)(ii).<sup>105</sup>

Generally, a working condition fringe under this rule is available to the driver and all passengers of a qualified non-personal use vehicle. However, in the case of a school bus or a passenger bus used as such with at least a 20-passenger capacity, the exclusion is available only with respect to the driver and not the passengers.<sup>106</sup>

The prior law rule in which numerous cases found that the more-than-incidental personal use of company vehicles resulted in income to the employee, was confirmed by the 1984 Act's legislative history and carried forward in the regulations.<sup>107</sup>

*Comment:* Earlier litigated cases often involved vehicle use by the owner and/or principal shareholder of a closely held corporation. Frequently, the employee was charged with a constructive dividend rather than additional compensation income.<sup>108</sup> The IRS often uses this approach in such cases because it also denies the close corporation the benefit of a compensation deduction. Taxpayers and their advisors need to be mindful that this is still an alternative possibility notwithstanding the 1984 Act changes.<sup>109</sup>

An allocation between personal and business use is required whenever there is more than de minimis employee personal use of an employer-provided vehicle. The rules, which are detailed in the regulations, apply on a vehicle-by-vehicle basis, and require an allocation of the value of vehicle use on the basis of the ratio of business use and personal use miles.<sup>110</sup>

Under the IRS formula, use by persons such as a spouse whose use is chargeable to the employee is included as employee personal use.<sup>111</sup> The company car rules also apply to employer trucks and other means of transportation besides automobiles, as "vehicle" for this purpose is any vehicle within a very broad regulatory definition.<sup>112</sup> An example illustrates this mileage-based allocation requirement:

<sup>105</sup> §274(i). See Reg. §1.132-5(h)(1), §1.274-5(k), as amended by T.D. 10043, 91 Fed. Reg. 13,500 (Mar. 20, 2026). Examples include a fire engine, a clearly marked police vehicle, a flatbed truck, a school bus, or an ambulance. An unmarked police car also may qualify under limited circumstances. See IRS Info. Letter 2004-0046. For taxable years ending on or after March 20, 2026, unmarked vehicles used by firefighters, members of rescue squads, or ambulance crews employed on a full-time basis by a governmental agency or entity, including those at the local and county levels, also are considered qualified nonpersonal use vehicles. In general, a working condition fringe under this rule is available to the driver and all passengers of a qualified non-personal use vehicle, but is available only with respect to the driver (and not with respect to any passengers) of passenger buses used as such with a capacity of at least 20 passengers or school buses. Reg. §1.132-5(h)(2).

<sup>106</sup> Reg. §1.132-5(h)(2).

<sup>107</sup> Supplemental House Report at p. 1601; 1984 Act Bluebook at p. 856; Reg. §1.132-5(b)(1)(i).

<sup>108</sup> *Whipple Chrysler-Plymouth v. Commissioner*, T.C. Memo 1972-55; *Riss & Co., Inc. v. Commissioner*, T.C. Memo 1964-190 (1964), *aff'd*, 374 F.2d 161 (8th Cir. 1967); *Dole v. Commissioner*, 43 T.C. 697 (1965) (reviewed opinion), *aff'd per curiam*, 351 F.2d 308 (1st Cir. 1965).

<sup>109</sup> See, e.g., *Yarbrough Oldsmobile Cadillac, Inc. v. Commissioner*, T.C. Memo 1995-538.

<sup>110</sup> Reg. §1.132-5(b).

<sup>111</sup> Reg. §1.132-5(b)(1)(ii).

<sup>112</sup> Reg. §1.132-5(b)(1)(i) cross-referencing Reg. §1.61-21(e)(2). See, e.g., Rev. Rul. 86-97 (rules for determining whether a truck may be treated as a "qualified non-personal use" vehicle).

<sup>98</sup> Eleven of the 19 examples in the First Discussion Draft focused on various aspects of employer-provided transportation. First Discussion Draft, §1.61-16 Exs. (1), (2), (5) through (9), (11), (12), (14), and (15).

<sup>99</sup> Reg. §1.132-5(b)(1); First House Report at p. 296; Supplemental House Report at p. 1601; 1984 Act Bluebook at p. 855.

<sup>100</sup> Reg. §1.132-5(b)(1)(iii). This rule is consistent with pre-§132 law. See *Rodgers Dairy Co. v. Commissioner*, 14 T.C. 66 (1950), *acq.*, 1950-2 C.B. 4; Joint Committee Summary at p. 6.

<sup>101</sup> See discussion of the de minimis exception at II.B.2.d. This rule also is consistent with pre-§132 law. See, e.g., *Num Specialty, Inc. v. United States*, 257 F. Supp. 1 (W.D. Pa. 1966) at p. 4; *Mann v. Commissioner*, T.C. Memo 1981-684.

<sup>102</sup> Reg. §1.132-5(d); Supplemental House Report at p. 1601; see also First Discussion Draft, §1.61-16(f) Exs. (11) and (12); Second Discussion Draft, §1.61-18(c) Ex. (3); §1.61-19(d) Ex. (10); Task Force Staff Report at p. 10.

<sup>103</sup> Reg. §1.132-6(e)(2).

<sup>104</sup> See discussion at IV.A.7.

*Example:* Assume that the annual value of an employer-provided vehicle is \$4,000 before any application of the working condition exclusion. Employees X and Y are assigned the vehicle for use in the employer's business and may use it to drive home or for other personal purposes when their personal vehicle is unavailable. X drove the vehicle 5,000 miles, Y drove it 4,500 miles, and Y's spouse drove it 500 miles, for a total of 10,000 miles during the year. Of that total, 7,000 miles were driven for employer business purposes, 1,000 miles were driven by X for personal purposes, 1,500 miles were driven by Y for personal purposes and 500 miles were driven by Y's spouse. The amount of the working condition fringe exclusion to X is \$1,600 ( $\$2,000 \times 4,000/5,000$ ) and the amount includible in X's income is \$400. Similarly, the amount of the exclusion to Y is \$1,200 ( $\$2,000 \times 3,000/5,000$ ) because Y's spouse's use is attributable to Y. The amount includible in Y's income is \$800.

Implementing congressional direction, the availability of the §132(a)(3) working condition exclusion has been expressly predicated on satisfaction of the detailed recordkeeping requirements of §274.<sup>113</sup> Thus, the employer and/or the employee will in many cases be subject to the substantive rules of that section to support the allocation of the value of the benefit of a company car between exempt working condition business use and taxable personal use.

Many employers have attempted to deal with the issues arising from employee use of employer-provided vehicles through the common practice of employee payments to the employer of an amount to compensate the employer for the employee's use of a company vehicle on weekends or for other personal purposes. This practice is allowed under the regulations.<sup>114</sup> If the employer uses one of the special valuation rules of Reg. §1.61-21, the employee must include in income only the amount determined by the employer less any amount reimbursed by the employee to the employer. Further, the employer and employee may use the special valuation rules to determine the amount of the reimbursement due the employer by the employee. Thus, if an employee reimburses an employer for the value of a benefit as determined under a special valuation rule, no amount is includible in the employee's gross income.<sup>115</sup>

While commuting costs usually are nondeductible personal costs, Congress authorized a limited safe harbor for the benefit of an employee who is required by an employer to use a company car for commuting purposes.<sup>116</sup> Under these circumstances, the employee is permitted to exclude the availability of the vehicle (other than for commuting) as a working condition fringe, provided the employee is entitled to value (and, in fact, does value and include in income) the commuting benefit in the amount of \$1.50 per one-way commute.<sup>117</sup>

The use of this special valuation rule entails satisfying all of the following tests:

- the vehicle must be owned or leased by the employer and must be used in its trade or business other than just for commuting and must be so provided to one or more employees;
- the employer must require the employee to commute to and/or from work in the vehicle for bona fide noncompensatory business reasons;
- the employer must have established a written policy precluding the use by the employee, or any individual whose use would be taxable to the employee, of the vehicle for personal purposes (other than commuting or de minimis personal purposes, such as a stop for a personal errand on the way between a business delivery and the employee's residence);
- the employee must not in fact use the vehicle for personal purposes (either than commuting or de minimis personal purposes); and
- the employee who is required to use the vehicle must not be a "control employee."<sup>118</sup>

The term "control employee" means, for a non-governmental employer, a 1% or more owner of an equity, capital or profits interest in the employer (applying the attribution rules of §318 and the controlled group aggregation rules of §414(b), §414(c), and §414(m)), a director of the employer, an officer of the employer whose compensation equals or exceeds \$50,000, or an employee whose compensation equals or exceeds \$100,000.<sup>119</sup> The term "control employee" in the context of a government employer is defined as an employee who is either an elected official or an employee whose compensation equals or exceeds the compensation paid to a federal government employee holding a position at Executive Level V.<sup>120</sup>

While use of the special commuting valuation rule is optional as a means of valuing commuting,<sup>121</sup> for purposes of determining the ability of the employee to exclude (as a working condition fringe) the value of the availability of a vehicle that qualifies for the special valuation rule, the special commuting valuation rule must be used and the amount so ascertained under the special rule either included in the employee's income or reimbursed by the employee to the employer.<sup>122</sup>

In addition to the special valuation rule for commuting, complex special valuation rules are provided by the regulations under §61 with respect to joint business and personal use circumstances.<sup>123</sup> These rules are discussed in II.C.3. To provide consistency with treatment under these special rules, a specific rule conforms the amount of the §132 working condition exclu-

<sup>118</sup> Reg. §1.61-21(f)(1)(i)–§1.61-21(f)(1)(v).

<sup>119</sup> Reg. §1.61-21(f)(5). The \$50,000 and \$100,000 amounts are subject to cost-of-living adjustments by the IRS. For current and prior year dollar amounts, see Tables, Charts & Lists, *Pension and Retirement Plans — IRC Cost of Living Adjustments*.

<sup>120</sup> Reg. §1.61-21(f)(6).

<sup>121</sup> Reg. §1.61-21(c)(2)(ii).

<sup>122</sup> Reg. §1.132-5(f) (last sentence).

<sup>123</sup> Reg. §1.61-21(c)–§1.61-21(f).

<sup>113</sup> Reg. §1.132-5(c); Conf. Rep. at p. 855.

<sup>114</sup> Reg. §1.61-21(c)(2)(ii). For a discussion of the special valuation rules, see II.C.3.

<sup>115</sup> Reg. §1.61-21(c)(2)(ii).

<sup>116</sup> Pub. L. No. 99-44, Conf. Rep. No. 67, 99th Cong., 1st Sess. 10 (1985). See Reg. §1.132-5(f), §1.274-6T(a)(3).

<sup>117</sup> Reg. §1.61-21(f)(3).

sion to the amounts includible and excludible from income under the special valuation rules.<sup>124</sup>

Alternatively, employees also may exclude from income a specified amount per month for commuting in employer-provided commuter highway vehicles as a qualified transportation fringe under §132(f)(1)(A).<sup>125</sup>

(ii) *Company Aircraft*

An employee does not realize income from the use of an employer's aircraft in the discharge of employment duties as this is a working condition.<sup>126</sup> But it appears that *any* personal use of an employer's airplane ordinarily will be taxable to the employee,<sup>127</sup> and, unlike the exception for incidental use of an employer automobile, a body of law holding that "incidental" use of a corporate airplane is not taxable to the employee has not developed.<sup>128</sup> This is presumably because the operation of an airplane involves such substantial expense that it is effectively precluded from ever being de minimis. The IRS has not developed explicit allocation rules that apply to personal use of employer aircraft as they did for personal use of an employer vehicle. Instead, the regulations merely cross-reference the special flight valuation rules of the §61 regulations.<sup>129</sup> The unstated inference appears to be that any amount not treated as includible in income under those rules is the amount properly excluded under §132 as a working condition fringe. The special flight valuation rules are discussed at II.C.3.b.

(b) *Office Decor and Administrative Support*

Having a corner office or one that is attractive or well-appointed is a working condition fringe benefit that does not cause an employee to realize income.<sup>130</sup> Numerous other elements of an administrative nature associated with the office or workplace environment fall within this exception.<sup>131</sup> Most such items are inconsequential and many, although not addressed by rulings or cases, may be excludible under the de minimis exclusion as well. On the other hand, the IRS has ruled, for example, that a "tool allowance" paid pursuant to a union contract in circumstances where the company furnished company tools and equipment to all employees who wanted them, was simply a taxable part of the company's wage structure.<sup>132</sup>

<sup>124</sup> Reg. §1.132-5(d).

<sup>125</sup> See discussion at II.B.2.e.(5)(a).

<sup>126</sup> Supplemental House Report at p. 1601; 1984 Act Bluebook at p. 855. This is conceptually correct because the Tax Court has upheld the deduction of such expenses under §162, which is the precondition for exclusion. See *Noyce v. Commissioner*, 97 T.C. 670 (1991).

<sup>127</sup> This is consistent with pre-§132 law. See *Ireland v. United States*, 621 F.2d 731 (5th Cir. 1980); *Vesco v. Commissioner*, 39 T.C.M. 101 (1979); *Cowling v. Commissioner*, T.C. Memo 1969-135.

<sup>128</sup> It is notable, however, that in the period before the fringe benefit rule codification of the 1984 Act, the Joint Committee suggested an "incidental use" exclusion in connection with its examination of the tax returns of former President Nixon and recommendation of tax treatment appropriate to alleged personal use of government aircraft by Nixon, members of his family and friends. Staff of the Joint Committee on Internal Revenue Taxation, Examination of President Nixon's Tax Returns for 1969 Through 1972, S. Rep. No. 93-768, 93d Cong., 2d Sess. (Apr. 3, 1974) (Nixon Tax Return Report) at p. 163.

<sup>129</sup> Reg. §1.132-5(k), cross-referencing Reg. §1.61-21(g).

<sup>130</sup> Second Discussion Draft, §1.61-18(d) Ex. (2); Task Force Staff Report at p. 10; Treasury Summary and Explanation, First Discussion Draft at p. 8; Chapoton and Egger Joint Statement at p. 7.

<sup>131</sup> See discussion at II.B.2.a.(4)(i).

(c) *Employer-Provided Electronics*

(i) *Home Computers*

Employers commonly provide computers, peripheral equipment and software to employees for use while traveling or at home. If the standards for deductibility under §162 are met, home computers or laptops may qualify as working condition fringes, and the value of the employee's use may be excluded from income.

Computers or peripheral equipment placed in service after 2017 are not "listed property" under §280F.<sup>133</sup> Computers placed in service before 2018 are included as "listed property" under §280F<sup>134</sup> because they were both less common and significantly more expensive when the listed property rules were first enacted. Therefore, like employer-provided automobiles, computers and peripheral equipment are subject to special rules. Because a home computer or laptop is potentially available for personal use by the employee and the employee's family, the

<sup>132</sup> Rev. Rul. 65-187. See also CCA 200745018, in which the IRS Chief Counsel's Office advised that an employer's tool reimbursement plan was not an accountable plan under Reg. §1.62-2, and the amounts were not really reimbursements but a recharacterization of the hourly wage. Thus, amounts paid under the tool plan were includible in gross income and were subject to income tax withholding and employment taxes. Before the years at issue, the employer (T) compensated its technicians solely on an hourly wage basis with no specific amount attributable to the provision of tools. T implemented a tool plan as a tax-saving measure whereby T would recharacterize a portion of the technicians' compensation as a tool expense reimbursement without increasing the technicians' overall compensation and did not provide any evidence that it verified whether the tools were actually required or used in the technicians' employment with T. The plan calculated a total tool expense for each technician, which the technicians could increase when purchasing new tools if they provided receipts. The plan then recharacterized a portion of each technician's hourly wage as a tool expense reimbursement until the total tool expense had been paid as a tool expense reimbursement. The technicians' pay then returned to the normal hourly wage, but at no point did the recharacterization affect the technicians' total pay. Furthermore in IRS Coordinated Issue Paper "Motor Vehicle Industry Employee Tool & Equipment Plans, Previously — Service Technicians' Tool Reimbursement Plans" (LMSB-04-0608-037) (UIL 62.16-00, July 2, 2008), (de-coordinated effective Jan. 21, 2014 by IRS Directive LB&I-04-0114-002 (Jan. 21, 2014)), the IRS concluded that, generally, tool plans do not satisfy the three requirements of an accountable plan under Reg. §1.62-2(c)(1) and possibly evidence a pattern of abuse. As a result, the IRS advised, payments made to employees under such plans will be treated as paid under a nonaccountable plan and must be included in the employee's gross income, reported as wages or other compensation on the employee's Form W-2, and are subject to withholding and payment of employment taxes. Nonetheless, in PLR 200930029, the IRS ruled that an expense reimbursement arrangement which paid a tool allowance to hourly wage service technicians hired to provide repair and maintenance services to customers through a professional consulting business satisfied the business connection, substantiation, and return of excess requirements of an accountable plan under Reg. §1.62-2(d), §1.62-2(e), and §1.62-2(f). The technicians were required to provide and maintain their own tools and equipment; no reimbursement was available for items purchased before the plan start date; and tools had to be kept on-site and used exclusively to perform work for the employer. Cash advances were not permitted. Plan reimbursements were not related to compensation, were made only for covered costs that the technician substantiated to the employer, and were limited based on the total amount allocated for reimbursements and available in the general fund. Thus, plan payments made to covered technicians for expenses for trade equipment, training and certification required as a condition of employment were excludible from their income.

<sup>133</sup> §280F(d)(4)(A), as amended by TCJA, Pub. L. No. 115-97, §13202(b), effective for property placed in service after December 31, 2017, in taxable years ending after such date.

<sup>134</sup> Former §280F(d)(4)(A)(iv), removed by Pub. L. No. 115-97, §13202(b).

employer must determine the value of any personal use and include such value in the employee's income. The allocation between business and personal use is determined by dividing the number of hours the computer is used for business purposes during the year by the total number of hours that the computer is used during the year.<sup>135</sup> The value of personal use is includible in employee income and subject to withholding, unless it is excludible as a de minimis fringe benefit.<sup>136</sup>

Use of a computer placed in service before 2018 also is specifically subject to the substantiation rules of §274,<sup>137</sup> and business use of a computer may not be excluded as a working condition fringe unless the employee substantiates business use of the computer by adequate records.<sup>138</sup>

If an employer-provided home computer or laptop, placed in service before 2018, is not used more than 50% for business purposes, the employer is limited to depreciation under the straight-line method<sup>139</sup> and loses the option to expense the cost of the computer under §179.<sup>140</sup> If a computer meets the 50% business use test for the year in which it was placed in service but fails to meet such test for a subsequent year, "excess depreciation" is subject to recapture.<sup>141</sup>

*Comment:* Under §280F(d)(3), employee use of listed property is not treated as use in a trade or business for purposes of §168 cost recovery or §179 expense deductions unless such use is both: (1) for the convenience of the employer; and (2) required as a condition of employment. The IRS has interpreted these tests quite restrictively, making it difficult for employees to obtain tax benefits in connection with their business use of individually purchased computers.<sup>142</sup> The employer's provision of the equipment appears to resolve these problems by clearly demonstrating through provision of the computer the "employer convenience" and presumably the "condition of employment" requirements. Thus, in practical terms, exclusion of use of a home computer or laptop as a working condition fringe may be substantially easier if the employer provides the computer than if the employee purchases it. A mandatory (and possibly employer-assisted) employee computer purchase program may also be a good alternative.<sup>143</sup>

The above limitations do not apply to any computer placed in service before 2018, whether fixed or portable, that is used exclusively at a regular business establishment that is owned or leased by the person operating the establishment.<sup>144</sup>

See 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses*, for further discussion of the limitations that apply to listed property.

#### (ii) Cell Phones

Employers often provide employees with cellular telephones, "blackberries" or other similar telecommunications equipment to facilitate business communication. There has never been any significant question that to the extent that an employee uses such communications devices for business purposes, the related costs are deductible business expenses for the employer, as long as the substantiation requirements of §274(d) are met.<sup>145</sup>

However, because employees typically engage in some personal use of employer-provided cell phones or other communications equipment, the tax treatment of such personal use has been a continuing concern. The rules applicable to such usage have also been evolving. In the early days of cell phone technology, mobile devices and their use were expensive, and employers ordinarily provided cell phones or other communications devices only for top executives. Moreover, such devices were large and bulky, and usage was generally billed on a per-call basis. Accordingly in 1989, at a time when Congress did not envision the current common business use for cell phones and other communications devices, it added cell phones to §280F(d)(4) making them "listed property."<sup>146</sup> Accordingly, the IRS took the position that, to the extent to which an employee used a cell phone or other similar equipment for business, the fair market value of that usage qualified as a working condition fringe excludible from the employee's gross income. However, the fair market value of the employee's personal use of the cell phone was includible in the employee's gross income.

Under the general substantiation rules of §274, employees needed to specifically substantiate the amount of the cell phone expense, the use of the property, the business purpose of the expense, and the business relationship of the employer and the cell phone users. However, because of Congress's classification of cell phones as "listed property," employees needed, in addition, to substantiate: (1) the amount of each separate expenditure, such as the cost of acquisition, and the amount of each business use (essentially every call) based on an appropriate measure (e.g., time) and the amount of total use of the cell phone for the taxable period; (2) the date of each expenditure or use; and (3) the business purpose for the expenditure or cell phone's use.<sup>147</sup>

As communications technology evolved, cell phones, blackberries and similar equipment became a daily part of business at all levels, and today, employers do not provide cell phones to employees as an extravagant perk. Rather, cell phones act as an extension of the office such that employees may now stay in touch with their office, business associates and customers at any time and place. Moreover, service is now fre-

<sup>135</sup> Reg. §1.280F-6(e)(3).

<sup>136</sup> See discussion at II.B.2.d.

<sup>137</sup> §274(d)(3), redesignated by Pub. L. No. 115-97, §13304(a)(2)(A) (formerly §274(d)(4)), effective for amounts paid or incurred after December 31, 2017; Reg. §1.274-5T(e)(1).

<sup>138</sup> Reg. §1.132-5(c).

<sup>139</sup> §280F(b); Reg. §1.280F-3T(c)(1).

<sup>140</sup> §280F(b); Reg. §1.280F-3T(c)(1).

<sup>141</sup> §280F(b)(2); Reg. §1.280F-3T(d).

<sup>142</sup> *Munshi v. Commissioner*, T.C. Memo 1995-578; *Bryant v. Commissioner*, T.C. Memo 1993-597, *aff'd by unpub. op.*, 39 F.3d 1168 (3d Cir. 1994). Compare *Cadwallader v. Commissioner*, T.C. Memo 1989-356, *aff'd*, 919 F.2d 1273 (7th Cir. 1990), with PLR 8629060, PLR 8615071, and PLR 8615024.

<sup>143</sup> See GCM 39518 (Dec. 24, 1985).

<sup>144</sup> Former §280F(d)(4)(B), generally effective for property placed in service before 2018; Reg. §1.280F-6(b)(5). See also the discussion of de minimis personal use of employer office equipment at II.B.2.d.(4)(a).

<sup>145</sup> §274(d)(3).

<sup>146</sup> Former §280F(d)(4)(A)(v), added by Omnibus Budget Reconciliation Act of 1989 (OBRA '89), Pub. L. No. 101-239, §7643, and removed by Small Business Jobs Act of 2010, Pub. L. No. 111-240, §2043(a).

<sup>147</sup> Reg. §1.274-5T(a), §1.274-5T(b)(6), §1.274-5T(e)(2).

quently made available for a flat monthly fee.<sup>148</sup> Against this background the special substantiation requirements related to listed property seemed increasingly and excessively burdensome.

Accordingly, in 2009, the IRS announced that it was considering simplified substantiation requirements for employee usage of employer-provided cell phones that taxpayers could use in lieu of the §274(d) substantiation requirements.<sup>149</sup> The optional, alternative substantiation methods under consideration included a minimal personal use method, a safe harbor substantiation method, and a statistical sampling method, separately or combined. Under a minimal personal use method, an employer would have been permitted to deem all of an employee's use of the cell phone as business usage if the employee could account to his or her employer with sufficient records to establish that the employee maintained and used a personal (non-employer-provided) cell phone for personal purposes during the employee's work hours. Another minimal personal use method would have disregarded a specified amount or type of "minimal" personal use in determining the amount of personal use of an employer-provided cell phone. Under the safe harbor method, an employer would have treated 75% of each employee's use of an employer-provided cell phone as business usage, and the remainder would have been deemed personal use.<sup>150</sup> Under the statistical sampling method, employers would have been able to use approved statistical sampling techniques<sup>151</sup> to measure an employee's personal use of an employer-provided cell phone. The employer would have multiplied the employee's percentage of personal use by the value of each employee's total usage to determine the value of personal usage, and the remaining portion of the employee's usage would have been deemed to be business use.

The IRS noted that it did not consider an employer's cost to provide the cell phone to be determinative of the fair market value of an employee's fringe benefit, but that it would consider whether a simplified valuation method would be helpful and appropriate to determine the fair market value of an employee's use of an employer-provided cell phone that did not qualify as a working condition fringe.

Under the Notice, an employer intending to use a simplified cell phone substantiation method would have had to implement a written policy that required employees to carry and use the employer-provided cell phones in connection with the employer's business and that prohibited personal use (other than minimal personal use) of those phones.

But, events outran the IRS Notice and legislation passed in September 2010 removed cell phones and similar equipment from the definition of "listed property" under §280F(d)(4).<sup>152</sup> Accordingly employees and employers no longer had to com-

ply with the detailed substantiation obligations imposed on "listed property" for using a cell phone provided by an employer in furtherance of the employer's business.

However, Congress's action left the status of the IRS's Notice 2009-46 and intentions unclear. If cell phones, blackberries and other similar equipment were no longer "listed property," they would seem to be just another piece of employer equipment, no different from copiers and other office equipment (other than computers that continue to be "listed property") and subject to the general rules applicable to employee use of such employer-provided equipment,<sup>153</sup> which allow a modest amount of personal use by employees without any revenue inclusion or reduction in the employer's deductions with respect to equipment, and without the requirements for an employer to adopt a written plan and policies regarding such use.

The IRS resolved this question when it issued Notice 2011-72. Under Notice 2011-72, effective for tax years beginning after December 31, 2009, when an employer provides an employee with a cell phone for noncompensatory business reasons,<sup>154</sup> the IRS will treat the employee's use of the phone for business reasons as a working condition fringe benefit, the value of which is excludible from the employee's income and, solely for purposes of determining whether the working condition fringe benefit applies, the substantiation requirements that ordinarily would have to be fulfilled under §162 are deemed satisfied. The employee's personal use of such phone would be excludible as a de minimis fringe benefit, which is addressed below.

#### (d) Professional Memberships, Dues, and Publications

Employees do not realize income to the extent that an employer pays professional dues or the cost of attending professional meetings or training sessions, or the costs of membership in organizations that are not social or entertainment-oriented organizations connected with the job they perform.<sup>155</sup> Conversely, it is clear that a sufficient business nexus is required based on the standard of deductibility under §162, and, thus, that exclusion is not available for the benefit of memberships in social or entertainment-oriented organizations such as country clubs, notwithstanding that they may receive occasional business use.<sup>156</sup>

The IRS has taken a pragmatic approach to administering the related and overbroad language of §274(a)(3) that disallows deductions for payment of dues to any club organized for "business, pleasure, recreation, or other social purpose" that could be construed more broadly than the congressional purpose of lim-

<sup>148</sup> 156 Cong. Rec. S5514, 5519 (daily ed. June 29, 2010) (statement of Sen. Ensign); see also 156 Cong. Rec. S5514 (daily ed. June 29, 2010) (statement of Sen. Baucus) ("[I]s that compensation to the employee or is that an investment by the employer.")

<sup>149</sup> Notice 2009-46. See also Notice 2011-72.

<sup>150</sup> This rule was similar to but less generous than the rules for personal use of other employer-provided equipment such as copiers (see discussion at II.B.2.d.(4)(a)), perhaps because of cell phones' status as listed property under §280F(d)(4).

<sup>151</sup> The sampling techniques would have been similar to those for meal and entertainment expenses, as set out in Rev. Proc. 2004-29.

<sup>152</sup> Small Business Jobs Act of 2010, Pub. L. No. 111-240, §2043, 124 Stat. 2504 (2010).

<sup>153</sup> See discussion at II.B.2.d.(4)(a). See discussion at II.B.2.a.(4)(c)(i) regarding computers.

<sup>154</sup> An employer will be considered to have provided an employee with a cell phone primarily for noncompensatory business purposes if there are substantial reasons relating to the employer's business for provided in the employee with a cell phone, e.g., 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 work day.

<sup>155</sup> 1984 Act Bluebook at p. 856; First Discussion Draft, §1.61-16(f) Ex. (17); *Townsend Industries v. Commissioner*, 342 F.3d 890 (8th Cir. 2003).

<sup>156</sup> See discussion at II.B.2.a.(4)(j).

iting deductions to social and country clubs. The IRS applies a principal purpose test and determines, based on the purposes and activities of an organization (rather than just its name), whether a principal purpose of an organization is to conduct entertainment activities for members or their guests or to provide members or their guests with access to entertainment facilities. Moreover, the regulations clarify that, absent a showing of the prohibited principal purpose of entertainment described above, business leagues, trade associations, chambers of commerce, boards or trade, real estate boards, professional organizations (e.g., bar associations and medical associations), and civic or public service organizations are not treated as clubs organized for business, pleasure, recreation or other social purposes. Thus, employer payments of dues and fees with respect to such organizations, if otherwise within the §162 rule, qualify for exemption as a working condition fringe.<sup>157</sup>

Similarly, employees do not realize income to the extent that an employer purchases professional publications or materials that are related to their job performance.<sup>158</sup>

#### (e) Educational Assistance

Before the addition to the I.R.C. of a special provision for educational assistance programs,<sup>159</sup> the provision of educational assistance directly to an employee did not, in general, result in gross income to the employee, provided the education was directly related to the employee's job skills and met certain other requirements.<sup>160</sup> This followed from regulations under §162 as a practical expedient on the theory that if an employee was required to include any amount in gross income for the cost of such training, the employee could deduct an equivalent amount.<sup>161</sup> Because such deductibility meets the literal requirements of §132(d), any such educational assistance payments qualify for exclusion as a working condition fringe benefit regardless of whether they also may qualify under other provisions.<sup>162</sup>

*Comment:* For various practical reasons, including the difficulty of distinguishing between qualifying and nonqualifying education based on job nexus, many employers have adopted educational assistance plans qualifying under §127. However, to the extent educational benefits meet the deductibility requirements of §162 but are not provided under a qualifying plan (or were provided during a period to which the benefit of §127 had not been extended),<sup>163</sup> they should alternatively qualify for exclusion from income under §132 as a working condition fringe benefit.

Confirming this congressional intention, §132(j)(8) specifically provides that, to the extent that employer-provided educational assistance is not excludible under §127 because it exceeds the maximum dollar limitation of that section, it may be excludible as a working condition fringe if the requirements of

§132 are met (e.g., the education is job-related as defined under §162). Thus, §132(j)(8) is of particular importance as a backstop during the periods when §127 was not effective.<sup>164</sup> Educational assistance may not, however, be excluded under any other provision of §132.<sup>165</sup>

#### (f) Security Arrangements

##### (i) In General

Employer expenditures for the security of employees were generally regarded as deductible by the employer and excluded from income of recipient employees even before enactment of §132<sup>166</sup> and regardless of whether the expenses related to securing the employer's offices<sup>167</sup> or an employee's home.<sup>168</sup> Moreover, the benefit could extend to individuals other than the employee, e.g., to the employee's family.<sup>169</sup> However, when such expenses had a useful life of over one year, it was necessary for the employer to capitalize the expense and recover it through depreciation.<sup>170</sup> The legislative history of the 1984 Act confirmed prior law with respect to the general exclusion of benefits provided for employee safety and security.<sup>171</sup>

##### (ii) Transportation Security

Under prior law, special rules applied with respect to use of employer vehicles or airplanes to provide security while traveling.<sup>172</sup> The fringe benefit regulations provide detailed requirements that must be satisfied as a precondition to exclude from employee income the benefit of security expenditures by the employer that involve the provision of transportation for security reasons. If the benefit of any employer-provided transportation is sought to be excluded under §132 as a working condition fringe, detailed requirements related to substantiation and specific benefit allocation must be followed.

##### (A) Substantiation of Need for Secure Transportation

The employer must demonstrate the existence of a bona fide business-oriented security concern related to the employer transportation based on all the facts and circumstances. Such demonstration must include:<sup>173</sup>

- establishing external circumstances requiring the security; and

<sup>164</sup> See discussion at III.A.7.

<sup>165</sup> Omnibus Budget Reconciliation Act of 1989 (OBRA '89), Pub. L. No. 101-239, §7101.

<sup>166</sup> Supplemental House Report at p. 1602; Chapoton and Egger Joint Statement at p. 7; *Munson v. Commissioner*, 18 B.T.A. 232 (1929), *acq.*, IX-1 C.B. 38. *Cf. Reakirt v. Commissioner*, 29 B.T.A. 1296, 1298 (1934); *I.T.* 3588, 1942-2 C.B. 89, *obsolete*, Rev. Rul. 68-661.

<sup>167</sup> Second Discussion Draft, §1.61-18(d) *Ex.* (4); First Discussion Draft, §1.61-16(f) *Ex.* (7).

<sup>168</sup> Second Discussion Draft, §1.61-18(d) *Ex.* (7); *Munson v. Commissioner*, 18 B.T.A. at 235 (1929); Nixon Tax Return Report, at pp. 162, 172-73, 179 and 196.

<sup>169</sup> Second Discussion Draft, §1.61-18(d) *Ex.* (7); *Munson v. Commissioner*, 18 B.T.A. at 235 (1929); Nixon Tax Return Report, at pp. 162, 172-73, 179 and 196.

<sup>170</sup> TAM 8141011; PLR 7752010.

<sup>171</sup> Supplemental House Report at p. 1602; 1984 Act Bluebook at p. 856.

<sup>172</sup> House Report at p. 1602; First Discussion Draft, §1.61-16(f) *Ex.* (11); Nixon Tax Return Report at p. 162.

<sup>173</sup> Reg. §1.132-5(m)(2).

<sup>157</sup> Reg. §1.274-2(a)(2)(iii).

<sup>158</sup> Supplemental House Report at p. 1601; First House Report at p. 296; 1984 Act Bluebook at p. 856.

<sup>159</sup> See discussion of educational assistance programs at III.A.

<sup>160</sup> See Rev. Rul. 76-71, Rev. Rul. 76-62, Rev. Rul. 76-65, all amplified by Rev. Rul. 76-352 and Rev. Rul. 78-184.

<sup>161</sup> Reg. §1.162-5, §1.162-17(b)(1).

<sup>162</sup> Supplemental House Report at p. 1602; First House Report at p. 297; 1984 Act Bluebook at p. 856; IRS Pub. 15-B (Employer's Guide).

<sup>163</sup> See discussion at III.A.6.

- establishing an “overall security program.”

The first element is essentially evidentiary, and the regulations provide guidance with respect to the types of evidence that are satisfactory. The external evidence test may be satisfied by facts indicating death threats, threats of kidnapping or serious bodily harm, or recent violent terrorist activity against the employee or similarly situated employees.<sup>174</sup> A bona fide business-oriented security concern does not exist unless the facts and circumstances establish a specific basis for concern regarding the employee’s safety. A generalized concern is not sufficient. In addition, even though a bona fide business-oriented security concern is determined to exist with respect to a particular employee, the employer remains responsible for periodically re-evaluating the facts and circumstances to determine whether the bona fide business-oriented security concern still exists.

An overall security program is defined as a plan pursuant to which security is provided to protect the employee on a 24-hour basis, including protection at the employee’s residence, workplace and while commuting or engaging in other travel, whether for personal or business purposes. The IRS requires that an overall security program must include the provision of a bodyguard/driver who is trained in evasive driving techniques; an automobile specially equipped for security; guards, metal detectors, alarms, or similar methods of controlling access to the employee’s workplace and residence; and, in appropriate cases, flights on the employer’s aircraft for business and personal reasons.<sup>175</sup>

Recognizing that circumstances may, in certain cases, permit a lower level of precautions than those required for an overall 24-hour security program, the IRS will accept a security program that is based on the reasonable recommendations of an independent security consultant in the following circumstances:

- a security study is performed with respect to the employer and the employee (or a similarly situated employee) by an independent security consultant;
- the security study is based on an objective assessment of all the facts and circumstances;
- the recommendation of the security study is that an overall security program (as defined in the regulations) is not necessary and such recommendation is reasonable under the circumstances; and
- the employer applies the specific security recommendations contained in the security study to the employee on a consistent basis.<sup>176</sup>

With respect to government employees, the IRS will accept a security study performed under the following circumstances:

- the security study is conducted by a person designated by the government employer as having the responsibility to determine the need for employer-provided security and the

appropriate protective services in response to that determination;

- the security study is conducted in accordance with written internal procedures that require an independent and objective assessment of the facts and circumstances, such as the nature of the threat to the employee, the appropriate security response to that threat, an estimate of the length of time protective services will be necessary, and the extent to which employer-provided transportation may be necessary during the period of protection;
- the security study evaluates the extent to which personal use of the employer-provided transportation may be necessary during the period of protection and makes a recommendation as to what would be considered reasonable personal use during that period; and
- the employer applies the specific security recommendations contained in the study to the employee on a consistent basis.<sup>177</sup>

#### (B) Amount of Transportation Security Exclusion

If both elements related to substantiation of the need for secure transportation have been met, the employee may, in connection with otherwise personal travel, exclude as a working condition fringe benefit the value of the security element of the transportation. Thus, the employee may not be able to exclude the full value of the transportation.<sup>178</sup> For example, in connection with commuting or other personal use of a vehicle driven by a qualified driver/bodyguard and containing appropriate safety modifications such as bullet-proof glass, the employee calculates the value of the personal use of the vehicle without any income for the driver/bodyguard and using the cost of the vehicle without the security improvements.<sup>179</sup>

In addition, the regulations clarify that the value of a driver/bodyguard’s services is excludible from income if provided as part of an overall security program or pursuant to an independent security study. For this purpose, the driver/bodyguard must be trained in evasive driving techniques.<sup>180</sup> This would appear to be the correct result in view of the legislative history.<sup>181</sup>

A special exclusionary rule is provided for personal use of an employer aircraft required pursuant to an independent security study or as part of an overall security program. Recognizing that in the absence of security concerns the employee in many cases would have used a flight on a commercial airline rather than chartering a plane, the exclusion is the excess of the employer’s transportation cost over first-class airfare (or the amount determined under Reg. §1.61-21(g) if the safe harbor valuation has been elected) with the latter amount being in-

<sup>174</sup> Reg. §1.132-5(m)(2)(i).

<sup>175</sup> Reg. §1.132-5(m)(2)(ii), §1.132-5(m)(2)(iii).

<sup>176</sup> Reg. §1.132-5(m)(2)(iv).

<sup>177</sup> Reg. §1.132-5(m)(2)(v).

<sup>178</sup> The full value of both the transportation and security would be excludible with respect to business use of the employer-provided transportation. See discussion at II.B.2.a.(4)(a).

<sup>179</sup> Reg. §1.132-5(m)(8) Exs. (1), (4).

<sup>180</sup> Reg. §1.132-5(m)(5).

<sup>181</sup> Supplemental House Report at p. 1602; First House Report at p. 296; 1984 Act Bluebook at p. 856 (applying the rule to government employees).

cludible in the employee's income as the benefit of the personal transportation.<sup>182</sup>

The regulations provide an oddly discriminatory special valuation rule for commuting provided to government employees in connection with a bona fide business-oriented security concern. Under the special valuation rule, the commuting use may be valued under the vehicle cents-per-mile rule of Reg. §1.61-21(e)(1)(i) or the \$1.50 per 1-way commute rule of Reg. §1.61-21(f)(3) *without* regard to the other requirements of Reg. §1.61-21(e) or §1.61-21(f). Further, a government employer is deemed to have met the requirements of the special valuation rules of Reg. §1.61-21(c).<sup>183</sup> By comparison, a private sector control employee may not generally value commuting under either of these special valuation rules.

*Comment:* The use of these special valuation rules by governmental senior executives represents a considerable departure from the long-standing IRS view that senior executives should not be able to reduce the income inclusion for perquisites such as personal use of an employer-provided limousine by application of a special valuation rule designed for moderately priced vehicles and non-executive employees. The economics of providing vehicle security improvements and ergonomics of adequate interior room for both the employee and the driver/body-guard militate against the employer choosing a smaller, moderately priced vehicle, with the result that executives may be required to suffer an income inclusion for a vehicle that because of security concerns, may be considerably more expensive than they might otherwise have chosen. However, what is true for a senior government executive is equally true for senior private-sector executives. The authors believe the IRS should apply valuation and other incidental benefit rules to senior private-sector executives with security concerns in a way that both (i) recognizes that improvement of an expensive vehicle for employer-security purposes may result in over-inclusion to the employee and (ii) avoids the appearance of politically based inequity that results from senior IRS and Treasury officials enforcing materially different inclusion rules on private-sector executives than they are willing to impose on themselves and other senior government officials.

### (C) Dependent Transportation Security

As an exception to the general rule that working condition fringe benefits may be provided only to an employee,<sup>184</sup> the reg-

<sup>182</sup> Reg. §1.132-5(m)(4), 1.132-5(m)(8) *Ex.* (2). In PLR 200705010, after employment, a former employee worked as an independent contractor for his former employer for one year providing protective services pursuant to a security program that met the requirements of Reg. §1.132-5(m)(2)(iv) and included the use of corporate aircraft. The independent contractor used the aircraft for personal use and reimbursed his former employer for the safe harbor airfare in accordance with Reg. §1.132-5(m)(4) and excluded the excess value of his personal flights from his gross income as a working condition fringe. In the following year, although no longer an independent contractor, the former employee continued to use the aircraft for personal use and reimburse his former employer for the safe harbor airfare. Because he no longer was an independent contractor, he could not receive the safe harbor airfare and the fringe benefit was valued under Reg. §1.61-21(g)(7) and §1.61-21(g)(11). Thus, the former employee incurred gross income in the excess of the reimbursement amount already paid to his former employer and the regular valuation amount. This amount also constituted wages due to the prior employer-employee relationship.

<sup>183</sup> Reg. §1.132-5(m)(6).

<sup>184</sup> See discussion of permissible recipients at II.B.4.a.

ulations provide that if a bona fide business-oriented security concern exists with respect to an employee, such concern is deemed to exist with respect to that employee's spouse and dependents. Thus, if the employee's spouse and dependents fly on the same aircraft as the employee for security reasons, or travel in the same vehicle, the requirements for a security program are met and no income inclusion is required.<sup>185</sup> However, for other types of security provided to an employee's spouse and dependents, for example, travel on an employer aircraft separately from travel by the employee, the requirements of a security concern must still be separately substantiated for that employee's family members.<sup>186</sup>

In deference to a perceived need for protection of certain government employees, such as those in law enforcement (but again disregarding horizontal tax equity for comparably situated private sector individuals), the regulations contain a special rule for personal use, other than commuting, of vehicle transportation (but not aircraft transportation) provided to a government employee's spouse and dependents during the time a bona fide business-oriented security concern exists. Under the special rule, the value of vehicle transportation for personal purposes (other than commuting) is excluded from the government employee's income as long as the personal transportation is consistent with the recommendation of the government employer's security study as to what is considered reasonable and necessary personal use during the time a bona fide business-oriented security concern exists.<sup>187</sup>

*Comment:* The requirements discussed above in connection with providing secure transportation technically do not apply unless a transportation benefit is provided. Nonetheless, those requirements, which include a professional security study and an overall 24-hour security plan, are so pervasive that meeting those standards may come to be the expected standard for supporting and substantiating all material employee security benefit expenditures, including those not involving transportation.

### (g) Product Testing Programs

The IRS has utilized its regulatory authority under §132 to establish detailed rules with respect to the exclusion from employee income of items provided to an employee pursuant to a consumer product testing program.<sup>188</sup> Under the general rule,

<sup>185</sup> Reg. §1.132-5(m)(3)(ii). This rule liberalized the rule of former Reg. §1.132-5T(m)(2)(v), which provided that the benefit of transportation security provided to spouses and dependents could be excluded only if the existence of bona fide business-oriented concerns were separately substantiated for each such person. Such demonstration involved the same elements required with respect to the employees. Thus, it appeared to require threats or hostile activities specifically against spouses or dependents (or similarly situated individuals) and either a corresponding overall security program or fully implemented independent security study for each such person.

<sup>186</sup> Reg. §1.132-5(m)(3)(iii).

<sup>187</sup> Reg. §1.132-5(m)(3)(iv).

<sup>188</sup> Relatively little prior authority addressed the taxability of materials received by an employee for testing. The IRS had ruled, in Rev. Rul. 70-498, that books received by a book reviewer, who donated the books to a charitable organization and claimed a contribution deduction, were includible in gross income. A similar result was reached in *Haverly v. United States*, 513 F.2d 224 (7th Cir. 1975), in which the court held that an elementary school principal who received unsolicited sample textbooks from publishers and donated them to the school library had taxable income for the value of the samples received. It is notable in each case that an income inclusion may have been equitably neces-

the value of a product is excludible as a working condition fringe benefit if each of the following conditions (derived from the legislative history) is met:

- consumer testing and evaluation of the product is an ordinary and necessary business expense of the employer;
- business reasons necessitate that the testing and evaluation of the product be performed off the employer's business premises by employees (i.e., the testing and evaluation cannot be carried out adequately in the employer's office or in laboratory testing facilities);
- the product is furnished to the employee for purposes of testing and evaluation;
- the product is made available to the employee for no longer than necessary to test and evaluate its performance and must be returned to the employer at completion of the testing and evaluation period;
- the employer imposes limitations on the employee's use of the product that significantly reduce the value of any personal benefit to the employee; and
- the employee must submit detailed reports to the employer on the testing and evaluation, and the length of the testing and evaluation period must be reasonable in relation to the product being tested.<sup>189</sup>

To satisfy the requirements of the fifth condition above, the employer must both limit the employee's ability to select among models or varieties of the product and prohibit use of the product by members of the employee's family.<sup>190</sup> For purposes of satisfying the prohibition on family use, the employer also may have to provide employees with the opportunity to purchase or lease the same type of product at employee expense for family use. Any charge by the employer for personal use of a product being tested is taken into account for determining whether the fifth condition has been satisfied.<sup>191</sup>

In addition, employers should avoid certain factors that may lead to a determination that the program is not a qualified product testing program. First, the employer must tabulate and examine the testing results within a reasonable amount of time. Failure to do so will cause the program to fail to qualify for the exclusion from income. Other factors the IRS may consider are: (1) whether the nature of the product and other considerations are sufficient to justify the testing program; and (2) whether the expense of the program outweighs the benefits to be gained from testing and evaluation.<sup>192</sup> Finally, there is a qua-

sary to support the basis needed for the charitable deduction and/or avoid an apparent double benefit of exclusion plus charitable contribution.

<sup>189</sup> Reg. § 1.132-5(n)(1); Supplemental House Report at p. 1602. For factors negating the existence of a product testing program, see Reg. § 1.132-5(n)(4).

<sup>190</sup> Reg. § 1.132-5(n)(2); Supplemental House Report at p. 1602.

<sup>191</sup> Reg. § 1.132-5(n)(2)(ii).

<sup>192</sup> Reg. § 1.132-5(n)(4). In TAM 9401002, the IRS held that a program did not meet all of the requirements under the then-temporary regulation, with the result that the value of the personal use had to be included in the employee's gross income under § 61. The IRS determined that: (1) the company's products were not furnished to its employees for the purposes of testing and evaluation, but rather, were compensatory in nature; (2) company products were made available to employees for a longer period than necessary to test and evaluate performance; and (3) the employees did not submit detailed reports to the company on the testing and evaluation.

si-nondiscrimination rule pursuant to which the IRS will examine the extent to which employer products have been furnished to highly compensated employees. If the IRS determines that an employer furnishes products under a testing and evaluation program only to highly compensated employees, this fact may be considered in determining whether the products are furnished for testing and evaluation purposes or for compensation purposes. Employers, however, have the opportunity to show a business reason for the classification of employees to whom the products are furnished (e.g., automobiles that have been furnished for testing and evaluation by an automobile manufacturer to its design engineers and supervisory mechanics).<sup>193</sup>

#### (h) Travel and Entertainment Reimbursements

The IRS confirmed in regulations the long-standing rule that the reimbursement of an employee's expenses incurred in entertaining or traveling for employer business purposes is a working condition benefit excludible to the extent that the general rule of deductibility under § 162 has been satisfied, and subject to the further detailed substantiation requirements of § 274.<sup>194</sup> The general rule is that, so long as the employee's travel and entertainment expenses are for employer requirements and the costs are sufficiently documented, reimbursements provided to the employee pursuant to an "accountable" reimbursement plan are not includible in gross income.<sup>195</sup> Moreover, the full amount of reimbursement may be excluded if such tests are met notwithstanding that 50% of such amount may be rendered nondeductible to the paying employer pursuant to § 274(n).<sup>196</sup> Most such expenses of the employer also are within the record-keeping provisions of § 274.<sup>197</sup> Nothing in the 1984 Act codification of the fringe benefit rules changed the prior law rule that an employee realizes gross income on allowances or reimbursements for expenses not incurred or accounted for to an employer as a condition of employment.<sup>198</sup> This has been con-

<sup>193</sup> Reg. § 1.132-5(n)(3); Supplemental House Report at p. 1602.

<sup>194</sup> Reg. § 1.62-2.

<sup>195</sup> Reg. § 1.62-2(c)(2)(i). Amounts excludible from income are not reported on the employee's Form W-2, and are exempt from withholding and employment tax requirements. See Reg. § 1.62-2(c)(4). For an example of an accountable travel and entertainment expense plan that utilizes electronic substantiation and reporting, see Rev. Rul. 2003-106.

<sup>196</sup> Reg. § 1.62-2(h)(1). See also Rev. Rul. 2008-23 (rulings as to which party is subject to § 274(n) limitation where trucking company leases truck drivers from leasing company and leasing company reimburses drivers for meal and incidental expenses they incur in course of performing services). Note that in an attempt to aid struggling restaurants during the Covid-19 pandemic, the Consolidated Appropriations Act, 2021 eliminated the 50% deduction disallowance for meal expenses for expenses for food and beverages provided by a restaurant if the expense is paid or incurred in 2021 or 2022. § 274(n)(2)(D), added by the Consolidated Appropriations Act, 2021, Pub. L. No. 116-260, Div. EE, § 210.

<sup>197</sup> H.R. Rep. No. 1811, 87th Cong., 2d Sess. at pp. 19 and 26 (1962). The TCJA, Pub. L. No. 115-97, § 13304, amended § 274 to limit business deductions for expenses of certain fringe benefits, including transportation and commuting expenses and entertainment expenses. See 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses*, for further discussion of the limitations that apply to listed property. See, e.g., *Walliser v. Commissioner*, 72 T.C. 433 (1979), in which an executive's deductions for business trips were found to be ordinary and necessary under the test of § 162 but failed under the stiffer requirements of § 274.

<sup>198</sup> *Cockrell v. Commissioner*, 321 F.2d 504 (8th Cir. 1963); Rev. Rul. 74-445. Cf. Rev. Rul. 65-187.

firmed in the regulations that harmonize the interface between §62,<sup>199</sup> §132, and §274.<sup>200</sup>

(i) *Outplacement Services*

An employer may provide employees with outplacement services in connection with termination of employment. Outplacement services are programs designed to assist the employee in finding other suitable employment, and range from such services as career counseling and seminars on resume preparation or interviewing skills to use of copiers and telephones in conducting a job search.

In general, an employee is entitled to deduct all expenses directly related to a search for employment in the same trade or business if the expenses are directly connected with the trade or business, even if the search is unsuccessful.<sup>201</sup> Thus, if an employer paid for outplacement services that a terminated employee would have been able to deduct had such employee paid the expenses directly, it was generally thought that the payment of these expenses by the employer qualified as a working condition fringe.

*Comment:* The IRS created a furor in 1989 when it ruled in a private letter ruling that outplacement assistance provided under an employer's separation program did not qualify as a working condition fringe because any deduction taken by an employee would be related to such individual's trade or business as an employee separate from the employee's relationship with the employer.<sup>202</sup> The IRS subsequently withdrew its ruling and announced that it was placing under study the issue of whether the value of employer-provided job placement services was excludible as a working condition fringe.<sup>203</sup> It further noted that under the facts of the ruling, in which employees had a choice between cash compensation and job placement services, an employee who elected the job assistance would be viewed as in constructive receipt of the cash that the employee could have elected and the employee would be taxed on that amount.

Following its study, the IRS announced in Rev. Rul. 92-69<sup>204</sup> that outplacement services provided by an employer qualify as working condition fringe benefits if the employer derives a substantial business benefit from providing the services that is distinct from the benefit that it would derive from paying additional compensation, and (restating a condition generally applicable to all working condition fringes) the payment would be allowable as a deduction to the employee under §162. The substantial business benefit provides a link between the provision of the services and the employee's trade or business of being an employee of that employer, as is required by the regulations.<sup>205</sup> A "substantial business benefit" includes such purposes as promoting a positive corporate image, maintaining corporate morale and decreasing the likelihood of wrongful termination suits in connection with a reduction in force; or fostering a positive work atmosphere and helping to attract quality employees in connection with ordinary employee turnover.<sup>206</sup>

However, consistent with the rationale of the earlier private letter ruling, if the employer provides an employee with a choice between unreduced severance pay or reduced severance pay and outplacement services, the outplacement services cannot be excluded as a working condition fringe and the employee is deemed to be in constructive receipt of income. The employee receives gross income equal to the difference between the unreduced severance pay and the reduced severance pay, but may deduct the value of the outplacement services as a miscellaneous itemized deduction subject to the 2% floor (suspended for tax years 2018 through 2025), the general reduction of itemized deductions and the limitations generally applicable to high-income individuals and highly compensated employees. Further, the value of the services constitutes wages subject to income and employment tax withholding.

*Comment:* To avoid the constructive receipt rule, an employer should offer outplacement services as an additional benefit and not offer outplacement services to employees who are being terminated as an alternative to cash either currently or as part of the severance package.

If the conditions set forth in Rev. Rul. 92-69 are otherwise satisfied, the requirement under the regulations that an individual currently be employed when the individual receives the services, is deemed to be satisfied with respect to the outplacement services during the period the services are provided.<sup>207</sup>

*Comment:* An employer adopting an outplacement services program should, in addition to avoiding any cash alternative, specifically set forth the substantial business benefits to be derived from the provision of outplacement services to former employees to ensure that the employees are able to exclude the services from income.

*Comment:* Generally, working condition fringe benefits are not subject to a nondiscrimination standard. See discussion at II.B.5.e.(1). Although not addressed in Rev. Rul. 92-69, it appears that, based on the general rule, outplacement services could be offered solely to any particularly impacted subset of employees, including executives or other highly compensated employees. The ruling further recognizes that executives may require a broader scope of services than clerical or other non-professional employees. When services are provided to a select group such as engineers or executives, to protect these employees from income inclusion, the employer should assess and document the executive's need for such expanded services. Note also that an employee technically would not be able to exclude outplacement services from income if he or she is seeking a job in a different career. The applicable career apparently may be defined to include such broad categories as "clerical" or "executive."

In any event, the occasional use of copiers, telephones and other employer-provided items by departing or former employees to contact prospective employers, or use of a secretary to type a resume, should qualify as a *de minimis* fringe.<sup>208</sup>

<sup>199</sup> Reg. §1.62-2.

<sup>200</sup> See, e.g., Reg. §1.162-25(b); TAM 9547001.

<sup>201</sup> Rev. Rul. 75-120.

<sup>202</sup> See PLR 8913008.

<sup>203</sup> PLR 9040025.

<sup>204</sup> See also Pub. 15-B (Employer's Guide).

<sup>205</sup> Reg. §1.132-5(a)(2)(i).

<sup>206</sup> See Rev. Rul. 92-69, reversing PLR 8913008.

<sup>207</sup> Reg. §1.132-1(b)(2).

<sup>208</sup> Reg. §1.132-6(e)(1).

(j) *Country, Social, and Entertainment Club Dues and Memberships*

Many businesses use city or country clubs for meeting and entertainment purposes, and, before 1993, taxpayers could claim deductions for club dues if they could establish that the use of the club was primarily for the furtherance of the taxpayer's trade or business and that any specific expenses were directly related to the active conduct of that trade or business.<sup>209</sup> In the 1993 RRA Congress — which was concerned both about revenue and a perceived element of personal pleasure in membership in institutions such as country clubs — added §274(a)(3), providing a categorical rule that no deduction is allowed for the payment of dues to any club organized for business, pleasure, recreation or other social purpose.<sup>210</sup> Accordingly, no deduction is allowed, notwithstanding that the taxpayer's use of the facility would, absent the limitation of §274(a)(3), otherwise be allowable as an ordinary and necessary business expense.

Because an employee's exclusion as a working condition fringe depends initially upon the deductibility of an item if it had been incurred by the employee receiving the benefit, the addition of §274(a)(3) created the possibility that if an employer paid dues expenses for an employee, such payment might give rise to double taxation of the amount paid (by disallowance of the employer's deduction, inclusion in the employee's income and disallowance of any employee deduction). To prevent this result, which the IRS considered to be harsher than Congress had intended,<sup>211</sup> the IRS issued a regulation that limits the disallowance to a single tier by providing that, if an employer's deduction is disallowed by §274(a)(3), the amount of the employee's working condition fringe benefit relating to the employer-provided membership in the club is determined without regard to the application of §274(a) if the employer does not treat the membership as compensation under §274(e)(2). The regulation also provides an election for an employer to treat the provision of the benefit as compensation to the employee, thus making the entire amount deductible to the employer. However, in such a case, §274(a)(3) applies at the employee level to require full inclusion of the amount of dues treated as compensation, without any offsetting deduction to the extent of business use.<sup>212</sup>

The regulation contains an example of an employer that provides a country club membership valued at \$20,000, when the employee can substantiate that the membership was used 40% for business purposes. According to the example, notwithstanding the employer-level disallowance for the business use, the employee may exclude \$8,000 (40% × \$20,000) as a work-

ing condition fringe, if the employer does not treat the membership as compensation.

*Comment:* The Example makes clear that the economics of the IRS position militate toward employer inclusion of dues in employee income (possibly with a tax gross up if the employer deems appropriate). In the Example, the employer is stated to have forgone the deduction, increasing its taxable income by \$20,000, effectively a 100% disallowance. Additionally, because the employee's working condition fringe exclusion was only \$8,000 (40% of the total \$20,000 dues), the employee has income of \$12,000. Thus the aggregate income increase related to the §274 disallowance is 160% of the total dues. By comparison, if the employer had paid the \$20,000 to the employee as income, it would have received a full deduction for that amount as compensation and the employee would have had to include the full \$20,000 in income — effectively a combined 1-time, 1-level disallowance of only the full 100%.

(k) *Spouse and Dependent Travel*

The rule is well-settled that an employer's payment of the cost related to having a spouse, dependent or friend accompany an employee results in income to the employee.<sup>213</sup> However, it was also recognized that no income was realized to the extent a spouse or other person accompanying the employee was doing so in order to perform substantive duties related to the employer's business.<sup>214</sup>

However, for years beginning in 1994 and after, taxpayers face additional disallowance of payments for various spousal, dependent and other travel expenses, notwithstanding that business reasons may have required the spouse or other individual to accompany the taxpayer and that such expenses would, absent the additional limitations discussed below, be otherwise allowable as an ordinary and necessary business expense.

Apparently for revenue reasons or possibly because of concerns related to taxpayer manipulation,<sup>215</sup> Congress decided to include in the 1993 RRA an outright disallowance of deductibility of expenses related to accompanying travel by a spouse, dependent or other person, regardless of the business justification for such travel. The disallowance is effected by §274(m)(3), which provides that no deduction is allowed for the travel of persons accompanying a taxpayer (or an officer or employee of the taxpayer) unless:

- the accompanying person is an employee of the taxpayer;
- the accompanying person's travel is for a bona fide business purpose; and
- the travel expenses would otherwise be deductible by the accompanying person.

<sup>209</sup> Rev. Rul. 72-273.

<sup>210</sup> Pub. L. No. 103-66, §13210. See H.R. Rep. No. 103, 103d Cong., 1st Sess. 208 (1993).

<sup>211</sup> 59 Fed. Reg. 64,909 (Dec. 16, 1994) (preamble).

<sup>212</sup> Reg. §1.132-5(s)(1), which also refers to Reg. §1.274-2(f)(2)(iii)(A).

The regulations further provide that, in the case of a tax-exempt employer, any reference in the regulations to a deduction disallowed by §274(a)(3) is treated as a reference to the amount that would be disallowed as a deduction by §274(a)(3) to the employer if the employer were not exempt from taxation, thereby clarifying that the payment of club dues by a tax-exempt employer is eligible for the working condition fringe exclusion. Reg. §1.132-5(s)(2).

<sup>213</sup> *United States v. Gotcher*, 401 F.2d 118 (5th Cir. 1968); *Patterson v. Thomas*, 289 F.2d 108 (5th Cir. 1961); *Challenge Mfg. v. Commissioner*, 37 T.C. 650 (1962), acq., 1962-2 C.B. 4; *Fenstermaker v. Commissioner*, T.C. Memo 1978-210; *Bauer v. Commissioner*, T.C. Memo 1973-111.

<sup>214</sup> Reg. §1.162-2(c); *United States v. Disney*, 413 F.2d 783 (9th Cir. 1969); *McDonnell v. Commissioner*, T.C. Memo 1967-18; *Peoples Life Ins. Co. v. United States*, 373 F.2d 924 (Ct. Cl. 1967); *Bank of Stockton v. Commissioner*, T.C. Memo 1977-24.

<sup>215</sup> The legislative history essentially recites existing law as the reason for the change. Pub. L. No. 103-66, §13272. See H.R. Rep. No. 103, 103d Cong., 1st Sess. 350-51 (1993).

The language of §274(m)(3) is problematic in part because of its extraordinarily broad scope. The application of the disallowance to “any other individual” coupled with the requirement that the accompanying person be an employee, could be read to disallow employer deductions in a totally business context. For example, there could be a disallowance for the cost of having an outside consultant (such as an appraiser, accountant or attorney, each of whom would be likely to be an independent contractor rather than an employee) accompany an employee on a trip requiring such consultant’s expertise. In response to these concerns, IRS regulations provide that any expenditure by a taxpayer for entertainment or travel described in §274(m)(3) is not subject to the regulations’ limitations on allowability of deductions to the extent that the expenditure is includible in gross income as compensation for services rendered, or as a prize or award under §74, by a recipient of the expenditure who is not an employee of the taxpayer. However, this exclusion does not apply to any amount paid or incurred by the taxpayer that is required to be reported (or would be so required except that the amount is less than \$600) by the taxpayer on an information return but which is not reported.<sup>216</sup> The regulations further provide that for purposes of §274(m)(3), the term “other individual” does not include a business associate (as defined in Reg. §1.274-2(b)(2)(iii)) who otherwise meets the bona fide business purpose and other deductibility requirements of §274(m)(3)(B) and §274(m)(3)(C).<sup>217</sup>

Because an employee’s exclusion as a working condition fringe depends initially upon the deductibility of an item as if it had been incurred by the employee receiving the benefit, the addition of §274(m)(3) created another instance in which there was a possibility that, if an employer paid spousal or dependent travel expenses when such individuals accompanied an employee, such payment might give rise to double taxation of the amount paid (by disallowance of the employer’s deduction, inclusion in the employee’s income and disallowance of any employee deduction). To prevent this result, which the IRS recognized to be more harsh than Congress intended,<sup>218</sup> the IRS issued a regulation that limits the disallowance to a single tier by providing that, if an employer’s deduction is disallowed by §274(m)(3), the amount of the employee’s working condition fringe benefit relating to the employer-provided travel expenses is to be determined without regard to the application of §274(m)(3). To be excludible as a working condition fringe benefit, however, the amount otherwise must qualify for deduction by the employee under §162(a). The amount qualifies for deduction and for exclusion as a working condition fringe

<sup>216</sup> Reg. §1.274-2(f)(2)(iii)(B). See §274(e)(9); see also T.D. 8666, 61 Fed. Reg. 27,005 (May 30, 1996). For an individual who is not the taxpayer’s employee, costs are treated as compensation if the amount for travel using a company’s aircraft is included in an information return under Part III of subchapter A of chapter 61 (unless not required to be reported under those provisions). Notice 2005-45, §B(10), prior to obsolescence by T.D. 9597, 77 Fed. Reg. 45,480, 45,482 (Aug. 1, 2012). Although Notice 2005-45 was obsoleted August 1, 2012, the computational methodology set forth in Reg. §1.274-10, T.D. 9597, 77 Fed. Reg. 45,480 (Aug. 1, 2012), is similar to that set forth in Notice 2005-45.

<sup>217</sup> Reg. §1.274-2(g). See also T.D. 8666, 61 Fed. Reg. 27,005 (May 30, 1996).

<sup>218</sup> Preamble, 59 Fed. Reg. 64,909 (Dec. 16, 1994). *Vesco v. Commissioner*, T.C. Memo 1979-369; *Marlin v. Commissioner*, 54 T.C. 560 (1970), acq., 1970-2 C.B. xx; Rev. Rul. 56-168.

benefit if it can be adequately shown that the spouse’s, dependent’s, or other accompanying individual’s presence on the employee’s business trip has a bona fide business purpose, and if the employee substantiates the travel under Reg. §1.132-5(c). If the travel does not qualify as a working condition fringe benefit, the employee must include in gross income as a fringe benefit the value of the employer’s payment of travel expenses with respect to a spouse, dependent, or other individual accompanying the employee on business travel.<sup>219</sup> The regulation also provides an election for an employer to treat the provision of the benefit as compensation to the employee, making the entire amount deductible to the employer. However, in such case, §274(m)(3) would apply at the employee level requiring full inclusion of the amount of travel expenses treated as compensation without any offsetting deduction to the extent of business justification for the travel.<sup>220</sup>

*Comment:* Because the employee-level exclusion as a working condition fringe is limited to the business use, it should be advantageous in most cases of mixed business and personal travel for the employer to make the election to treat the payment as compensation. Taxpayers should also note that §274(m)(3) does not provide any allocation rules. This is important because, under prior case law that should continue to be controlling, allocation was allowed, in most instances, first to the business traveler up to the amount that the employee would have incurred if traveling separately.<sup>221</sup> It follows that if there are no excess travel costs, there should be no expenses within the purview of §274(m)(3).

#### (l) Miscellaneous Practices

The list of benefits subject to exclusion as working condition fringes is not limited to those discussed in this portfolio. Any benefit fitting the definitional requirements of §132(d) may qualify. Thus, for example, benefits such as the provision of liability insurance for directors and officers are commonly regarded as falling within the working condition exception, particularly when, as with such insurance, such benefits also would have been exempt before the §132 codification.<sup>222</sup> In addition, employer-paid premiums for private supplemental unemployment benefit insurance are excludible as working condition fringe benefits under §132(d) and Reg. §1.132-5(a)(2)(i) because, if the employees had made the payments themselves, the payments would be deductible by the employees under §162 with respect to the employees’ specific trade or business of being employees.<sup>223</sup>

The value of certain identity protection services are not included in wages. These are services that employers may pro-

<sup>219</sup> Reg. §1.132-5(t). See Reg. §1.61-21(a)(4), §1.162-2(c). The regulations further provide that, in the case of a tax-exempt employer, any reference in the regulations to a deduction disallowed by §274(m)(3) to the employer applies as if the employer were not exempt from taxation, thereby clarifying that the payment of travel expenses by a tax-exempt employer is eligible for the working condition fringe exclusion. Reg. §1.132-5(t)(2).

<sup>220</sup> Reg. §1.132-5(t)(1), which also refers to Reg. §1.274-2(f)(2)(iii)(A).

<sup>221</sup> The First Discussion Draft likewise incorporated this rule at §1.61-16(f) Exs. (5) and (6).

<sup>222</sup> Rev. Rul. 69-491 holding premiums paid by employer bank on policy insuring against loss from officers’ wrongful acts does not constitute income to bank officer employees.

<sup>223</sup> PLR 201201003.

vide employees in response to data breaches of an organization's recordkeeping systems, and may include credit reporting and monitoring services, identity theft insurance policies, identity restoration services or other similar services. An employer providing identity protection services to employees whose personal information may have been compromised in a data breach of the employer's (or employer's agent or service provider's) recordkeeping system does not need to include the value of the identity protection services in the employee's gross income and wages. This exclusion does not apply to cash received in lieu of identity protection services or to identity protection services received for reasons other than as a result of a data breach, such as those included in an employee's compensation benefit package.<sup>224</sup>

#### (5) Excluded Benefits

Certain benefits specifically do not qualify as working condition fringes. Such benefits include flexible spending accounts and physical examination programs.

##### (a) Flexible Spending Accounts

A flexible spending account is defined as an agreement between an employer and an employee that makes available to the employee over a time period a certain level of unspecified noncash benefits with a pre-determined cash value.<sup>225</sup> However, certain types of flexible spending accounts (e.g., those that reimburse employee health expenses) may be provided by an employer on a tax-free basis through a cafeteria plan if certain rules are met.<sup>226</sup>

##### (b) Physical Examination Programs

Even though physical examination programs generally are not excludible as a working condition fringe,<sup>227</sup> such programs may be excluded from an employee's income under §105 if the program covers medical diagnostic procedures (e.g., routine medical examinations, blood tests and X-rays) performed at a facility that provides only medical and ancillary services<sup>228</sup> or if an employer pays a physician directly for the cost of physical examinations required as a prerequisite to employment.<sup>229</sup>

#### (6) Accounting for Cash Reimbursements

Because of the nature of a working condition fringe, it was unclear after the enactment of §132 whether and to what extent employer cash payments could qualify. Congress added an accounting requirement applicable to employer cash reimbursement payments for incidental fringe benefits.<sup>230</sup> The IRS implemented this provision in the final regulations by providing that a cash payment made by an employer to an employee does not qualify as a working condition fringe unless the employer requires the employee to:

- use the payment for expenses in connection with a specific or pre-arranged activity or undertaking for which a deduction is allowable under §162 or §167;
- verify that the payment actually is used for such expenses; and
- return to the employer any part of the payment that is not so used.<sup>231</sup>

Notably, the special cash reimbursement rule applicable to working condition fringe benefits is consistent with the general rules under §62(c) regarding employee business expense reimbursement arrangements<sup>232</sup> and the IRS is inclined to interpret the rules in parallel.

Relying on this integrated interpretation approach, the IRS has held that reimbursements in the form of compensation reductions do not meet the special cash reimbursement rule. In PLR 9325023, the employer, an insurance company, proposed a reimbursement arrangement under which it would pay each of its district managers a gross amount from which they were expected to pay all their own normal business expenses, and each district manager could annually elect to reduce his or her compensation by up to 40% and also to receive reimbursement for incurred expenses up to the amount of the forgone compensation. Under the proposal, if the actual incurred expenses were less than the amount elected, the excess amount would be forfeited.

Even though the employer represented that it would only reimburse expenses that satisfied the business connection and substantiation requirements, because of the recharacterization of the reimbursement, the IRS determined that the arrangement did not satisfy the reimbursement and business connection requirements of Reg. §1.62-2(d). Citing Reg. §1.62-2(j) Ex. 9, which indicates that where a portion of salary is recharacterized as an expense reimbursement, the business connection requirement is not met, the IRS interpreted the regulations to create, in effect, a fourth requirement — that expense reimbursements must be in addition to salary. Accordingly, the IRS ruled that all amounts paid under the arrangement would not be considered as paid under an accountable plan under the §62 regulations and thus would be includible in the district managers' gross incomes and subject to employment taxes. It follows that the IRS will not view a reimbursement arrangement to be excludible where the amount that otherwise would have been paid is recharacterized by the parties as a reimbursement, even if it

<sup>224</sup> Announcement 2016-2, Announcement 2015-22.

<sup>225</sup> Reg. §1.132-5(a)(1)(i).

<sup>226</sup> See Prop. Reg. §1.125-5, REG-142695-05, 72 Fed. Reg. 43,938 (Aug. 6, 2007).

<sup>227</sup> Reg. §1.132-5(a)(1)(iv).

<sup>228</sup> Reg. §1.105-11(g)(1).

<sup>229</sup> PLR 9040051.

<sup>230</sup> §62(c), added by the Family Support Act of 1988, Pub. L. No. 100-485, §702(a).

<sup>231</sup> Reg. §1.132-5(a)(1)(v). For example, uniform allowance payments and dog food allowance payments to law enforcement officers are working condition fringes excludible from income where a county established the business necessity of the payments and its intention to comply with the substantiation requirements. PLR 9109041. Compare PLR 9443025, where the IRS ruled that payments to security guards for maintaining their uniforms were includible in income because the payments' actual use could not be verified. While indicating that employee surveys, especially self-serving types, must be scrutinized carefully and are insufficient to meet the cash verification requirement of Reg. §1.132-5(a)(1)(v), the IRS noted that it was not expressing an opinion as to whether, under the same regulation, the allowance would be considered a payment for expenses in connection with a specific or pre-arranged activity or undertaking for which a deduction is allowable under §162 or §167. See Rev. Rul. 2012-25 (an arrangement that recharacterizes taxable wages as nontaxable reimbursements or allowances does not satisfy the business connection or nexus requirement and is not considered an accountable plan under §62(c)).

<sup>232</sup> See Reg. §1.62-2.

is forfeitable and even if the amounts spent are properly substantiated.

*Comment:* Employers considering a recharacterization of a portion of salary as an expense reimbursement to satisfy the §62 regulations should avoid recharacterizing any part of *current* compensation as an expense reimbursement and should consider slowing increases in or freezing current compensation and establishing an entirely new arrangement for reimbursement in excess of that amount for actual expenses.

On the other hand, the IRS appears to be flexible in accepting alternative means of reporting. In PLR 9706018, the IRS ruled that electronic reporting procedures directly between a credit card company and the employer satisfied the substantiation requirement of §62(c) even though the employee who incurred the expenses did not give the employer paper receipts for the credit card charges. Consequently, the employer's reimbursement program was determined to be an accountable plan such that the affected employees were not required to report their reimbursed employee expenses as above-the-line deductions on their individual income tax returns.<sup>233</sup>

#### b. No-Additional-Cost Services

The second broad general class of excludible incidental fringe benefits is so-called "no-additional-cost services."<sup>234</sup> This classification appears to be the distant descendant of a Bureau of Internal Revenue ruling in the earliest days of revenue administration that held that free travel passes provided by a railroad to its employees were gifts that did not constitute income taxable to the employees.<sup>235</sup> Although the "gift" rationale for the holding was later discredited by the Supreme Court,<sup>236</sup> an underlying premise of the ruling was the fact that the railroad could provide the transportation without additional cost. Based on that ruling and later widespread industry practices of granting free or reduced price travel to airline, railroad and bus company employees and their families, the principle became administratively accepted that the provision of such benefits was not subject to income tax.<sup>237</sup>

##### (1) Services Covered

A "no-additional-cost" service is a service, such as space-available travel, provided to an employee for which the employer does not incur any "substantial" additional cost.<sup>238</sup> The legislative history cites the following examples of excess capacity services: employer furnishing of airline, railroad and subway transportation, hotel rooms and telephone service.<sup>239</sup> The regulations confirm this list and add bus and cruise line transportation as additional examples.<sup>240</sup> If a benefit qualifies,

<sup>233</sup> For further discussion of accountable and non-accountable plans under §62(c), see 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses*, for further discussion of the limitations that apply to listed property.

<sup>234</sup> §132(a)(1).

<sup>235</sup> O.D. 946, 1921-4 C.B. 110.

<sup>236</sup> See discussion at II.B.2.d.(4)(f) and III.C.

<sup>237</sup> Joint Committee Statement at p. 6. However, the Joint Committee Staff had earlier questioned the consistency of this practice with the general rule of inclusion. See Nixon Tax Return Report at p. 159.

<sup>238</sup> Reg. §1.132-2(a)(1)(ii).

<sup>239</sup> Supplemental House Report at p. 1594; 1984 Act Bluebook at p. 845.

<sup>240</sup> Reg. §1.132-2(a)(2).

the entire value of any qualifying service provided to an employee is excludible from the employee's income.

##### (2) Requirements for Exclusion

The first requirement that an employer offering no-additional-cost services must satisfy is demonstrating the absence of substantial additional cost in providing the service to employees. Because the concept is that employees are using employer capacity that otherwise would be unused, for purposes of determining whether any substantial cost has been incurred, any revenue that is lost by the employer because the service is provided to an employee rather than to a customer must be included, but any amount paid by the employee for the service must be disregarded.<sup>241</sup> However, it is immaterial for purposes of the exclusion whether the service is provided directly for no charge (or a reduced charge) or the employee is charged and given a subsequent cash rebate.<sup>242</sup>

The regulations provide that an employer must take into account the cost of labor incurred in providing services in determining whether or not "substantial" additional costs have been incurred. As a consequence, the regulations specify that an employer is regarded as incurring substantial additional costs whenever the employer or its employees spend a substantial amount of time providing the service. Moreover, the IRS applies this rule regardless of whether the persons spending time might otherwise have been "idle" or perform the services outside business employment hours for which they are compensated.<sup>243</sup> The regulations cite the facilitation of a securities purchase by a brokerage firm as an example of a nonexcess capacity service.<sup>244</sup> Thus, if a brokerage firm were to offer the privilege of free stock trading to its employees, it could not exclude the value of such service from its employees' income under the no-additional-cost services exclusion (and the IRS could be expected to apply this rule to insurance, real estate and other brokerages and similar services it regards as labor intensive).

However, an employer is not deemed to have incurred substantial additional costs when the services provided by its employees are incidental to a primary service. Thus, the services of a flight attendant to employees utilizing the benefit of space-available air transportation are cited as an example of incidental employee services. Moreover, the costs of in-flight meals and any additional fuel are cited as examples of nonlabor costs that are not substantial.<sup>245</sup> Similarly, maid service provided to hotel employees renting hotel rooms on a space-available basis is merely incidental to the primary service being provided (i.e., hotel accommodations).

In addition to incurring no substantial additional costs, a service must satisfy certain additional requirements with respect to the employer's line of business. The statute requires that the service provided to an employee be a service "offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing ser-

<sup>241</sup> §132(b)(2); Reg. §1.132-2(a)(5).

<sup>242</sup> Reg. §1.132-2(a)(3); Supplemental House Report at p. 1593; 1984 Act Bluebook at p. 844.

<sup>243</sup> Reg. §1.132-2(a)(5)(ii).

<sup>244</sup> Reg. §1.132-2(a)(5)(ii).

<sup>245</sup> Reg. §1.132-2(a)(5)(ii).

vices.<sup>246</sup> This requirement is designed to contain the scope of the exclusion and prevents, for example, a conglomerate employer owning an airline and a hotel chain from offering free hotel accommodations to its airline employees and vice versa. The requirements involved in the line of business requirement are discussed at II.B.4. The IRS has interpreted this requirement in the regulations to mean a line of business in which the employee performs “substantial” services,<sup>247</sup> presumably to avoid potential abuse.

### (3) *Permissible Recipients and Discrimination*

Special definitions of the terms “employee,” “employer” and “line of business” apply for purposes of the no-additional-cost services exclusion as described in II.B.4. Their general effect is to permit no-additional-cost services benefits to be provided to certain former employees and family members in addition to current employees.

In addition, a special nondiscrimination rule applicable to certain incidental fringe benefits must be satisfied.<sup>248</sup>

### (4) *Special Rules and Specific Benefits*

#### (a) *Travel Passes and Privileges*

The legislative history makes clear that travel privileges qualify for exclusion under the no-additional-cost service rule. Thus, the 1984 Act changes quelled certain earlier Treasury indications of an intent to pursue the taxation of this benefit.<sup>249</sup>

#### (b) *Reciprocal Agreements*

Under a special provision applicable only to the no-additional-cost services exclusion, certain services provided reciprocally by employers other than the employee’s employer are entitled to income exclusion. The special rule operates by treating the providing employer as the employee’s employer if the following three conditions (the first two of which are statutory) are met:<sup>250</sup>

- The reciprocal benefit must be provided pursuant to a written agreement between the providing employers.
- Neither employer may incur any substantial additional cost (including forgone revenue) in providing such benefit.
- The service provided to the employees meets the line of business requirement on a reciprocal basis.

Thus, for example, if two airlines that are not commonly controlled agree in writing to extend space-available transportation to each other’s airline employees, this reciprocal benefit falls within the no-additional-cost exclusion. The legislative history makes clear that an agreement is not necessary when employers are under common control.<sup>251</sup>

<sup>246</sup> §132(b)(1).

<sup>247</sup> Reg. §1.132-2(a)(1)(i).

<sup>248</sup> See discussion at II.B.5.

<sup>249</sup> Chapoton and Egger Joint Statement at p. 5; Second Discussion Draft, Reg. §1.61-17(d) Ex. (1); §1.61-19(c) Ex. (3); and §1.61-20(c) Ex. (4). This was a change from the First Discussion Draft that had continued the prior law administrative exclusion. See First Discussion Draft, Reg. §1.61-16(f) Exs. (1) and (2).

<sup>250</sup> §132(i); Reg. §1.132-2(b).

### (c) *Telephone Services*

The provision of free telephone service to telephone company employees was stated in both the legislative history and the regulations to be a type of service potentially qualifying under the no-additional-cost exclusion.<sup>252</sup> Nonetheless, the qualification of such services raises a number of interesting theoretical issues, particularly in view of changes in technology and changes in industry structure following the anti-trust breakup of AT&T. The benefit most closely fitting the §132(a)(1) requirements for a no-additional-cost service appears to be providing long-distance toll service to employees. To the extent that an employee’s long distance call uses excess long-distance circuit or bandwidth capacity of the employer’s telecommunications network, it appears to fall squarely within the exclusion, assuming the line of business, nondiscrimination and similar requirements have been satisfied. Extension of this result to employee calls that may require the use of other carriers’ long-distance facilities would also appear to qualify as long as the reciprocal service agreement requirements have been satisfied by the companies involved.

Qualification of local telephone service under the no-additional-cost services rules appears more difficult. The provision of free local calls when customers customarily are charged on a per-call or message-unit basis would appear to qualify in the same way as free long distance services to the extent of excess capacity between local exchanges.

*Comment:* It remains unclear how a telephone, cable, or other telecommunications company’s provision of free basic service — i.e., connection to the local system — meets the statutory test. The separate line or circuit that connects each telephone to the local exchange or network ordinarily is a dedicated connection that would not appear to satisfy the excess capacity requirement. Presumably, the costs of installing and/or maintaining such local service connections are not so great as to cause disqualification under the no substantial additional cost requirement of the exclusion. Thus, the level of such costs may provide a dollar benchmark of the permissible level of additional excludible costs in other businesses.

Finally, the possibility that local and long distance services might be characterized as different lines of business was resolved by committee report language,<sup>253</sup> which was helpful at the time but too narrow to be controlling as technology evolves and transmission mediums converge and cable and other telecommunications companies offer multiple services, for example phone, cable, and internet through a single connection, and not infrequently on a broadband service basis.

#### c. *Qualified Employee Discounts*

The third broad general class of excludible incidental fringe benefits is qualified employee discounts.<sup>254</sup> Employers have found it desirable in attracting and retaining employees to make various goods or services available to their employees at reduced cost. Often such benefits represent only the employ-

<sup>251</sup> Supplemental House Report at p. 1595; 1984 Act Bluebook at p. 846.

<sup>252</sup> Reg. §1.132-2(a)(6); Supplemental House Report at p. 1594.

<sup>253</sup> Supplemental House Report, fn. 8 at p. 1596; 1984 Act Bluebook fn. 76 at p. 848.

<sup>254</sup> §132(a)(2), §132(c).

er's forgoing of all or part of the potential profit margin in sales to employees. However, absent some form of limitation, such benefits could be structured to be compensatory and involve significant employer cost or forgone revenue.

Before enactment of the §132 statutory exclusion for qualifying discounts, the treatment of employee discounts had been an area of particular uncertainty. Prior regulations<sup>255</sup> had been construed, in at least one case,<sup>256</sup> to make any such discounts taxable to employee recipients, although IRS administrative practice appeared to have been to raise this issue only in abusive situations.<sup>257</sup>

### (1) Discounts Covered

The exclusion provides, with respect to qualified employee discounts, that no amount is includible in an employee's income.<sup>258</sup> Although detailed rules, discussed below, limit the size of an employee discount that may be considered a "qualified employee discount," the provision is drafted to apply generally to most discount plans that do not exceed the size limitations.

Special anti-abuse rules prevent application of the exclusion rule in several situations. The exclusion does not apply to any property that is:

- real property;
- property of a kind ordinarily held for investment; or
- property or services not offered for sale to customers in the ordinary line of business of the employer in which the employee is performing services.<sup>259</sup>

Thus, an employee may not exclude from income employee discounts on the purchase of securities, commodities or currency, or of either commercial or residential real estate, whether or not a purchase is made for investment purposes.<sup>260</sup> This limitation was added because Congress did not believe that employees were entitled to favorable tax treatment when noncash compensation is provided in the form of property that the employee typically could sell at close to the same price at which the employer sells the property to its customers.<sup>261</sup> Qualified property or services are not offered for sale to customers in the ordinary course of the line of business of the employer if such property or services are sold primarily to employees and their families (e.g., merchandise sold at an employee store or through an employer-provided catalog service).<sup>262</sup>

### (2) Requirements for Exclusion

For services, the maximum excludible discount is 20% of the price at which the employer offers the services to nonemployee customers.<sup>263</sup> For products or merchandise, the maxi-

imum excludible discount is the employer's "gross profit percentage."<sup>264</sup>

Note that the employer need not make a profit on the specific item or product sold to the employee. Gross profit percentage is defined to be the excess of the aggregate sales price of products sold to nonemployee customers over the aggregate cost of the property, divided by the aggregate sales price.<sup>265</sup> It is calculated generally using the employer's tax year immediately prior to the tax year in which the discount is available as a representative time period and the employer's actual profit experience.<sup>266</sup> For this calculation, the employer considers all products offered for sale to customers (including employees) in the line of business in which the employee performs services or some other reasonable classification of merchandise.<sup>267</sup> If the discount offered to an employee exceeds these limitations (the gross profit percentage in the case of merchandise or 20% in the case of services), the excess discount is included in the employee's income and treated as taxable compensation unless excludible under a provision of the I.R.C. other than §132(a)(2) (e.g., the no-additional-cost service rule).<sup>268</sup>

### (3) Permissible Recipients and Discrimination

In addition to meeting the applicable percentage size or profit margin discount test, to qualify, a discount must satisfy certain additional requirements with respect to: (1) the employer's line of business; and (2) nondiscrimination.<sup>269</sup> Each of these requirements and special definitions of employee and employer are discussed at II.B.4. The value of any discount given to an individual who is not an "employee" as defined by §132(h) and Reg. §1.132-1(b)(1) is taxable as income to the employee who designated such individual.<sup>270</sup>

### (4) Special Rules and Specific Benefits

#### (a) Services that Qualify for Discount

Under special rules, certain items specifically are treated as services for purposes of the exclusion for employee discounts. Thus, an insurance policy is considered to be a service, and an employer engaged in leasing property is viewed as providing a service. Employees may receive a discount of up to 20% on the price of a life insurance policy or on the rental price of leased property. However, the qualified employee discount exclusion is not available for loans by banks or other lending institutions at a discounted rate of interest.<sup>271</sup>

<sup>255</sup> Reg. §1.61-2(d)(2).

<sup>256</sup> *Beckert v. Commissioner*, 47 P-H Tax Ct. Mem. 3005, ¶ 78,903 (1978).

<sup>257</sup> See, e.g., *Demor, Inc. v. Commissioner*, T.C. Memo 1968-279 (a part-owner of a dress store realized income from employer-provided clothes but making no adjustment with respect to other employees who were provided free clothing up to an annual limit at wholesale costs). Cf. Reg. §31.3121(a)-1(f); Chapoton and Egger Joint Statement at p. 6; Rev. Rul. 53-28.

<sup>258</sup> §132(a)(2).

<sup>259</sup> §132(c)(4); Reg. §1.132-3(a)(2).

<sup>260</sup> Reg. §1.132-3(a)(2)(ii); Supplemental House Report at p. 1597.

<sup>261</sup> Supplemental House Report at 1597; 1984 Act Bluebook at p. 850.

<sup>262</sup> Reg. §1.132-3(a)(2)(iii); Supplemental House Report at p. 1598.

<sup>263</sup> §132(c)(1)(B); Reg. §1.132-3(a)(1)(ii).

<sup>264</sup> §132(c)(1)(A); Reg. §1.132-3(a)(1)(i).

<sup>265</sup> §132(c)(2); Reg. §1.132-3(c)(1)(i).

<sup>266</sup> Reg. §1.132-3(c)(1)(ii).

<sup>267</sup> §132(c)(2).

<sup>268</sup> Reg. §1.132-3(e); 1984 Act Bluebook at 849.

<sup>269</sup> Reg. §1.132-3(c)(2), §1.132-3(a)(6).

<sup>270</sup> Reg. §1.61-21(a)(4); FAA 20171202F (employer-provided discount program where employee can designate any person to participate, regardless of employee's relationship with that person, results in taxable income to employee if employee designates individual who is not "employee" as defined by §132(h) and applicable regulations).

<sup>271</sup> Supplemental House Report at p. 1600, fn. 12; 1984 Act Bluebook at p. 850.

*(b) Method of Providing Discount*

Employee discounts may be furnished through various methods, including the provision of property or services at no charge, at a reduced price or through a partial or total cash rebate.<sup>272</sup> Discounts may be provided directly by the employer or through a third party. For example, an employee of an appliance manufacturer may receive a qualified employee discount on the manufacturer's appliance purchased at a retail store. However, if the employee receives additional rights not provided to customers (such as the right to return or exchange property or special warranty rights), such additional rights may not be excluded as a qualified employee discount.<sup>273</sup>

*(c) Amount of Employee Discount*

An "employee discount" is defined as the excess of the price at which the property or service is being offered by the employer for sale to customers over the price at which the property or service is provided by the employer to an employee for use by the employee.<sup>274</sup>

In determining the amount of an employee discount, the price at which the property or service is being offered to customers at the time of the employee's purchase controls.<sup>275</sup>

*Example:* An employer offers a product to customers for \$20 during the first six months of the calendar year, but because of a wholesale price increase, at the time the employee purchases the product, the price has been raised to \$25. Therefore, the price from which the employee discount is measured is \$25.

*Comment:* Because the rule applies equally to price reductions, employees may realize the greatest benefit from a discount plan by making their purchases when merchandise is on sale.

The employee is not entitled to a quantity discount unless he or she actually purchases the requisite quantity.<sup>276</sup> If the employee pays at least fair market value for damaged, distressed or returned property, no income inclusion is required.<sup>277</sup>

If the employee performs substantial services in more than one line of business, the gross profit percentage of the line of business in which the property is sold determines the amount of the excludible employee discount.<sup>278</sup>

The price must be discounted if the employer regularly sells at discounted prices to large groups of consumers.<sup>279</sup> If sales at discounted prices equal at least 35% of the employer's gross sales during a representative period, the price from which the employee discount may be computed is a discounted price. The discounted price is the undiscounted price reduced by the percentage discount at which the greatest percentage of the employer's discounted gross sales are made for the representative period. Representative period is defined as the taxable year of

the employer immediately preceding the taxable year in which the property or service is provided to the employee at a discount.<sup>280</sup>

*Example:* Assume that a retail employer offers a 20% discount to members of the American Bar Association, a 15% discount to members of the American Medical Association and a 10% discount to employees of the federal government. Assume further that during the prior taxable year of the employer, sales to American Bar Association members equal 15% of the employer's gross sales, sales to American Medical Association members equal 20% of the employer's gross sales and sales to federal government employees equal 25% of the employer's gross sales. The current undiscounted price at which the property or service is being offered by the employer for sale to customers may be reduced by the 10% federal government employee discount.<sup>281</sup>

*(d) Calculation of Gross Profit Percentage*

The IRS provides guidance in calculating the gross profit percentage, which is the excess of the aggregate sales price for merchandise sold by the employer in the relevant line of business over the aggregate cost of such merchandise to the employer divided by the aggregate sales price.<sup>282</sup> For example, if total sales of merchandise during a year that is a measuring period is \$1,000,000 and the employer's cost for the merchandise was \$600,000, the gross profit percentage for that year is 40% ( $\$1,000,000 - \$600,000 = 40\%$  of  $\$1,000,000$ ). Thus, an employee discount with respect to such merchandise during the measuring year was applicable could be excluded from income to the extent that it does not exceed 40% of the selling price of the merchandise to nonemployee customers.<sup>283</sup>

The gross profit percentage is calculated separately for each line of business based on the aggregate sales price and aggregate cost of property in that line of business for a representative period. A representative period is defined as the employer's taxable year immediately preceding the taxable year in which the discount is available.<sup>284</sup> The aggregate sales price is determined in accordance with generally accepted accounting principles and in the same manner as it is computed for federal income tax purposes.<sup>285</sup>

An employer in its first year of existence has two methods of estimating its gross profit percentage. The employer may either base its gross profit percentage on its markup from cost, or use an appropriate industry average.<sup>286</sup>

Discounts offered by employers who are operating at a loss pose a special problem. If substantial changes in an employer's business indicate that it is inappropriate for the prior year's gross profit percentage to be used for the current year, the employer must redetermine the gross profit percentage for

<sup>272</sup> Reg. §1.132-3(a)(4); Supplemental House Report at p. 1597.

<sup>273</sup> Reg. §1.132-3(a)(5).

<sup>274</sup> §132(c)(3).

<sup>275</sup> Reg. §1.132-3(b)(2).

<sup>276</sup> Reg. §1.132-3(b)(2)(ii).

<sup>277</sup> Reg. §1.132-3(b)(3); Supplemental House Report at p. 1609.

<sup>278</sup> Reg. §1.132-3(c)(1)(ii).

<sup>279</sup> Reg. §1.132-3(b)(2)(iv).

<sup>280</sup> Reg. §1.132-3(b)(2)(iv).

<sup>281</sup> See Reg. §1.132-3(b)(2)(v) Ex. (2).

<sup>282</sup> §132(c)(2); Reg. §1.132-3(c)(1)(i).

<sup>283</sup> Reg. §1.132-3(c)(1)(i); Supplemental House Report at p. 1599.

<sup>284</sup> Reg. §1.132-3(c)(1)(ii).

<sup>285</sup> Reg. §1.132-3(c)(3); Supplemental House Report at p. 1600.

<sup>286</sup> Reg. §1.132-3(c)(1)(iii).

the remainder of the current year as if it were the employer's first year of business.<sup>287</sup>

An employer generally is required to determine the gross profit percentage for each separate line of business. Alternatively, the employer may use a narrower classification that is reasonable. Examples of reasonable classifications under the regulations include computing the gross profit percentage according to the department in which the products are sold, or computing on the basis of the type of merchandise sold (high mark-up and low mark-up).<sup>288</sup>

#### (e) Excess Discount

If an employee discount exceeds the applicable limitation, the excess discount is included in the employee's income unless it is excludible under another §132 exclusion.<sup>289</sup>

*Example:* Assume that a commercial airline provides a pass to each of its employees permitting the employees to obtain a round-trip coach ticket with a confirmed seat to any destination the airline serves for \$100. Neither the exclusion of §132(a)(1) (relating to no-additional-cost services) nor any other statutory exclusion applies to a confirmed-seat flight taken primarily for personal purposes by an employee under this program. However, an employee discount of up to 20% may be excluded as a qualified employee discount. Thus, if the price charged to customers for the flight taken is \$300 (under advance purchase or other restrictions comparable to those actually placed on travel associated with the employee airline ticket), \$60 is excludible from gross income as a qualified employee discount and \$140 (\$300 – \$100 employee payment and \$60 exclusion) is includible in gross income.<sup>290</sup>

#### (f) Leased Section of Department Store

Special rules apply to employees working in a “leased” section of a department store. A leased section of a department store is any part of a department store where over-the-counter sales are made under a lease or similar arrangement when it appears to the general public that individuals making the sales are employees of the person operating the department store.<sup>291</sup> Examples are over-the-counter sales of cosmetics or beauty supplies.

For purposes of the qualified employee discount exclusion, employees of the leased section are treated as if they are employees of the department store in the line of business of the department store.<sup>292</sup> Therefore, employees in the leased section may receive discounts on merchandise purchased in the department store, and employees in the department store may receive discounts on merchandise purchased in the leased section.<sup>293</sup>

<sup>287</sup> Reg. §1.132-3(c)(1)(iv).

<sup>288</sup> See Reg. §1.132-3(c)(2); Supplemental House Report at p. 1600. Cf. PLR 8936041 (dividing products into four categories — (1) general merchandise, (2) footwear and men's and women's apparel and accessories, (3) children's and infants' clothing and (4) sports equipment — was a reasonable classification for purposes of computing the gross profit percentage).

<sup>289</sup> Reg. §1.132-3(e).

<sup>290</sup> Reg. §1.132-3(e).

<sup>291</sup> §132(j)(2); Reg. §1.132-3(d)(1).

<sup>292</sup> §132(j)(2); Reg. §1.132-3(d)(1).

<sup>293</sup> Reg. §1.132-3(d)(2)(ii).

#### d. De Minimis Fringe Benefits

The fourth broad general class of excludible incidental fringe benefits is “de minimis” benefits.<sup>294</sup> Under pre-1984 Act authorities, if an employer provided an occasional benefit to an employee of low fair market value, the benefit was not taxed to the employee.<sup>295</sup>

##### (1) Benefits Covered

Any property or services provided to an employee qualifies as a de minimis fringe benefit and may be excluded from the employee's income if the fair market value of the property or service is so small that accounting for the property or service would be unreasonable or administratively impracticable.<sup>296</sup> Thus, the scope of benefits covered in practical terms is determined by such benefits' size and by administrative and accounting constraints.

For example, in informal guidance about work-life referral programs, the IRS indicated that services that are limited to informational and referral consultations that assist employees to identify, contact, and negotiate with life-management resources for solutions to a personal, work, or family challenge are de minimis fringe benefits. These types of resources include adult-care and child-care centers, legal services providers, financial services providers, and home repair tradespeople. Examples of permissible types of services are: identifying appropriate education, care, and medical service providers; navigating the medical system and eligibility for government benefits; evaluating and using paid leave programs; choosing a child or dependent care program; locating professionals who can adapt a home for special care needs; and connecting with local retirement and financial planning professionals. However, any payment, whether direct or indirect, by the employer for the actual services offered through those resources or other services that may be bundled with the program is presumed to be gross income to the employee unless it is specifically excluded from gross income.<sup>297</sup>

However, the burden is on the employer to demonstrate that the accounting for providing such a benefit is “administratively impracticable.” Thus, in FSA 200219005, the IRS Chief Counsel's Office considered whether the taxpayer's refund claims had sufficiently demonstrated that accounting for certain meal and entertainment expenses was administratively impractical. The taxpayer's employees incurred various expenses for meals, entertainment, tickets to sporting events, and

<sup>294</sup> §132(a)(4).

<sup>295</sup> See, e.g., Rev. Rul. 59-58 (small employer gifts such as a turkey or ham at Christmas). These principles also were recognized in both the First and Second Discussion Drafts. First Discussion Draft, §1.61-16(c) Ex. (16); Second Discussion Draft, §1.61-19(c) Exs. (8), (10).

<sup>296</sup> §132(e)(1); Reg. §1.132-6(a). Thus, compare TAM 200437030, in which the IRS National Office advised that employer-provided \$35 gift coupons redeemable at local stores were not excludible from employees' wages as a de minimis fringe benefit because the gift coupons had a readily ascertainable value, although the disallowance might alternatively have been predicated on the coupon's cash equivalency, under Reg. §1.132-6(c). See also IRS Info. Letter 2012-0008 (generally describing benefits that are and are not considered de minimis fringe benefits).

<sup>297</sup> IRS Fact Sheet FS-2024-13 (Apr. 2024) (frequently asked questions about work-life referral services). These services also may be known as caregiver or caretaker navigation services.

coffee, doughnuts, lunches, and dinners for business meetings for employees and clients on and off the taxpayer's premises. The taxpayer maintained various numbered accounts for these expenses and classified the expense as either "100% deductible" (under §274(n)(2)) or "50% deductible" (under §274(n)(1)). Section 274(n)(1) limits an employer's deduction for food or beverages incurred by employees to 50%. Under §274(n)(2), however, expenses for food or beverages excludible from an employee's income by reason of being a de minimis fringe benefit are not subject to the 50% limitation.

Addressing the issue of administrative impracticability, the Chief Counsel's Office stated its view that accounting for the value of a cash payment to an employee cannot be administratively impracticable, and that providing a "cash fringe benefit" is never treated as a de minimis fringe benefit unless special meal money rules apply. Similarly, the FSA stated that absent application of the special meal money rules, accounting for the benefit provided to a particular employee who receives reimbursement for meal and entertainment expenses is not administratively difficult. For example, if several employees eat together and one employee pays for all and is reimbursed, the fact that one receipt exists for several employees' meals does not in the IRS's view mean that it is administratively impracticable for the employer to account for the value of the benefit provided to each employee. Rather, the Chief Counsel views the employer as having simply failed to establish a system to account for the benefit provided to each employee. Citing *American Airlines v. United States*,<sup>298</sup> the FSA reiterated that the method chosen by the employer to account for benefits provided to employees is not dispositive of whether accounting for the value of the benefits is administratively impracticable, and accounting for the value of certain meals is not administratively impracticable simply because the employer chooses to account for them collectively. The FSA concluded that the taxpayer failed to establish that it would have been administratively impracticable to properly account for the benefits at the time the benefits were provided.

Additionally, an employer's inability to properly account for employer-provided benefits due to its choice of accounting systems, however, is not considered administrative impracticability. Thus, an employer cannot tailor its procedures to be administratively difficult for the purpose of achieving de minimis fringe benefit treatment.<sup>299</sup>

In TAM 201903017, however, the IRS National Office concluded that the value of snacks and beverages provided by an employer free of charge to employees was excludible from gross income as a de minimis fringe benefit under §132(e)(1) and Reg. §1.132-6. Quantifying the value of the snacks provided to individual employees on a continual basis in open-access areas was deemed administratively impractical where the snacks were of low value and came in small, often difficult to quantify portions.<sup>300</sup>

<sup>298</sup> 40 Fed. Cl. 712 (1998), *aff'd*, 204 F.3d 1103, 1112 (Fed. Cir. 2000).

<sup>299</sup> See *American Airlines v. United States*, 40 Fed. Cl. 712 (1998), *aff'd*, 204 F.3d 1103, 1112 (Fed. Cir. 2000), which considered an employer's issuance of blank "Be My Guest" American Express restaurant credit card vouchers to employees. The certificates were held to have "cash equivalent benefit" and thus did not qualify as de minimis fringe benefits as airline failed to offer evidentiary support for assertion that it was administratively impractical to account for such vouchers.

## (2) Requirements for Exclusion

The IRS notes that in determining whether the fair market value of the property or service provided is sufficiently small, the frequency with which similar fringe benefits are provided by the employer to all employees must be considered, together with any other relevant factors.<sup>301</sup>

Frequency is measured with respect to the frequency with which each individual employee receives a particular fringe benefit. However, if it would be administratively difficult to measure frequency with respect to each individual employee, the employer may measure frequency with respect to its workforce as a whole.<sup>302</sup>

However, in FSA 200219005, discussed above,<sup>303</sup> the IRS Chief Counsel's Office stated that the IRS's position is that when an employer has the information to determine that particular benefits were provided to particular employees, the employer must determine frequency using the employee-measured frequency standard. The Chief Counsel noted that whether the frequency determination is administratively difficult is based on an objective demonstration of difficulty, and a taxpayer cannot assume that a determination of difficulty depends on the method of payment and choice of procedures used to account for the benefits. In the case of the employee meals at issue (for which the taxpayer accounted collectively rather than by determining the number of meals provided to each employee), while Reg. §1.132-6(b) does not specify the exact method an employer must use to establish the number of meals that are provided to an individual employee, it does require the employer to establish the number or establish that to do so would be administratively difficult. The Chief Counsel concluded that the evidence submitted by the taxpayer was insufficient because it never determined the number of meals that were provided to each employee.

The FSA further states that when the employer-measured frequency standard is utilized, the focus is on whether the benefit was provided to employees so frequently that, given the value of the benefit, the provision of the benefit could not properly be characterized as a de minimis fringe benefit. Such an analysis requires determining the total number of times particular or similar benefits were provided to employees. Thus, the FSA concluded that the applicable taxpayer did not establish the frequency with which such benefits were provided to its workforce as a whole, and that the taxpayer's use of sampling of its expense accounts did not provide evidence as to the number of times similar benefits were provided to employees.

In PLR 201005014, which was subsequently revoked in PLR 201135022, the IRS ruled that a state political subdivision that provides clothing and accessories to employees and volunteers for use while working could exclude the benefit from income as a de minimis fringe benefit. The entity's departments secure the items annually through vendors who bid under a contract system in which the contracts rarely enumerate the precise number of items being ordered or the cost of each item, but usually specify a maximum number of items that can be or-

<sup>300</sup> See TAM 201903017 (referencing Reg. §1.132-6(e)(1)).

<sup>301</sup> §132(e)(1).

<sup>302</sup> Reg. §1.132-6(b).

<sup>303</sup> See discussion at II.B.2.d.(1).

dered. The entity showed that the cost of an item might vary due to escalation clauses and variations in the material and size. However, based on their approximate cost, the items are of low value. Also, although the departments' distribution policies vary and may depend on employment status (e.g., full-time, part-time, seasonal, volunteer) and job function, the items generally are provided to employees no more than once or twice a year. The entity also established that if it were to use the employee-measured frequency standard, the costs would exceed the nominal tax revenue generated by including the value of the benefits in income. Factors showing administrative difficulty included the costs of establishing a tracking system, the difficulty of determining the fair market value of the items, and the costs to input, transmit and maintain records of those values. There also was no indication that the system had been designed with the intent to make it administratively impracticable to track the items' values. In PLR 201135022, the IRS revoked its earlier ruling based on additional information that showed variations in the departments' acquisition and distribution of the clothing and accessories and prevented it from concluding, on a categorical basis, that the items were de minimis fringe benefits. The revocation was not applied retroactively.

To ease the burden on employers in determining the amount of a taxpayer's substantiated expenses paid or incurred for meals and entertainment excepted from the 50% disallowance deduction of §274(n)(1) by reason of §274(n)(2)(B), statistical sampling using procedures prescribed by the IRS in Rev. Proc. 2004-29 is allowed. The revenue procedure sets forth standards for plan sampling and technical formulas and additional procedures in the case of de minimis fringes.<sup>304</sup>

In *Jacobs v. Commissioner*,<sup>305</sup> the U.S. Tax Court held that the Boston Bruins' provision of pregame meal to its players and personnel at away city hotels qualified as a de minimis fringe under §274(n)(2)(B), and therefore the cost of such meals was not subject to the 50% limitation of §274(n)(1). In concluding that the provision of meals was a de minimis fringe, the Tax Court first concluded that the eating facility was leased by the Bruins. In this case, although the contracts entered into by the Bruins and the hotels were not specifically identified as leases, the Tax Court thought they still operated as such. The Tax Court reached this decision even though the Bruins didn't pay for the rental of any of the rooms in which meals were provided. The court relied on a definition of lease that provided that the right to use and occupy property must be conveyed in exchange for consideration. Despite the fact that the banquet room where meals were served was provided for free, the Tax

<sup>304</sup> See Rev. Proc. 2004-29, effective for taxable years ending on or after May 3, 2004. With respect to statistical sampling by a taxpayer for a taxable year ending before such date for which the applicable period of limitations has not expired, the application of Rev. Proc. 2004-29 is allowed (but not required). Rev. Proc. 2004-29 may not be used to: (1) substantiate meal and entertainment expenses required by §274(d); (2) determine a taxpayer's liability for employment taxes or whether an amount is excludible from a taxpayer's income; or (3) establish the correctness of a taxpayer's interpretation of §274(n) or characterization of meal and entertainment expenses as excepted from §274(n)(1). In addition, use of the revenue procedure does not preclude the IRS from raising or pursuing income, employment, or other tax issues that may arise on review of a statistical sample. Rev. Proc. 2004-29, §4.03.

<sup>305</sup> 148 T.C. 490 (2017), *acq. in result*, 2019-08 I.R.B. 569, AOD 2019-01 (the IRS will follow *Jacobs* only with respect to cases involving sports teams in which the material facts are substantially identical).

Court concluded that there was ample consideration because the Bruins did pay for lodging and food and the banquet room was provided for free as an enticement to secure that payment. Secondly, the Tax Court found that the requirement that an eating facility be located on or near the business premises of the employer was met. The Tax Court decided that inquiries concerning business premises inferred functional rather than spatial unity and were not limited by questions of geography or the quantum of business activities. The Tax Court reiterated that it is not necessary for an eating facility to be located in an employer's principal structure for it to be considered on the business premises. The Tax Court concluded that away city hotels were part of the Bruins' business premises because significant business duties were performed there and staying at away hotels was an integral part of the Bruins' professional hockey business.

Note that the de minimis fringe benefit exclusion under which the team owners prevailed, §274(n)(2)(B), was stricken from the I.R.C. by the TCJA.<sup>306</sup> Thus, the Bruins would not have obtained the same result under TCJA. Instead, they would be limited to the 50% deduction under §274(n)(1). For amounts paid or incurred after December 31, 2025, no deduction will be allowed for such expenses.<sup>307</sup>

### (3) *Permissible Recipients and Discrimination*

The character of the de minimis exclusion, particularly the fact that the benefits are, by definition, too insignificant to account for, limits the extent to which other restrictions can be applied. Thus, the nondiscrimination rules, line of business requirements and recipient limitations do not apply.

### (4) *Special Rules and Specific Benefits*

#### (a) *Use of Office Support Staff, Equipment, and Cell Phones*

Before the 1984 Act, the benefit of occasional and insignificant personal use of office support, such as having a secretary type a personal letter, was not regarded as an event requiring income recognition to the employee.<sup>308</sup> This result was specifically affirmed by the committee reports<sup>309</sup> and the regulations.<sup>310</sup>

A similar special rule applies for copying machines, pursuant to which an employer that restricts use of a copying machine in a way that at least 85% of the use of the machine can be shown to be for business purposes, may treat any personal use of the machine in excess of that amount as an ex-

<sup>306</sup> TCJA, Pub. L. No. 115-97, §13304(b)(1), effective for amounts paid or incurred after December 31, 2017.

<sup>307</sup> §274(o), added by Pub. L. No. 115-97, §13304(d), and amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70305(a). Limited exceptions apply for (1) expenses for goods or services sold to customers under §274(e)(8) in a bona fide transaction for full and adequate consideration, such as expenses for items purchased in connection with preparing and providing meals to paying customers (who may include employees) that are also consumed at the worksite by employees, and (2) meals provided on certain fishing boats and at certain fish processing facilities, as described in §274(n)(2)(C), as amended by the OBBBA, Pub. L. No. 119-21, §70305(b).

<sup>308</sup> First Discussion Draft, §1.61-16(f) Ex. (16); Task Force Staff Report at p. 10.

<sup>309</sup> Conf. Rep. at p. 1168; Supplemental House Report at p. 1604.

<sup>310</sup> Reg. §1.132-6(e)(1).

cludible de minimis fringe. Presumably a similar percentage use test would be appropriate for other office equipment, including telephones, dictating equipment, calculators and computers (provided they are used solely at the employer's business location).<sup>311</sup> Thus, for example, a legal secretary who uses word processing equipment occasionally to type school papers or reports for a child should realize no income from such use pursuant to the de minimis exclusion.

It is arguable that as a result of the Small Business Jobs Act of 2010, the treatment described above for copiers and other office equipment should also apply to employer-provided cell phones. The Act reversed prior law and made clear that a cell phone provided by an employer is no longer "listed property" subject to special substantiating documentation of its use. The primary discussion on the subject is located in the working condition fringe benefit section.<sup>312</sup>

Although cell phones were no longer considered "listed property," questions remained regarding the tax consequences relating to employer-provided cell phones. The IRS finally resolved questions relating to employer-provided cell phones when it issued Notice 2011-72. Notice 2011-72 provides that, for taxable years beginning after December 31, 2009, if a cell phone is provided primarily for non-compensatory business reasons, the employee's use of the cell phone for business reasons is treated as a working condition fringe benefit, and the value of the cell phone usage will be excluded from the employee's wages.<sup>313</sup> However, the employee's personal use of a phone provided primarily for non-compensatory reasons is excludible from the employee's income as a nontaxable de minimis fringe benefit.

#### (b) Meal Allowances and Taxi Fares

The 1984 Act legislative history made clear<sup>314</sup> that the statutory de minimis exclusion was intended to sanction the long-standing IRS administrative practice of treating "supper money" provided to employees required to work late or unusual hours as a deductible employer expense that was not income to the recipient employees.<sup>315</sup> Similarly, taxi fares provided to employees under the same circumstances were not treated as includible in gross income.

The 1984 Act codification also served to resolve some uncertainty that had arisen in this area. Treasury's willingness to continue the practice was evidenced in both the First and Second Discussion Draft regulations.<sup>316</sup> However, the Supreme

Court questioned the practice's consistency with the general rule of inclusion under pre-§132 law.<sup>317</sup> Moreover, there had been a question under the prior administrative rules as to how far the exclusion might extend, although it was clear that the previous administrative rules did not extend to the costs of hotel rooms or apartments near the office,<sup>318</sup> presumably because such items were unlikely to represent such small costs as to satisfy the de minimis standard. The pre-§132 administrative rules also did not permit the deduction of supper money expenses when they were not reimbursed — thus they would have failed to qualify under the working condition exception.<sup>319</sup>

The regulations set forth standards for determining whether supper money or taxi fare qualify as de minimis fringe benefits. The benefit must be reasonable and must be provided in a manner that satisfies the following three conditions:

- the meals, meal money or taxi fare is provided on an occasional basis;
- the meals, meal money or taxi fare is provided because the employee is working overtime; and
- in the case of meals or meal money, the meals or meal money are/is provided to enable the employee to work overtime.<sup>320</sup> Meal allowances that are provided on a routine basis to employees who work overtime do not qualify as de minimis fringe benefits, and the employee is required to include the allowances in income.<sup>321</sup>

*Comment:* The regulations do not define the term "occasional." The authors understand that the IRS may take a highly restrictive view and that "occasional" may mean as infrequently as once a week or once a month. It is unclear how such a view may square with workplace reality where an extended project may, for example, require employee overtime for a string of consecutive evenings until a particular project is completed and then not again until required by another deadline-critical project. The IRS signaled its intention to continue to examine meal allowances closely by including the issue in an Industry Specialization Program Coordination Issue Paper directed to all coordinated industry specialists.<sup>322</sup> Of particular concern to taxpayers is language in the coordinated issue paper, which states:

<sup>316</sup> Second Discussion Draft, §1.61-18(d) Exs. (1)(ii), (4) and (5); First Discussion Draft, §1.61-16(f) Exs. (7) and (8).

<sup>317</sup> *Commissioner v. Kowalski*, 434 U.S. 77, 93 (1977). See discussion at I.B.2.a.

<sup>318</sup> *Clayton v. Commissioner*, 7 T.C.M. 349 (1948); *Martin v. Commissioner*, 3 T.C.M. 626 (1944).

<sup>319</sup> *Antos v. Commissioner*, T.C. Memo 1976-89 *aff'd by unpub. op.*, 570 F.2d 350 (9th Cir. 1978); *Clayton v. Commissioner*, 7 T.C.M. 349 (1948); *Courtney v. Commissioner*, 32 T.C. 334 (1959).

<sup>320</sup> Reg. §1.132-6(d)(2)(i).

<sup>321</sup> TAM 9148001. See CCA 201219021 (meals purchased with reimbursements under accountable plans are not eligible for de minimis fringe benefit treatment under §274(n)(2)(B)).

<sup>322</sup> The issue paper has an effective date of April 14, 1994, and is periodically reviewed and updated by the IRS and available on the IRS's website at [www.irs.gov](http://www.irs.gov). Effective January 21, 2014, all LB&I Coordinated Issue Papers are de-coordinated. The de-coordination has no effect on whether the issue will continue to be pursued by LB&I in a taxpayer examination or on the IRS's views regarding any transaction, including listed transactions. See LB&I Directive De-coordinating All LB&I Coordinated Issue Papers, IRS Directive LB&I-04-0114-002 (Jan. 21, 2014).

<sup>311</sup> Reg. §1.132-6(e)(1); *Cf.* PLR 9442003 (use of employer's electronic tax return filer).

<sup>312</sup> See PLR 201005014, which was later revoked, for a good discussion of the "administratively impracticable" standard. See PLR 201135022.

<sup>313</sup> An employer will be considered to have provided an employee with a cell phone primarily for noncompensatory business purposes if there are substantial reasons relating to the employer's business, e.g., 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 work day. On the other hand, providing cell phones to "promote the morale or goodwill of an employee, to attract a prospective employee or as a means of furnishing additional compensation to an employee" do not qualify as being "primarily for noncompensatory business reasons." Notice 2011-72.

<sup>314</sup> Supplemental House Report at p. 1604.

<sup>315</sup> O.D. 514, 1920-2 C.B. 90.

Assuming all the conditions of §1.132-6(d)(2)(i) of the regulations are met, if an employee's receipt of meal money is dependent on the discretion of the employer, the meal money may be occasional and hence excludible under §132(a)(4) of the I.R.C. If it is the employer's policy to pay a meal allowance based upon a pre-identified factual pattern or pre-existing entitlement program or rule (written or unwritten), further analysis may be warranted to determine whether the employer's policy to provide meals is beyond that which would be considered "occasional" under the regulations.

*Comment:* This guideline is to some extent counter-intuitive. There is no assurance that a purely discretionary reimbursement plan might not be abused, while a properly drafted written or formalized plan could offer that assurance, for example, by providing that the particular benefit could not be claimed by a particular employee more than, say, twice a month. Nonetheless, given the IRS emphasis, it appears that employers with formalized or written meal allowance programs should routinely prepare in advance the information they expect to need to support their particular meal allowance program on audit.

The IRS's position is that meal money or taxi fare computed on the basis of the number of hours worked is not considered a de minimis fringe benefit.<sup>323</sup>

#### (c) Commuting

Special rules also may apply to certain trips involving commuting. Under a special rule, the value of commuting is deemed to be \$1.50 per 1-way commute if the conditions set forth in Reg. §1.61-21(f)(1) are met. The §132 regulations include the rule that the excess of the value of employer-provided transportation for commuting purposes over \$1.50 per 1-way commute may be excluded as a de minimis fringe under certain circumstances.<sup>324</sup> Accordingly, if the employer provides taxi fare for commuting to and from work because of unusual circumstances and it would be unsafe for the employee to use other available means of transportation, the employee may exclude from income the excess of the value of each 1-way trip over \$1.50 per 1-way commute.<sup>325</sup>

"Unusual circumstances" and "unsafe conditions" are determined on the basis of all the facts and circumstances. Examples of unusual circumstances include the employee being asked to work outside of his or her normal work hours or a temporary change in the employee's work schedule.<sup>326</sup> Factors that may be used to determine unsafe conditions are the history of crime in the geographic area surrounding the employee's workplace or residence and the time of day during which the employee must commute.<sup>327</sup>

<sup>323</sup> Reg. §1.132-6(d)(2)(i).

<sup>324</sup> An exclusion from income is consistent with examples in both the First and Second Discussion Drafts, although the exclusion is theoretically more consistent with the policy of the working condition fringe than the de minimis exclusion. First Discussion Draft, §1.61-16(f) Ex. (7); Second Discussion Draft, §1.61-18(d) Ex. (4).

<sup>325</sup> Reg. §1.132-6(d)(2)(iii)(A).

<sup>326</sup> Reg. §1.132-6(d)(2)(iii)(B).

<sup>327</sup> Reg. §1.132-6(d)(2)(iii)(C).

A "control employee" is not entitled to the benefit of this exclusionary rule.<sup>328</sup> A control employee is defined<sup>329</sup> as:

- an officer whose compensation exceeds an inflation-adjusted \$50,000 threshold,<sup>330</sup>
- a director;
- an employee whose compensation exceeds an inflation-adjusted \$100,000 threshold;<sup>331</sup> or
- a 1% owner.

Alternatively, the employer may treat the group of highly compensated employees as the group of control employees.<sup>332</sup>

*Comment:* Given the complexity of the income inclusion and uncertainty of the rules with respect to when employees are "occasionally" provided taxi money for commuting in connection with employer work requirements as well as the discriminatory treatment of "control employees," an urban employer that does not routinely provide employee parking may find it preferable to adopt a plan for reimbursing employee parking costs for days when work requirements prevent employees from maintaining a normal schedule because employees may exclude qualified parking in addition to any qualified transit pass benefits.<sup>333</sup> Use of a parking plan in such circumstances was contemplated in the legislative history.<sup>334</sup>

*Comment:* Under certain circumstances, the special valuation rule described at II.C.3.a.(2)(d) may be more useful to employers than the de minimis exclusions discussed above. The special valuation rule applicable to commuting provided or reimbursed to certain employees because of unsafe conditions does not have an overtime or unusual circumstances work requirement. Thus, the employer could furnish transportation to a qualified employee every day if the conditions of the rule are met. Furnishing transportation every day would not be provided on an occasional basis and would not be excludible under Reg. §1.132-6(d)(2)(i) as a de minimis fringe. Similarly, if the transportation is provided under circumstances that do not qualify as unusual, the value of the benefit in excess of \$1.50 per one-way commute would not be excludible under Reg. §1.132-6(d)(2)(iii).

Employees may exclude the qualified transportation fringes of commuting in employer-provided highway vehicles, transit passes under §132(f)(1)(A) and §132(f)(1)(B), and from 2009 through 2017, qualified bicycle commuting reimbursement, up to the applicable ceiling described at II.B.2.e.(2).<sup>335</sup>

<sup>328</sup> Reg. §1.132-6(d)(2)(iii)(A).

<sup>329</sup> Reg. §1.61-21(f)(5). Reg. §1.61-21(f)(6) defines a control employee for purposes of a government employer.

<sup>330</sup> This amount under Reg. §1.61-21(f)(5)(i) is subject to cost-of-living adjustments by the IRS. For current and prior year dollar amounts, see Tables, Charts & Lists, *Pension and Retirement Plans — IRC Cost of Living Adjustments*.

<sup>331</sup> This amount under Reg. §1.61-21(f)(5)(iii) is subject to cost-of-living adjustments by the IRS. For current and prior year dollar amounts, see Tables, Charts & Lists, *Pension and Retirement Plans — IRC Cost of Living Adjustments*.

<sup>332</sup> Reg. §1.61-21(f)(5). See discussion of the definition of highly compensated employee at II.B.5.b.(4).

<sup>333</sup> §132(f)(2)(B). See discussion of qualified parking at II.B.2.e.(5)(c).

<sup>334</sup> 1984 Act Bluebook at p. 856.

<sup>335</sup> §132(f), as amended by TCJA, Pub. L. No. 115-97, §11047(a) (adding §132(f)(8) to temporarily suspend exclusion for bicycle commuting reimburse-

For taxable years beginning after 2017, however, §274(a)(4) and §274(l) prohibit employer deductions for the expense of qualified transportation fringe benefits provided to employees and, unless necessary to ensure the safety of the employee, expenses incurred for transportation of employees commuting between home and work.<sup>336</sup>

(d) *Transit Passes*

A transit pass provided at a discount to defray an individual's commuting costs may be excluded as a de minimis fringe if the discount does not exceed \$21 in any month.<sup>337</sup> The de minimis transit pass is available to partners, 2% shareholders of S corporations, independent contractors and any other individual entitled to utilize the de minimis fringe benefit exclusion (but not included within the special definition of "employee" provided in §132(f)(5)(E)).<sup>338</sup>

The structure of the de minimis transit pass provision and the qualified transportation fringe transit pass provisions are quite similar, the IRS having apparently borrowed from the de minimis transit pass rules in developing rules for qualified transportation fringe transit passes. Pursuant to the de minimis transit pass exclusion, an employer alternatively may provide tokens or fare cards, or vouchers exchangeable solely for tokens or fare cards, so long as the value of the tokens, fare cards or vouchers does not exceed \$21 in any month. These discounted items may only be used to defray commuting costs, not other personal travel.

Reimbursements by an employer of an individual's public transit commuting expenses are also excludible from such individual's income again so long as the payments do not exceed \$21 per month and are made under a bona fide reimbursement arrangement. An employer does not need to substantiate each public transit expense if appropriate procedures are established for periodic verification that the commuting expenses of individuals provided with the benefit consistent with the payment being made by the employer.<sup>339</sup>

If the transit pass or reimbursement exceeds \$21 for a month, then no amount of the benefit is considered to be a de minimis fringe benefit. For example, if an employer provides a \$50 monthly public transit pass, the entire \$50 must be included in income, not just the \$29 excess value.<sup>340</sup>

(e) *Office Social Functions*

The 1984 Act legislative history<sup>341</sup> makes clear that the statutory de minimis exclusion was intended to sanction the

ment), effective for taxable years beginning after December 31, 2017, and before December 31, 2025, and by the OBBBA, Pub. L. No. 119-21, §70112(a) (striking §132(f)(1)(D), §132(f)(5)(F), and §132(f)(8), thereby permanently eliminating the bicycle commuting reimbursement exclusion), effective for taxable years beginning after December 31, 2025.

<sup>336</sup>For a discussion of employer deductions for expenses related to employee transportation, see 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses*, for further discussion of the limitations that apply to listed property.

<sup>337</sup>Reg. §1.132-6(d)(1).

<sup>338</sup>Notice 94-3, Q&A-7a.

<sup>339</sup>Reg. §1.132-6(d)(1). The exclusion for reimbursements incorporated in the regulations was initially provided in Notice 89-110 (as modified with respect to life insurance costs by REG-142695-05, 72 Fed. Reg. 43,938, 43,944 (Aug. 6, 2007)).

<sup>340</sup>Reg. §1.132-6(d)(4).

prior law rule that an employee does not realize gross income from the benefit of attending an occasional office function such as a Christmas party, company picnic or staff meeting at which refreshments are served.<sup>342</sup> Such expenses are deductible by the employer. This was also the IRS's administrative practice that both it and Treasury were prepared to formally recognize.<sup>343</sup> These practices are specifically identified in the regulations as examples of de minimis fringe benefits.<sup>344</sup>

(f) *Gifts and Awards*

The IRS has utilized its regulatory authority to confirm its long-standing position<sup>345</sup> that traditional gifts on holidays, birthdays or similar occasions of property of low fair market value are de minimis fringe benefits.<sup>346</sup> These include such items as a turkey given for a year-end holiday, although the frequency with which such gifts are provided must be taken into account. Thus, for example, if holiday gifts are provided to employees each month, the exclusion may be unavailable.<sup>347</sup>

Congress codified the IRS's long-standing position<sup>348</sup> that a cash fringe benefit or a cash equivalent fringe benefit (e.g., a gift certificate or gift card) is not excludible as a de minimis fringe benefit even if the benefit would have been excludible if provided in kind.<sup>349</sup> For example, providing cash to an employee for a holiday gift is not excludible as a de minimis fringe benefit even though the gift may itself have been excludible.<sup>350</sup> Similarly, although an employer may provide for electronic transmittal of employees' tax returns as a de minimis fringe benefit, an employer may not offer as a de minimis fringe benefit return preparation services with a specific fair market value or vouchers for tax preparation software that have a readily ascertainable value.<sup>351</sup>

Consistent with the IRS approach on cash awards, the IRS announced that cash incentives or "rebates" that some companies offer to employees in select areas to offset the purchase price of environmentally friendly hybrid cars are taxable compensation just like other forms of compensation.<sup>352</sup> Employers should include the cash incentive amounts in employees' compensation reported on year-end Form W-2 earnings statements.

<sup>341</sup>Supplemental House Report at p. 1604.

<sup>342</sup>*Haman v. Commissioner*, T.C. Memo 1972-118, *aff'd*, 500 F.2d 401 (9th Cir. 1974); *Le Sage v. Commissioner*, 6 T.C.M. 1263 (1947), *aff'd, rev'd and rem'd in part*, 173 F.2d 826 (5th Cir. 1949); *Bussabarger v. Commissioner*, 52 T.C. 819 (1969); *Miami Roofing and Sheet Metal Inc. v. Commissioner*, 6 T.C.M. 375 (1947); *Cf.* Reg. §31.3121(a)-1(f), §31.3306(b)-1(f), §31.3401(a)-1(b)(10).

<sup>343</sup>Second Discussion Draft, §1.61-19(c) *Ex.* (8); First Discussion Draft, §1.61-16(f) *Ex.* (17)(b); *see also* Chapoton and Egger Joint Statement at p. 7; Lubick Statement, Task Force Hearings at p. 24.

<sup>344</sup>Reg. §1.132-6(e)(1).

<sup>345</sup>Rev. Rul. 59-58; *Berkley Machine Works & Foundry Co. v. Commissioner*, T.C. Memo 1968-278, *aff'd per curiam*, 422 F.2d 362 (4th Cir. 1970); Task Force Staff Report at p. 10; Lubick Statement at Task Force Hearings p. 24.

<sup>346</sup>Reg. §1.132-6(e)(1).

<sup>347</sup>1984 Act Bluebook at p. 859.

<sup>348</sup>Rev. Rul. 71-53.

<sup>349</sup>§274(j)(3)(A)(ii), added by TCJA, Pub. L. No. 115-97, §13310, applicable to amounts paid or incurred after December 31, 2017.

<sup>350</sup>Reg. §1.132-6(c). *Cf.* TAM 200437030; FSA 200219005.

<sup>351</sup>*See* IRS Info. Letter 2004-0035.

<sup>352</sup>IRS News Release IR-2006-112.

The cash incentives also are subject to income tax withholding and employment tax.

In the Tax Reform Act of 1986 (1986 TRA), Congress clarified that the de minimis fringe benefit gift exclusion also applies to employee awards of low value and includes so-called “traditional” awards, such as a gold watch upon retirement after lengthy service for an employer.<sup>353</sup> Such an award may qualify as a de minimis benefit even though presentation of a relatively expensive item such as a gold watch given during the period of employment would not qualify for the exclusion. The theoretical basis for treating such an award as de minimis in the case of retirement is that the award is not made in recognition of any particular service or achievement, but relates to many years of employment, and in effect is not compensatory because it does not reflect any expectation of or incentive for the retiree’s rendering of future services.<sup>354</sup> Other employee awards also may qualify as de minimis benefits (e.g., a pin or similar item with a value of \$15), awarded on commencement of employment or like occasion. Conversely, non-monetary achievement awards having a fair market value of \$100 do not qualify as de minimis fringes and, consequently, constitute salary and wages.<sup>355</sup>

The question of whether it is unreasonable or administratively impracticable to account for an item may be affected by the existence of a program whereby the employer regularly accounts for other like items. Moreover, in some cases, the fact that a particular employee receives items having the maximum fair market value under the employee achievement award exclusion pursuant to §274(j) and the de minimis fringe benefit exclusion may suggest that the employer’s practice is not de minimis. This is particularly so when awards and other items, purportedly within the scope of the de minimis exclusion, are provided to the same employee in the same year.

For a further discussion of employee achievement awards under §74(c) and §274(j), see III.C.

#### (g) Theater or Sports Tickets

If employees occasionally are provided with tickets for the theater or sporting events, the value of the tickets is excludible as a de minimis fringe benefit.<sup>356</sup> However, season tickets to theatrical or sporting events are specifically identified as examples of items that are not excludible as de minimis fringe benefits.<sup>357</sup>

#### (h) Employee Welfare Benefits

##### (i) First Aid

The provision of minor facilities for employee comfort, health and well-being (e.g., medical and first aid facilities), was not treated as income under prior law.<sup>358</sup> After the 1984 Act, such facilities are excluded under either the working condi-

tion or de minimis fringe benefits exclusion.<sup>359</sup> Presumably, this is because of the perceived relation between the employee’s health and morale and the employee’s ability to perform his or her job. This had been the basis for approving deductions for other benefits related to employee well-being such as disaster relief.<sup>360</sup>

##### (ii) Dependent Life Insurance

Under prior law, employer-provided group-term life insurance on the life of an employee’s spouse and dependents of up to \$2,000 was excludible from gross income.<sup>361</sup> Ignoring the congressional directive that §132 was to be interpreted consistently with pre-1984 Act law,<sup>362</sup> regulations attempted to change this rule to provide that all of the cost of dependent life insurance would be included in employee income, and not excludible as a de minimis fringe benefit. In response to public comments, the IRS issued Notice 89-110, which made several changes to the final regulations. The notice postponed until further notice the effective date of the rule that dependent life insurance is not a de minimis fringe benefit, and reinstated the prior law rule that coverage of \$2,000 or less is deemed to be a de minimis fringe benefit. In determining whether coverage over \$2,000 is a de minimis fringe benefit, only the cost in excess of amounts paid for by employees on an after-tax basis is taken into account. Finally, the notice clarifies the §61 regulations to provide that no amount is included in income under that section to the extent that employees pay for the cost of coverage on an after-tax basis.

In determining the cost of coverage, the notice provides that the Table I rates under §79 should be used.<sup>363</sup> The Table I rates are age-based.<sup>364</sup> This requirement creates practical problems for employers who may offer a flat level of coverage at rates that are not related to dependents’ (or employees’) ages. In addition, the employer may be forced to compute Table I cost based on employee age if it does not have data on dependents’ ages. The term “spouse” includes married same-sex couples, but does not include domestic partners.<sup>365</sup>

The rule in Notice 89-110 differs from proposed cafeteria plan regulations. Under Prop. Reg. §1.125-1(k),<sup>366</sup> the employee includes in gross income the Table I cost of the coverage in excess of \$50,000 (minus all after-tax contributions by the employee for group-term life insurance coverage), and the entire amount of salary reduction and employer flex-credits for group-term life insurance coverage on the life of the employee

ductible under §132. 1984 Act Bluebook at p. 863. See discussion of Dependent Care Assistance Programs at III.B.

<sup>359</sup> Permissible medical benefits do not extend to more expensive items such as routine physicals. However, see discussion of physical examination programs at II.B.2.a.(5)(b).

<sup>360</sup> See Rev. Rul. 53-131 (amounts contributed by an employer to rehabilitate employees and their families who sustained injuries or damages in a tornado were deductible but did not constitute income to the employees).

<sup>361</sup> Former Reg. §1.61-2(d)(2)(ii)(b).

<sup>362</sup> See discussion at II.A.3.

<sup>363</sup> Notice 89-110.

<sup>364</sup> Reg. §1.79-3(d)(2), as amended by T.D. 8821, 64 Fed. Reg. 29,788 (June 3, 1999).

<sup>365</sup> Reg. §301.7701-18. For discussion of the federal tax treatment of same-sex spouses, see 351 T.M., *Plan Qualification — Pension and Profit-Sharing Plans*.

<sup>366</sup> REG-142695-05, 72 Fed. Reg. 43,938, 43,944 (Aug. 6, 2007).

<sup>353</sup> H.R. Rep. No. 841, 99th Cong., 2d Sess. II-19 (1986 Conf. Rep.); Prop. Reg. §1.274-8(d)(2).

<sup>354</sup> Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 33 (May 4, 1987) (1986 Act Bluebook).

<sup>355</sup> CCA 200108042.

<sup>356</sup> Reg. §1.132-6(e)(1); Supplemental House Report at p. 1604.

<sup>357</sup> Reg. §1.132-6(e)(2).

<sup>358</sup> Second Discussion Draft, §1.61-8(d) Ex. (1)(i); Treasury Summary and Explanation, First Discussion Draft at p. 11; Cf. Reg. §31.3121(a)-1(f). There was some authority for similarly treating employee daycare as an exempt welfare benefit. Although daycare is statutorily addressed, it also may be de-

is excludible from the employee's gross income. Taxpayers may rely on the proposed regulations for guidance pending the issuance of final regulations and Notice 89-110 was modified, effective August 6, 2007.<sup>367</sup>

Citing Notice 89-110, a 2013 chief counsel advice memorandum concluded that group-term life insurance with a face amount exceeding \$2,000 was not deemed to be a de minimis fringe benefit. Consistent with Notice 89-110, the IRS stated that, in determining whether dependent group-term life insurance with a face value exceeding \$2,000 is de minimis or not, it would only take into account the excess (if any) of the cost of the insurance over the amount paid for the insurance by the employee on an after-tax basis. The IRS stated that if the benefit exceeded either the value or the frequency limitations for de minimis fringe benefits, the entire benefit would be included in the employee's income, rather than just the portion that exceeded the de minimis limits.<sup>368</sup>

### (iii) Other Welfare Benefits

Under older rulings, it was argued that employer contributions of amounts to defray administrative expenses made to political action committees maintained by an employer to encourage individuals to become involved in political activities were in the nature of an employee welfare benefit, the expense of which were deductible by the employer but that did not cause the employee to realize gross income.<sup>369</sup> A technical advice memorandum concluded that rather than charging employees with income from employer contributions to political action committees, the IRS would disallow employer expenses in this area.<sup>370</sup>

*Note:* A challenge of tax-exempt treatment would appear likely when the benefits provided are not directly related to the employer's business or have the appearance of personal employee benefit.<sup>371</sup> For example, the relationship to the employer's business has been held to be insufficient to support employer deductions for a Christian Science practitioner retained as a consultant to corporate employees.<sup>372</sup>

Exemplifying its welfare benefit approach, the IRS ruled that the value of tax return preparation services provided to employees under a Volunteer Income Tax Assistance (VITA) program sponsored by the employer is an excludible de minimis fringe benefit under §132(a)(4). Tax return preparation services provided at a VITA site are provided free of charge, and under Reg. §301.7701-15(a)(7), the individuals who provide tax assistance under the VITA program and an organization which sponsors or administers a VITA program are not considered to be tax return preparers and are not subject to the requirements

and penalties applicable to tax return preparers. Thus, the IRS concluded that the employer's VITA site would make tax return preparation services more accessible to its employees but would not provide them with a benefit or service to which they would not otherwise be entitled. Also, the IRS decided, the value of the ready access to the income tax return preparation services to which the employees are otherwise entitled is so small as to make accounting for it unreasonable and administratively impracticable.<sup>373</sup> However, in contrast, the ruling concluded that the value of services provided to an employee by a return preparer is not so small as to make accounting for it unreasonable or administratively impracticable. Under §7701(a)(36), the services of a return preparer are not available to the public free of charge and generally are more sophisticated than the services provided by VITA volunteers.

The IRS also ruled that the value of the services of an electronic filer in formatting and/or transmitting an employee's return is excludible by the employee as a de minimis fringe benefit under §132(a)(4) because the value of such services is so small as to make accounting for them unreasonable or impracticable. This result applies whether the services are provided by the employer as an electronic filer itself or as compensation paid by the employer to an electronic filer on behalf of an employee but, in either case, only where the services do not alter the return substantively, because if the returns are altered substantively, the electronic transmittal thereof will make the provider of such services a return preparer.<sup>374</sup>

Further, according to the ruling, the use of coupons distributed by an employer for tax return clinic services does not affect characterization of the services obtained with them as de minimis fringe benefits. When coupons can be used by employees only to obtain income tax return preparation or electronic filing services, they are more like the provision of the particular service or item than a provision of cash that could be used to purchase a variety of items and, thus, they are not considered a cash equivalent fringe benefit under Reg. §1.132-6(c).

### (iv) Miscellaneous Benefits

Further examples of de minimis fringe benefits are set forth in the regulations and include coffee, doughnuts and soft drinks; local telephone calls; and flowers, fruit, books or similar property provided under special circumstances (e.g., on account of illness, outstanding performance, or family crisis).<sup>375</sup> The regulations also provide examples of benefits that *do not* qualify as de minimis fringe benefits. These include membership in a private country club or athletic facility and the use of employer-owned or -leased facilities (such as an apartment, a hunting lodge or a boat) for a weekend.<sup>376</sup> Some amount of the value of these types of benefits may, however, qualify under other provisions of §132, such as the working condition fringe exclusion.

### e. Qualified Transportation Fringes

In the early 1990s, having allowed the §124 exclusion for van pools to expire, Congress became concerned that the

<sup>367</sup> REG-142695-05, 72 Fed. Reg. 43,938, 43,944 (Aug. 6, 2007).

<sup>368</sup> CCA 201350037.

<sup>369</sup> Rev. Rul. 62-156. Cf. PLR 7742008.

<sup>370</sup> TAM 8202019.

<sup>371</sup> See PLR 9135022, in which the IRS revoked PLR 9116030, which allowed an employer to depreciate the intangible asset created by the contributions of funds for the construction of a clubhouse to be used by its employees and others in a small community based on *Oswego Falls Corp. v. Commissioner*, 46 B.T.A. 801 (1942), *acq.*, 1942-1 C.B. 13, *rev'd on other grounds*, 137 F.2d 173 (2d Cir. 1943).

<sup>372</sup> *Fred W. Amend Co. v. Commissioner*, 55 T.C. 320 (1970), *aff'd*, 454 F.2d 399 (7th Cir. 1971); see also TAM 8140018 (Transcendental Meditation courses).

<sup>373</sup> PLR 9442003.

<sup>374</sup> PLR 9442003.

<sup>375</sup> Reg. §1.132-6(e)(1).

<sup>376</sup> Reg. §1.132-6(e)(2).

I.R.C. did not provide sufficient incentives for employees to use mass transit for commuting. The I.R.C. contained an unlimited exclusion for employer-provided parking, but only a limited exclusion for the provision of transit passes. Accordingly, as part of the 1992 Energy Act,<sup>377</sup> Congress added qualified transportation fringes as the fifth general category of excludible fringe benefits under §132,<sup>378</sup> and the IRS provided comprehensive guidance under §132(f) in Notice 94-3.<sup>379</sup> Congress amended some of these provisions in the Transportation Equity Act for the 21st Century,<sup>380</sup> and added the new benefit of qualified bicycle commuting reimbursements in the Energy Improvement and Extension Act of 2008 effective beginning January 1, 2009.<sup>381</sup>

In 2001, the IRS issued final regulations §1.132-9(b)<sup>382</sup> providing guidance under §132(f) in question-and-answer format, as discussed below.

### (1) Transportation Fringes Covered

Under §132(f), which applies to both governmental and non-governmental employers,<sup>383</sup> an employee may exclude qualified employer-provided transportation fringe benefits from income up to the ceiling provided in §132(f)(2). The four transportation fringe benefits described in §132(f) are: (1) transportation in a commuter highway vehicle in connection with travel between the employee's residence and place of employment; (2) transit passes; (3) qualified parking; and (4) for taxable years beginning before 2018, qualified bicycle commuting reimbursements, and an employer may simultaneously provide an employee with any one or more of these benefits<sup>384</sup> except pre-2018 qualified bicycle commuting reimbursements reimbursements.<sup>385</sup>

For taxable years beginning after 2017, however, §274(a)(4) and §274(l) prohibit employer deductions for the expense of qualified transportation fringe benefits provided to employees and, unless necessary to ensure the safety of the employee,

expenses incurred for transportation of employees commuting between home and work.<sup>386</sup>

### (2) Exclusion Ceiling

An employee may exclude only a limited amount of qualified transportation fringes from income each month.<sup>387</sup> The value of transportation in a commuter highway vehicle, transit passes, qualified parking, and qualified bicycle commuting reimbursement (for which no exclusion is available after 2017) is calculated on a monthly basis to determine whether the applicable statutory monthly limit has been exceeded,<sup>388</sup> except for qualified bicycle commuting reimbursement which was available only for taxable years 2009 through 2017, was computed on a monthly basis but subject to a limitation which is annual<sup>389</sup> and any amount over the monthly §132(f)(2) or annual §132(f)(5) threshold not paid by the employee is taxable. Employers are responsible for determining the taxable amount, if any, and including it in the employee's wages. Any taxable amount of benefits also would generally be subject to employment tax.<sup>390</sup> Moreover, to the extent that qualified transportation fringes exceeded the applicable §132(f) limitations, such benefits may not be excludible as a working condition fringe benefit or as a de minimis fringe.<sup>391</sup>

If the value of a benefit does not exceed the applicable statutory limit in any month (or year as applicable), the unused portion of the exclusion may not be carried over to subsequent months. Similarly, if the employer provides a benefit having a monthly value greater than the statutory limit, the value in excess of the statutory limit may not be excluded by combining the monthly or annual exclusions. An employer may, however, reimburse an employee for qualified transportation fringe benefit costs incurred over several months (e.g. quarterly) if the value of the benefit is calculated on a monthly basis.<sup>392</sup>

Under regulations pre-dating the qualified bicycle commuting reimbursement exclusion, there are two separate limitations for purposes of determining the amount that is excludible from gross income: (1) transportation in a commuter highway vehicle and transit passes are subject to one combined limita-

<sup>377</sup> Pub. L. No. 102-486.

<sup>378</sup> Specifically, §132(a)(5).

<sup>379</sup> Employers could elect to apply the rules of Notice 94-3 to comply with §132(f) for benefits provided between January 1, 1993, and March 31, 1994, but were *required* to use such rules to comply with §132(f) for benefits provided after March 31, 1994. According to the notice, for qualified transportation fringes provided between January 1, 1993, and March 31, 1994, employers could alternatively use any reasonable good faith method of compliance with §132(f).

<sup>380</sup> Pub. L. No. 105-178.

<sup>381</sup> Division B, Title II, of Section 211 of The Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-383 (the "EIEA").

<sup>382</sup> T.D. 8933, 66 Fed. Reg. 2241 (Jan. 11, 2001), replacing earlier proposed regulations at REG-113572-99, 65 Fed. Reg. 4388 (Jan. 27, 2000). Reg. §1.132-9 generally is effective for taxable years beginning after December 31, 2001.

<sup>383</sup> Reg. §1.132-9(b), Q&A-5a; Notice 94-3; Cf. PLR 9548017.

<sup>384</sup> §132(f). See Reg. §1.132-9(b), Q&A-1 (does not reflect changes made by Pub. L. No. 110-343).

<sup>385</sup> See former §132(f)(5)(F)(iii)(II), added by Pub. L. No. 110-343, Div. B, §211(c), effective for taxable years beginning after December 31, 2008, and repealed by the OBBBA, Pub. L. No. 119-21, §70112(a)(4), effective for taxable years beginning after December 31, 2025; pre-OBBBA §132(f)(8), added by TCJA, Pub. L. No. 115-97, §11047(a) (suspending qualified bicycle reimbursement exclusion for taxable years beginning after 2017 and before 2026), effective for taxable years beginning after December 31, 2017, and repealed by OBBBA §70112(a)(5) (striking provision), effective for taxable years beginning after December 31, 2025.

<sup>386</sup> For a discussion of employer deductions for expenses related to employee transportation, see 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses*.

<sup>387</sup> §132(f)(2); §132(f)(6), as amended by TCJA, Pub. L. No. 115-97, §11002(d)(5), effective for taxable years beginning after December 31, 2017, and by the OBBBA, Pub. L. No. 119-21, §70112(b) (changing the base year for inflation adjustments from 1998 to 1997, effective for taxable years beginning after December 31, 2025). The specific limitations are discussed below. The ceiling also is adjusted for inflation under Reg. §1.132-9(b); Q&A-9(a). See PLR 201532016 (for the purposes of determining whether the value of smartcards provided on annual basis to employees exceeded the monthly limit, IRS would attribute one-twelfth of the fair market value of the annual smartcard to each month for which it was valid).

<sup>388</sup> Reg. §1.132-9(b), Q&A-9(a).

<sup>389</sup> See §132(f)(5)(F), repealed by the OBBBA, Pub. L. No. 119-21, §70112(a)(4), effective for taxable years beginning after December 31, 2025.

<sup>390</sup> Reg. §1.132-9(b), Q&A-8(a); Notice 94-3, Q&A-2d.

<sup>391</sup> §132(f)(7). If, however, an employer provides local transportation, other than transit passes or transportation in a commuter highway vehicle, the value of the benefit may be excludible (either totally or partially) under fringe benefit rules other than the qualified transportation fringe rules of §132(f). See Reg. §1.132-9(b), Q&A-23; Notice 94-3, Q&A-11.

<sup>392</sup> Reg. §1.132-9(b), Q&A-9(b) and (d) Ex. 1; Notice 94-3. Pending contrary guidance, the IRS will presumably apply a similar approach to qualified bicycle commuting reimbursement.

tion; and (2) qualified parking is subject to a separate additional limitation. There is a statutory monthly limit on the value of the benefits from each category that is excludible from gross income.<sup>393</sup>

*Note:* Qualified transportation fringes not exceeding the applicable statutory monthly limit are not subject to employment taxes, but qualified transportation fringes exceeding the applicable statutory monthly limit are includible in the employee's wages for income and employment tax purposes.<sup>394</sup> If the value of noncash qualified transportation fringes provided to an employee exceeds the applicable statutory monthly limit, the employer may follow the reporting and withholding guidelines provided in Announcement 85-113<sup>395</sup> and may elect to treat the non-cash taxable fringe benefits as paid on a pay period, quarterly, semi-annual, annual, or other basis, provided that the benefits are treated as paid no less frequently than annually for employment and income tax withholding purposes.<sup>396</sup>

### (3) General Rules for Exclusion

An employer may provide qualified transportation fringes directly or through passes, vouchers or a bona fide cash reimbursement arrangement.<sup>397</sup>

The Treasury provided comprehensive guidance with respect to qualified transportation fringe benefits in a single omnibus regulation.<sup>398</sup>

*Comment:* Although the EIEA created a new subcategory (D) of benefit for bicycle commuters effective for periods beginning after December 31, 2008 (but, the exclusion is suspended for 2018 through 2025), the comprehensive regulation has not been updated to reflect this addition. However, by virtue of Congress' choice of designating qualified bicycle reimbursements as an additional form of qualified transportation fringe and not a separate subsection of §132, taxpayers should be able to rely on the general provisions of Reg. §1.132-9 with respect to substantiation and other elements common to all qualified transportation fringes where such reliance does not contravene a specific statutory rule or subsequent Treasury pronouncement to the contrary.

#### (a) Bona Fide Reimbursement Arrangement

What constitutes a bona fide reimbursement arrangement may vary depending on the facts and circumstances, including the method or methods of payment utilized within the mass transit system.<sup>399</sup> The employer must implement reasonable procedures to ensure that an amount equal to the reimbursement was incurred for transportation in a commuter highway vehicle, transit passes, qualified parking or qualified bicycle commuting reimbursement.<sup>400</sup> An employee certification at the time of

reimbursement in either written or electronic form may be a reasonable reimbursement procedure depending on the facts and circumstances.

#### (b) Special Rule for Transit Passes

A "transit pass" that qualifies for the exclusion is any pass, token, farecard, voucher or similar item (including an item exchangeable for fare media) that entitles a person to transportation on mass transit facilities.<sup>401</sup> Employers may provide employees with tax-free transportation on a mass transit system by distributing transit passes to their employees. A transit system voucher is an instrument that may be purchased by employers from a voucher provider that is accepted by one or more mass transit operators (e.g., train, subway, and bus) in an area as fare media or in exchange for fare media. Thus, for example, a transit pass that may be purchased by employers directly from a voucher provider is a transit system voucher.<sup>402</sup>

The statute also provides (somewhat opaquely) that inclusion of cash reimbursements within the term "qualified transportation fringe" applies to transit passes only if vouchers that are exchangeable for transit passes are not readily available for direct distribution to the employee.<sup>403</sup> The regulations clarify when transit passes or vouchers are "readily available" and provide that a voucher or similar item is considered readily available if an employer can obtain it from a voucher provider that: (1) does not impose fare media charges that cause vouchers to not be readily available; and (2) does not impose other restrictions that would cause vouchers to be treated as not being readily available (e.g., failing to offer vouchers at regular intervals, or in reasonably appropriate quantities or denominations).<sup>404</sup>

<sup>400</sup> Reg. §1.132-9(b); Q&A-16(c) and (d). Reg. §1.132-9(b), Q&A-16(d) provides the following examples of reasonable reimbursement procedures: (1) an employee presents to the employer a parking expense receipt for parking on or near the employer's business premises, the employee certifies that the parking was used by the employee, and the employer has no reason to doubt the employee's certification; (2) an employee either submits a used time-sensitive transit pass (such as a monthly pass) to the employer and certifies that he or she purchased it or presents an unused or used transit pass to the employer and certifies that he or she purchased it and the employee certifies that he or she has not previously been reimbursed for the transit pass and the employer has no reason to doubt the employee's certification; (3) if a receipt is not provided in the ordinary course of business (e.g., if the employee uses metered parking or if used transit passes cannot be returned to the user), the employee certifies to the employer the type and the amount of expense incurred, and the employer has no reason to doubt the employee's certification.

<sup>401</sup> §132(f)(5)(A).

<sup>402</sup> Reg. §1.132-9(b), Q&A-16(b)(2). The term "voucher provider" means any person in the trade or business of selling transit system vouchers to employers, or any transit system or transit operator that sells vouchers to employers for the purpose of direct distribution to employees. Thus, a transit operator might or might not be a voucher provider. A voucher provider is not, for example, a third-party employee benefits administrator that administers a transit pass benefit program for an employer using vouchers that the employer could obtain directly. Reg. §1.132-9(b), Q&A-16(b)(3).

<sup>403</sup> §132(f)(3).

<sup>404</sup> Reg. §1.132-9(b), Q&A-16(b)(4); IRS Info. Letter 2016-0007. See also IRS Info. Letter 2018-0006 (without other restrictions, third-party commuter company's cash-only policy was not sufficient to overcome the prohibition against cash reimbursements, because this policy did not make vouchers "not readily available" for direct distribution by the employer to employees). The determination of whether obtaining a voucher would result in fare media charges that cause vouchers to not be readily available is made with respect to each transit system voucher. If more than one transit system voucher is available for direct distribution to employees, the employer must consider the fees imposed for the lowest cost monthly voucher for purposes of determin-

<sup>393</sup> Reg. §1.132-9(b), Q&A-17.

<sup>394</sup> Reg. §1.132-9(b), Q&A-8, Q&A-22.

<sup>395</sup> Discussed in V.A.I.b.

<sup>396</sup> Reg. §1.132-9(b), Q&A-22(c).

<sup>397</sup> §132(f)(3).

<sup>398</sup> Reg. §1.132-9, T.D. 8933 (Jan. 10, 2001), amended T.D. 9294 (Oct. 19, 2006).

<sup>399</sup> Reg. §1.132-9(b); Q&A-16(c) and (d); Notice 94-3, Q&A-3b. For example, an employee may present a used transit pass to the employer at the end of the month and certify that he or she purchased and used it during the month, or he or she may present a transit pass to the employer at the beginning of the month and certify that he or she purchased and will use it during the month.

*Note:* Fare media charges relate only to fees paid by the employer to voucher providers for vouchers. Therefore, internal administration costs do not affect the determination of whether vouchers are readily available.<sup>405</sup> Restrictions that cause vouchers to not be readily available, other than fare media charges, are restrictions imposed by the voucher provider that effectively prevent the employer from obtaining vouchers appropriate for distribution to employees. Examples of such restrictions include the following: advance purchase requirements,<sup>406</sup> purchase quantity requirements,<sup>407</sup> and limitations on denominations of vouchers that are available.<sup>408</sup> Employers who obtain travel passes under the specified circumstances need not maintain a bona fide reimbursement arrangement because, in disbursing vouchers, they are not making cash reimbursements of employees' transit expenses. Vouchers or passes so disbursed are qualified transportation fringes.

There are no substantiation requirements if the employer distributes transit passes. Thus, an employer may distribute a transit pass for each month with a value that does not exceed the statutory monthly limit without requiring any certification from the employee regarding the use of the transit pass.<sup>409</sup>

*Note:* Employers may not provide qualified transportation fringes by cash advances as distinguished from reimbursements.<sup>410</sup>

Rev. Rul. 2014-32 provides guidance on how employers may use electronic media, such as smartcards and debit cards, to provide employees with nontaxable transit benefits.<sup>411</sup> The

ing whether the fees imposed by the voucher provider satisfy this paragraph. However, if transit system vouchers for multiple transit systems are required in an area to meet the transit needs of the individual employees in that area, the employer has the option of averaging the costs applied to each transit system voucher for purposes of determining whether the fare media charges for transit system vouchers satisfy this rule. Fare media charges cause vouchers not to be readily available if the average annual fare media charges that an employer reasonably expects to incur for vouchers purchased from the voucher provider (excluding reasonable and customary delivery charges) are more than 1% of the average annual value of the vouchers for a transit system. See Reg. §1.132-9(b), Q&A-16(b)(5), (6).

<sup>405</sup> Reg. §1.132-9(b), Q&A-16(b)(5).

<sup>406</sup> Reg. §1.132-9(b), Q&A-16(b)(6)(i), provides that advance purchase requirements cause vouchers to not be readily available only if the voucher provider does not offer vouchers at regular intervals or fails to provide the voucher within a reasonable period after receiving payment for the voucher. For example, a requirement that vouchers may be purchased only once per year may effectively prevent an employer from obtaining vouchers for distribution to employees. An advance purchase requirement that vouchers be purchased not more frequently than monthly does not effectively prevent the employer from obtaining vouchers for distribution to employees.

<sup>407</sup> Reg. §1.132-3(b), Q&A-16(b)(6)(ii), provides that purchase quantity requirements cause vouchers to not be readily available if the voucher provider does not offer vouchers in quantities that are reasonably appropriate to the number of the employer's employees who use mass transportation (for example, the voucher provider requires a \$1,000 minimum purchase and the employer seeks to purchase only \$200 of vouchers).

<sup>408</sup> Reg. §1.132-9(b), Q&A-16(b)(6)(iii), provides that if the voucher provider does not offer vouchers in denominations appropriate for distribution to the employer's employees, vouchers are not readily available. For example, vouchers provided in \$5 increments up to the monthly limit are appropriate for distribution to employees, while vouchers available only in a denomination equal to the monthly limit are not appropriate for distribution to employees if the amount of the benefit provided to the employer's employees each month is normally less than the monthly limit.

<sup>409</sup> Reg. §1.132-9(b), Q&A-16(c) and (d); Q&A-18.

<sup>410</sup> Reg. §1.132-9(b), Q&A-16; Notice 94-3, Q&A-3a.

<sup>411</sup> Rev. Rul. 2014-32, *modifying and superseding* Rev. Rul. 2006-57.

IRS reviewed eight situations featuring the use of electronic media to provide qualified transportation fringe benefits.

The issue in six of the situations was whether the electronic media were a transit system voucher under Reg. §1.132-9(b), Q&A-16(b)(2), or whether the use of the electronic media satisfied the requirements of a bona fide expense reimbursement arrangement under Reg. §1.132-9(b), Q&A-16(b)(1). The situations show that electronic media qualifies as a transit system voucher only if it is usable only for transit system fare media and that employers may provide transit benefits via a reimbursement arrangement only if both (a) the arrangement satisfies the requirements of a bona fide cash reimbursement arrangement, and (b) a transit system voucher or similar item exchangeable only for a transit pass is not "readily available" for purchase for direct distribution to employees within the meaning of §132(f)(3).

*Situations 1 and 2:* The first employer provided transit benefits to its employees via smartcards. The employer made monthly payments to a transit system on behalf of its employees. The transit system electronically allocated to each employee's smartcard an amount instructed by the employer. The amount stored on each smartcard was usable only as fare media; it could not be used for any other purpose or to purchase anything else. The second employer provided transit benefits to its employees via terminal-restricted debit cards (TID-debit cards). The employer made monthly payments to a debit card provider, which then electronically allocated to each employee's debit card an amount instructed by the employer. TID-debit cards are debit cards that are restricted for use only at merchant terminals at points of sale at which only fare media for local transit systems is sold. Neither the first or second employer provided amounts to employees exceeding the statutory monthly limit under §132(f)(2). Because amounts stored on smartcards and TID-debit cards were usable only as fare media for the transit system, the value of the fare media provided by the employer under both situations was excludible from employees' gross incomes, and also excluded from wages for FICA, FUTA and income tax withholding purposes.

*Situation 3:* The third employer provided transit benefits via merchant-category code restricted debit cards (MCC-restricted debit cards). MCC-restricted debit cards are restricted for use at merchants that have been assigned a merchant category code indicating that the merchant sells fare media. However, the merchant may or may not sell other merchandise, and the debit cards contained no additional restrictions limiting their use only to purchase transit passes. The employer made monthly payments to the MCC-restricted debit card provider, which then electronically allocated to each employee's debit card an amount instructed by the employer. A transit system voucher or similar item exchangeable only for a transit was not otherwise readily available.

Because the MCC-restricted debit cards could be used to purchase items other than fare media, the IRS ruled that the debit cards were not a transit system voucher. However, the IRS ruled that the employer could nonetheless provide nontaxable transit benefits via the MCC-restricted debit cards pursuant to a bona fide reimbursement arrangement because a voucher or similar item was not readily available for distribution by the employer to its employees. The IRS explained that whether a voucher or similar item is readily available is based

on the amount of fees the provider charges the employer and whether the provider has imposed any unreasonable advance purchase or quantity restrictions. The IRS also determined that the reimbursement arrangement met the substantiation requirement of Reg. §1.132-9(b), Q&A-16(c). Under the employer's program, in the first month of participation an employee paid for a transit pass with after-tax dollars and then substantiated that amount to the employer. For each subsequent month, the employer remitted to the provider an amount equal to the substantiated expenses that the provider electronically allocated to each employee's debit card. The employer periodically reviewed statements showing the use of the card, including the date and amount of each purchase and which merchant was used. For the first month, employees must certify that the debit card only was used for fare media. Although the employer did not require substantiation every month, it did require substantiation at least annually from each employee that the debit card only was used for fare media.

*Situation 4:* The fourth employer provided transit benefits via MCC-restricted debit cards similar to those in the third situation above, but too was nonetheless permitted to use the cards to provide nontaxable transit benefits via a bona fide reimbursement arrangement because a voucher or similar item was not readily available for distribution by the employer to its employees. The fourth employer's reimbursement arrangement did not, however, contain safeguards as extensive as those of the third employer. Before using the cards, an employee certified that the card would be used only to purchase transit passes. Each card contained a statement that the card was to be used only for transit passes and, that by using the card, the employee certified that the card was being used only to purchase passes. At no time did employees substantiate to the employer the amount of fare media expenses that they incurred. The arrangement was not a bona fide reimbursement arrangement because it provided advances rather than reimbursements and relied solely on employee certifications provided before the expenses were incurred.

*Situation 5:* The fifth employer provided transit benefits via MCC-restricted debit cards. The card provider had, however, worked with the bank that issued the debit cards to place additional restrictions on the debit card based on a merchant's identification number. These restrictions blocked all purchases from any merchant in the area with an acceptable MCC that sold any items other than fare media. These restrictions had been tested and effectively prohibited recipients of the debit cards from using them to purchase any items other than fare media. Because the card restricted purchases for fare media, the value of the fare media provided by the employer to its employees through the MCC-restricted debit cards was excluded from employees' gross income without requiring the employees to substantiate the use of the debit card.

*Situation 6:* The sixth employer provided its employees with transit benefits via a debit card with restrictions to that of the MCC-restricted debit card in Situation 5, but also provided the card to employees who commuted using vanpools. The employer required employees to use the debit card to purchase their vanpool vouchers, and the voucher provider did not sell any other merchandise. Employees could purchase the vouchers either in-person or online. If purchased online, the voucher provider imposed a reasonable and customary delivery charge.

The employee included the delivery charge as a cost of transit and paid for the delivery charge with the debit card. The IRS stated that the delivery charge was included as part of the excludible transit benefit.

At issue in the final situation addressed in the ruling was whether excludible qualified transportation fringe benefits can be provided through a bona fide reimbursement arrangement if a TID-restricted debit card is the only readily available means of providing the benefits. The IRS ruled that, beginning after December 31, 2015, employers would no longer be permitted to provide qualified transportation fringe benefits in the form of cash reimbursement in geographic areas where a TID-restricted debit card was readily available, as had been allowed under Rev. Rul. 2006-57.

*Situation 7:* The seventh situation featured two employers that provided their employees with transit benefits on a transit system that provided a smartcard that could be used by employers to provide transportation benefits to their employees. This smartcard included separate accounts to separately track funds provided directly by an employer that were available only for transit use, funds provided directly by an employer that were available only for nontransit use (such as parking), and funds added by the cardholder/employee that were available for either use. Funds in each of the three accounts could not be transferred between accounts.

One of these employers provided its employees with transit benefits via MCC-restricted debit cards under an arrangement similar to that of the employer in Situation 5, above. When its employees used the debit cards to load funds onto their smartcards, the funds were placed into the account holding funds available for either transit or nontransit use. Although the MCC-restricted debit cards were restricted to prevent use to purchase any item other than fare media, the cards did not qualify as transit passes because the debit card could be used to purchase items other than transit benefits. Namely, employees could use funds loaded onto their smartcards from the debit cards for either transit or nontransit use. The value of the benefits provided by this employer to its employees through the debit cards was accordingly included in employees' income and included in wages for FICA, FUTA and income tax withholding purposes.

The other employer in Situation 7 provided its employees with transit benefits by directly forwarding the benefit amounts to the transit system, which then placed an amount specified by the employer into each of its smartcard accounts that could be used only for transit benefits. The smartcard qualified as a transit pass with regard to the amounts provided by this employer to the transit system and placed into the account that could only be used for transit. The value of the fare media accordingly was excludible from the employees' incomes and was excluded from wages for FICA, FUTA and income tax withholding purposes.

The issue in another situation addressed by the ruling was whether excludible qualified transportation fringe benefits include delivery charges incurred by an employee in acquiring transit passes. The IRS concluded that they are not.

*Situation 8:* The employer has been providing transit benefits to its employees via a bona fide cash reimbursement arrangement. A debit card provider offered a TID-restricted debit card in the geographic area of the employer's business.

This debit card was readily available under Reg. §1.132-9(b), and was the only readily available voucher or similar item in the area. Therefore, beginning December 31, 2015, the employer would no longer be permitted to provide qualified transportation fringe benefits in the form of cash reimbursement for transit passes.<sup>412</sup>

### (c) Compensation Reduction Agreements

Qualified transportation fringe benefits also may be provided to employees pursuant to a compensation reduction agreement. If the requirements discussed below are satisfied, no amount is includible in an employee's income merely because the employer offers the employee a choice between cash and one or more qualified transportation benefits or a combination of such benefits, and no amount is includible in income merely because the employee is offered a choice among such qualified transportation benefits.<sup>413</sup> Thus, employers may offer employees the option of electing cash compensation instead of any qualified transportation benefit (other than qualified bicycle commuting reimbursements) or a combination of any such benefits or as an element of a compensation reduction plan. The amount of cash offered is includible in the employee's income only to the extent the employee elects the cash.

A compensation reduction arrangement is an arrangement under which the employer provides the employee with the right to elect whether to receive a fixed amount of cash (or cash equivalent) compensation at a specified future date or a fixed amount of qualified transportation fringes to be provided with respect to a specified future period (such as a future calendar month). The election must contain the date of the election, the amount of the compensation to be reduced, and the period for which the benefit will be provided.<sup>414</sup> The election must relate to a fixed dollar amount or fixed percentage of compensation reduction. An election to reduce compensation for a period by a set amount for such period may be automatically renewed for subsequent periods.

The compensation reduction election for any month in a year may not exceed the combined statutory monthly maximums for that year.<sup>415</sup> The election must be made in writing or

<sup>412</sup> Before 2016, if the only available vouchers that were exchangeable for transit passes were "terminal-restricted debit cards," employers could nonetheless use bona fide cash reimbursement arrangements. Rev. Rul. 2006-57, *modified and superseded by* Rev. Rul. 2014-32. See Notice 2012-38 (IRS solicited public comments on the circumstances that should render a terminal-restricted debit card "readily available").

<sup>413</sup> §132(f)(4), as amended by Pub. L. No. 119-21, §70112(a)(3). Before 2018, this constructive receipt protection did not apply to qualified bicycle commuting reimbursements, which were available only for taxable years 2009 through 2017 and permanently repealed after 2025. For taxable years beginning on or before December 31, 1997, the exclusion did not apply to any qualified transportation fringe unless such benefit was provided in addition to (and not in lieu of) any compensation otherwise payable to the employee. See former §132(f)(4); Notice 94-3; PLR 9548017 (voucher provided in addition to, and not in lieu of, any compensation otherwise payable to taxpayer's employees).

<sup>414</sup> Reg. §1.132-9(b), Q&A-12(a). The employee's election must be in writing or another form, such as electronic, that includes, in a permanent and verifiable form, the required information.

<sup>415</sup> Reg. §1.132-9(b), Q&A-13. For example, for a year in which the statutory monthly limit is \$115 for transportation in a commuter highway vehicle and transit passes, and \$220 for qualified parking, an employee could elect to reduce compensation for any month by no more than \$335 (\$115 + \$220) with respect to qualified transportation fringes. If an employee were to elect to reduce compensation by \$350 for a month, the excess \$15 (\$350 - \$335) would

as an element of a compensation reduction plan before the employee is currently able to receive the taxable compensation. The determination of whether the employee is currently able to receive the taxable compensation does not depend on whether the compensation has been constructively received for purposes of §451. An election must be irrevocable after the beginning of the period for which the qualified transportation fringes will be provided. However, unused amounts can be carried over to any subsequent months, including months in subsequent years, but cannot be used for any purpose other than permitted qualified transportation fringes under §132(f).

*Example:* An employee elects a monthly compensation reduction of \$200 to be used to reimburse qualified parking expenses. The employee incurs only \$150 in qualified parking expenses for that month. The \$50 in compensation reduction that exceeds the expenses can be rolled over and made available to reimburse parking expenses incurred in a future month. In no case, however, may the employer provide a refund of the amount by which the employee's compensation reduction amount exceeds the actual qualified transportation fringes provided to the employee by the employer.<sup>416</sup>

An employer may provide under its qualified transportation fringe benefit plan that a compensation reduction election is deemed to have been made if the employee does not elect to receive cash compensation in lieu of a qualified transportation fringe (other than qualified bicycle commuting reimbursements), provided that the employee receives adequate notice that a compensation reduction will be made and is given adequate opportunity to choose to receive the cash compensation instead of such qualified transportation fringe.<sup>417</sup>

The employee may not revoke a compensation reduction election after the employee is currently able to receive the cash or other taxable amount at the employee's discretion.<sup>418</sup> Unless an election is revoked in a manner consistent with the rule discussed above, an employee may not subsequently receive the compensation (in cash or any form other than by payment of a qualified transportation fringe under the employer's plan).<sup>419</sup> Thus, an employer's qualified transportation fringe benefit plan may not provide that an employee who ceases to participate in the employer's plan (such as in the case of termination of employment) is entitled to receive a refund of the amount by which the employee's compensation reductions exceed the actual amount provided to the employee.<sup>420</sup> In addition, a termi-

be includible in the employee's wages for income and employment tax purposes.

<sup>416</sup> Reg. §1.132-9, Q&A-14. For more discussion of the use of compensation reduction arrangements to provide qualified transportation fringe benefits, see IRS Info. Letter 2010-0146.

<sup>417</sup> Reg. §1.132-9(b), Q&A-12(b). The regulation, cross-referencing Reg. §1.401(a)-21, allows for the use of electronic media to deliver and make participant elections. T.D. 9294, 71 Fed. Reg. 61,877 (Oct. 20, 2006).

<sup>418</sup> Reg. §1.132-9(b), Q&A-14(c). In addition, the election may not be revoked after the beginning of the period for which the qualified transportation fringe will be provided.

<sup>419</sup> Reg. §1.132-9(b), Q&A-14(d).

<sup>420</sup> Reg. §1.132-9(b), Q&A-14(b); IRS Info. Letter 2019-0002 (unused transportation benefits are forfeited when employee terminates employment, either voluntarily or as a result of an involuntary termination); IRS Info. Letter

nated employee cannot use the funds for continued transportation expenses.<sup>421</sup>

In Rev. Rul. 2004-98, an employer implemented a payroll arrangement under which the amount of its employees' cash compensation was reduced in return for employer-provided parking. In addition, the employer reimbursed employees for parking expenses in amounts that caused employees' net after-tax pay to be the same amount as if there was no compensation reduction. The employer argued that the compensation reduction amounts and the "reimbursement" payments were excludible from employees' gross incomes and were not subject to employment taxes or federal income tax withholding.

The IRS ruled that the employer cannot exclude parking reimbursements from income and wages for employment tax and income tax withholding purposes when the parking has already been paid for by the employee on a pre-tax basis, explaining that an employee may exclude from gross income employer reimbursements for qualified parking expenses, but only if those expenses were actually incurred by the employee. If an employee is given a choice between cash compensation or an employer-provided benefit under a statutory exception to the constructive receipt rules such as §132(f)(4), or if an employer unilaterally reduces an employee's cash compensation for the purpose of providing a nontaxable benefit, the benefit is treated as provided directly by the employer rather than purchased by the employee with the amount of the compensation reduction.

In Rev. Rul. 2004-98, the value of the benefit was excludible from an employee's gross income under §132(a)(5) because (1) the cost of providing the parking was incurred by the employer, not the employee; and (2) the parking was on or near the employer's business premises and the benefit was provided by the employer. However, employees incurred no expense for the employer to reimburse, and therefore, the "reimbursement" payments that the employer made to employees were not excludible from gross income under §132(a)(5). Because the "reimbursement" payments were not reimbursements of expenses incurred by employees for parking, it was unreasonable for the employer to believe at the time the "reimbursements" were paid that employees would be able to exclude the payments from gross income under §132(a)(5). Thus, the IRS ruled that the "reimbursement" payments could not be excluded from employees' wages for FICA, FUTA, or income tax withholding purposes under §3121(a)(20), §3306(b)(16), or §3401(a)(19), respectively. The IRS added that the conclusion would be the same if the employer originally provided free parking to employees and then, upon implementing the payroll arrangement, purported to impose a charge on employees for parking,<sup>422</sup> and regardless of whether the compensation reduction was mandatory or elective.<sup>423</sup>

2003-0244 (terminated employee not entitled to refund of unused benefit account balance).

<sup>421</sup> See IRS Info. Letter 2019-0002.

<sup>422</sup> The IRS cited Rev. Rul. 2002-3, in which it ruled that the purported reimbursement of health insurance premiums paid by the employer and not by employees is not excludible from the employees' gross incomes under §106(a) and §105(b).

<sup>423</sup> Rev. Rul. 2004-98. See also IRS Info. Letter 2005-0059 (although value of parking was excludible by employees under §132(a)(5), employer's reimbursement payments to employees were not excludible because employees incurred no parking expenses), IRS Info. Letter 2004-0201 (because employer's

#### (4) Permissible Recipients and Discrimination

Qualified transportation fringes may be provided by employers only to employees. For this purpose, employees are individuals who are employees as defined under Reg. §1.132-1(b)(2)(i), which includes common law employees and other statutory employees, such as corporate officers.<sup>424</sup>

In an apparently revenue-driven departure from the rules that apply to the other general categories of §132 fringe benefits, §132(f)(5)(E) specifically provides the discriminatory rule that a self-employed person, as defined by §401(c)(1), is not an employee for purposes of the qualified transportation fringe benefit rules.<sup>425</sup> Therefore, partners, 2% shareholders of S corporations, sole proprietors, and independent contractors are not employees for purposes of §132(f). An individual who is both a 2% shareholder of an S corporation and an officer or a common law employee of that S corporation also is not considered to be an employee for purposes of §132(f).<sup>426</sup>

*Note:* The special exclusivity rule of §132(f) that precludes employees entitled to exclude qualified transportation fringes from claiming any excess amounts as working condition or de minimis fringes also does not apply to partners and others who are not treated as "employees" for purposes of the qualified transportation fringe benefit rules. Accordingly, such individuals may (as discussed below) be able to exclude certain transportation, parking and other benefits as working condition or de minimis fringes.<sup>427</sup>

An employee may receive qualified transportation fringe benefits from more than one employer. However, all employees treated as employed by a single employer under §414(b), §414(c), §414(m), or §414(o) are treated as employed by a single employer for purposes of §132(f). Thus, an employer cannot use payments by related entities to avoid the statutory transportation fringe benefit ceilings. But, an employee of one corporation that is part of a controlled group of corporations may, under certain circumstances, be eligible to receive qualified transportation fringes from another corporation within the controlled group.<sup>428</sup> The statutory dollar limitations with respect to that employee are not, however, increased under this rule.<sup>429</sup> In addition, an individual who is treated as a leased employee of an employer under §414(n) is treated as an employee of that employer for purposes of §132.<sup>430</sup>

Qualified transportation fringes need not satisfy any general nondiscrimination requirements. However, the benefits are effectively limited by the dollar limitations of §132(f)(2).<sup>431</sup>

parking plan was similar to that described in Rev. Rul. 2004-98, employer's parking reimbursement payments to employees were not reimbursements of parking expenses incurred by employees, and, therefore, reimbursements were not excludible from employees' income under §132(a)(5).

<sup>424</sup> Reg. §1.132-9(b), Q&A-5; Notice 94-3, Q&A-5b.

<sup>425</sup> §132(f)(5)(E). See discussion at II.B.4.a.(2).

<sup>426</sup> Reg. §1.132-9(b), Q&A-5, Q&A-24(a); Notice 94-3, Q&A-5(b).

<sup>427</sup> Reg. §1.132-9(b), Q&A-24(b), (c).

<sup>428</sup> Reg. §1.132-9(b), Q&A-10; Notice 94-3, Q&A-2c.

<sup>429</sup> Reg. §1.132-9(b), Q&A-10(a).

<sup>430</sup> Reg. §1.132-9(b), Q&A-10(a).

<sup>431</sup> See discussion at II.B.5.e.(3).

(5) *Special Rules and Specific Benefits*(a) *Commuting in an Employer-Provided Commuter Highway Vehicle*

Under §132(f)(1)(A), employees may exclude an inflation adjusted amount of benefits in the form of commuting in an employer-provided commuter highway vehicle. However, amounts paid by an employer for employer-provided commuter highway vehicle transportation benefits must be combined with any benefits provided by the employer for transit passes, may not be provided in addition to any qualified bicycle commuting reimbursement (the exclusion for which is suspended from 2018 through 2025), but may be provided in addition to any excluded parking benefit. The amount for transit passes and commuter highway vehicle transportation benefits is the same as the exclusion amount for qualified parking benefits.<sup>432</sup> Thus, if the benefits provided exceed the ceiling, only the excess per month is includible in income.

Employer- or employee-operated vanpool transportation qualifies for the exclusion if it is furnished in a commuter highway vehicle.<sup>433</sup> A commuter highway vehicle is defined as any highway vehicle that seats at least six adults (not including the driver) and at least 80% of the mileage use of which can reasonably be expected to be for purposes of transporting employees in connection with travel between their residences and their place of employment using at least one-half of the adult seating capacity of the vehicle (not including the driver).<sup>434</sup>

Private or public transit-operated vanpool transportation may qualify for the exclusion, too. Here, public transit authorities or a person in the business of transporting persons for compensation or hire owns or operates the vanpool. Like a commuter highway vehicle, the van must seat at least six adults (not including the driver). However, the requirements that 80% of the mileage use be for purposes of transporting employees and that the vehicle be used on trips during which the number of employees transported for such purposes be at least one-half of the adult seating capacity (not including the driver) do not apply.<sup>435</sup> Although neither the I.R.C. or regulations explicitly state

<sup>432</sup> §132(f)(2)(A), as amended by the Protecting Americans From Tax Hikes Act of 2015, Pub. L. No. 114-113, Div. Q, §105. Effective retroactively for months after December 31, 2014, the 2015 Act permanently amended §132(f)(2)(A) so that the maximum amount of qualified parking, and the aggregate of employer-provided transit passes and transportation in a commuter highway vehicle, excludible from an employee's gross income are the same. For the monthly limitations under §132(f)(2)(A) on the aggregate fringe benefit exclusion amount for transportation in a commuter highway vehicle and any transit pass in current and past years, see Worksheet 10 of this Portfolio.

<sup>433</sup> §132(f)(5)(D); Reg. §1.132-9(b), Q&A-2. See IRS Info. Letter 2014-0028.

<sup>434</sup> §132(f)(5)(B); Reg. §1.132-9(b), Q&A-2. See IRS Info. Letter 2002-0113 (when vanpool vehicle does not meet definition of commuter highway vehicle in §132(f)(5)(B), value of benefit or reimbursement of costs to employee by employer is not qualified transportation fringe benefit and must be included in employee's gross income). For 2020, if the employer reasonably expected the vehicle to meet the mileage and seating capacity percentage tests at the beginning of the calendar year, then the value of van pool transportation and cash reimbursements to employees for expenses incurred in connection with an employee-operated van pool could be excluded from the employee's gross income as a qualified transportation fringe if the other §132(f) requirements were met. IRS, Frequently Asked Question about COVID Relief for Van Pools, <https://www.irs.gov/newsroom/frequently-asked-question-about-covid-relief-for-van-pools>.

how to determine who "operates" a vanpool, the IRS considers relevant factors to this determination to include who drives the van, who determines the route, who determines the pick-up and drop-off locations and times and who is responsible for administrative details. The fact that an individual receives a transit pass to purchase van pool transportation does not, alone, necessarily signify that the van pool is private or publicly operated.<sup>436</sup>

Transportation in an employer-provided commuter highway vehicle may be valued under the general valuation rules of Reg. §1.61-21(b) or under the following special valuation rules:

- the automobile lease valuation rule in Reg. §1.61-21(d);
- the vehicle cents-per-mile rule in Reg. §1.61-21(e); or
- the commuting valuation rule in Reg. §1.61-21(f).<sup>437</sup>

Employer- and employee-operated van pools, as well as private or public transit-operated van pools, may qualify as qualified transportation fringes.<sup>438</sup> Employers may purchase or lease such vehicles to enable employees to commute together or may contract with and pay a third party to provide the vehicles, maintenance, and liability insurance. Cash reimbursements by an employer to employees for transportation in a van pool operated by employees independent of their employer are excludible, provided the van qualifies as a commuter highway vehicle.<sup>439</sup>

(b) *Transit Passes*

Under §132(f)(1)(B), employees may exclude up to the current exclusion ceiling of benefits provided for transit passes. The ceiling amount is further adjusted for inflation,<sup>440</sup> but must be combined with any benefits provided for commuting in employer-provided commuter highway vehicles,<sup>441</sup> but may be provided in addition to any excluded parking benefit.<sup>442</sup> If the benefits provided exceed the ceiling, only the excess over the applicable ceiling amount per month is includible in income.<sup>443</sup>

<sup>435</sup> IRS Info. Letter 2016-0004 (to establish private or public transit-operated van pool, either public transit authorities or person in business of transporting persons for compensation or hire must own and operate van pool); IRS Info. Letter 2014-0028. See also IRS Info. Letter 2015-0041 (whether vanpool is employee-operated or private transit-operated is factual question).

<sup>436</sup> IRS Info. Letter 2015-0004.

<sup>437</sup> Reg. §1.132-9(b), Q&A-21(e); Notice 94-3, Q&A-9(a)(ii). For example, under Reg. §1.61-21(f)(3), the value of commuting in an employer-provided vehicle is \$1.50 per 1-way commute (\$3.00 per round trip). The regulation further provides that if more than one employee commutes in a vehicle, the amount includible is \$1.50 per employee per 1-way commute.

<sup>438</sup> Reg. §1.132-9(b), Q&A-21(b) and (d).

<sup>439</sup> Reg. §1.132-9(b), Q&A-16(a) and Q&A-21. Notice 94-3, Q&A-9.

<sup>440</sup> §132(f)(2)(A), as amended by the Protecting Americans From Tax Hikes Act of 2015, Pub. L. No. 114-113, Div. Q, §105. Effective retroactively for months after December 31, 2014, the 2015 Act permanently amended §132(f)(2)(A) so that the maximum amount of qualified parking, and the aggregate of employer-provided transit passes and transportation in a commuter highway vehicle, excludible from an employee's gross income are the same. For the current and previous amounts, see Worksheet 10 of this Portfolio.

<sup>441</sup> §132(f)(2)(A). Transit passes could not be provided in addition to any qualified bicycle commuting reimbursement. §132(f)(5)(F)(iii)(II), repealed by OBBA, Pub. L. No. 119-21, §70112(a)(4).

<sup>442</sup> §132(f)(2)(A); Reg. §1.132-9(b), Q&A-7.

<sup>443</sup> Reg. §1.132-6(d)(4). See discussion at II.B.2.d.(4)(d). This differs from the result under the de minimis transit pass exclusion, where, if the value of transit passes provided exceeded \$21 per month, the entire value of the benefit was included in income. Reg. §1.132-9(b), Q&A-9(d) Ex. 6, illustrates that in determining the value of a transit pass sold at a discount for purposes of

A transit pass is defined as any pass, token, farecard, voucher or similar item (including an item exchangeable into fare media) entitling a person to transportation (or transportation at a reduced price) if such transportation is on mass transit facilities (whether or not publicly owned) or provided by any person in the business of transporting persons for compensation or hire if such transportation is provided in a vehicle that has the capacity to seat at least six adults (excluding the driver).<sup>444</sup> Types of transit facilities that may qualify for the exclusion include, for example, rail, bus and ferry.<sup>445</sup>

*Note:* There are no substantiation requirements if the employer distributes transit passes.<sup>446</sup> Thus, an employer may distribute a transit pass for each month with a value not exceeding the applicable monthly limit without requiring any certification from the employee regarding the use of the transit pass.

IRS guidance describes the circumstances under which a form of electronic media (such as smartcards, debit cards or credit cards) is a transit, thus rendering the value of transit benefits provided by an employer to its employees through the use of such media nontaxable. If the employer distributes the electronic media in-kind to employees, the value stored on the electronic media must only be usable as fare media for a public transit system and the amount allocated to each employee must be within the maximum allowable dollar amount.<sup>447</sup> The same is true for the value of fare media provided by an employer to its employees through the use of terminal-restricted debit cards that can be used only at merchant terminals at points of sale at which only fare media for a public transit system can be purchased, again provided that the amount allocated to each employee's debit card each month is within the maximum allowable dollar amount.<sup>448</sup> Transit benefits provided to employees via merchant category code (MCC) restricted debit cards may also be excludible, provided that the use of the card is restricted so that all purchases from any merchant in the area with an acceptable MCC that sells items other than fare media are blocked.<sup>449</sup>

*Example:* Employer (E) provides employees with transit benefits in an amount not exceeding the statutory monthly limit by making monthly payments to the local transit system (T), which T then electronically allocates to each employee's smartcard. Amounts stored on the smartcards are usable only as fare media or to purchase fare media. Because the smartcards qualify as transit passes, and because amounts allocated to the smartcards do not exceed the monthly limit, the value of fare media provided by E to each employee is excluded from the employee's gross income, and is excluded from wages for FICA, FUTA and income tax withholding. The result would be the same if E instead provided transit benefits by distributing to each employee a terminal-restricted debit card that can only be

used at merchant terminals at points of sale at which only fare media for local transit systems can be purchased.

*Example:* Same facts as above, except that E provides employees with transit benefits by distributing to each employee a debit card that can be used only at merchants that have been assigned a merchant category code (MCC) indicating that the merchant sells fare media. The merchant may or may not sell other merchandise. A voucher or similar item exchangeable only for a transit pass is not otherwise readily available for purchase by E for direct distribution to E's employees. The MCC-restricted debit card does not qualify as a transit pass because amounts stored on the cards are usable to purchase items other than fare media. E may therefore use the MCC-restricted debit cards to provide employees with transit benefits only if it uses the debit cards to provide employees with reimbursements for their transit expenses pursuant to a bona fide reimbursement arrangement.

*Example:* Same facts as above, except that the MCC-restricted debit cards contain additional restrictions that effectively prohibit employees from using the cards to purchase any items other than fare media for use on local transit systems. The value of the fare media provided by E to its employees through the MCC-restricted debit cards is excluded from its employees' income as a qualified transportation fringe benefit without requiring the employees to substantiate the use of the debit card. The value of the fare media is also excluded from wages for FICA, FUTA and income tax withholding.

In the case of transit passes provided to an employee, the applicable monthly limit applies to the transit passes provided by the employer to the employee in a month for that month or for any previous month in the calendar year.<sup>450</sup>

The value of transit passes provided in advance to an employee with respect to a month in which the individual is not an employee is included in the employee's wages for income tax purposes.<sup>451</sup>

Transit passes distributed in advance to an employee are excludible from wages for employment tax purposes under §3121, §3306, and §3401 (FICA, FUTA and income tax withholding) if the employer distributes transit passes to the employee in advance for no more than three months (such as for a calendar quarter) and, at the time the transit passes are distributed, there is no established date on which the employee's employment will terminate (e.g., if the employee has given notice of retirement) that will occur before the beginning of the last month of the period for which the transit passes are provided.<sup>452</sup>

<sup>444</sup> §132(f), the purchase price, rather than the face amount, of the transit pass controls.

<sup>445</sup> §132(f)(5)(A); Reg. §1.132-9(b), Q&A-3.

<sup>446</sup> H.R. Conf. Rep. No. 1018, 102d Cong., 2d Sess. at p. 395.

<sup>447</sup> Reg. §1.132-9(b), Q&A-18.

<sup>448</sup> Rev. Rul. 2014-32 (Situation 1), *modifying and superseding* Rev. Rul. 2006-57.

<sup>449</sup> Rev. Rul. 2014-32 (Situation 2).

<sup>450</sup> Rev. Rul. 2014-32 (Situations 5 and 7).

<sup>451</sup> Reg. §1.132-9(b), Q&A-9(b). The applicable monthly limit may be calculated by taking into account the monthly limits for all months in which the transit passes are distributed. In the case of a pass that is valid for more than one month, such as an annual pass, the value of the pass may be divided by the number of months for which it is valid for purposes of determining whether the value of the pass exceeds the statutory monthly limit.

<sup>452</sup> Reg. §1.132-9(b), Q&A-9(c)(1).

<sup>453</sup> Reg. §1.132-9(b), Q&A-9(c)(2).

*Example:* Employer (S) has a qualified transportation fringe benefit plan under which its employees receive transit passes near the beginning of each calendar quarter for that calendar quarter. All employees of S receive transit passes from S with a value of \$300 on March 31 for the second calendar quarter covering the months April, May and June (of a year in which the statutory monthly transit pass limit is \$100). Employee T, an employee of S, terminates employment with S on May 31. There was no established termination date for Employee (T) at the time the transit passes were distributed. Because the value of the transit passes may be calculated by taking into account the monthly limits for all months for which the transit passes are *distributed*, the value of the transit passes (three months  $\times$  \$100 = \$300) is excludible from the employees' wages for income and employment tax purposes. At the time the transit passes were distributed there was no established termination for T; therefore, the value of the transit passes provided for June (\$100) is excludible from T's wages for employment tax purposes but is not excludible from T's wages for *income* tax purposes, because Reg. §1.132-9(b), Q&A-9(c)(1), provides that the value of the transit passes provided in advance to an employee with respect to a month in which the individual is not an employee is included in the employee's wages for income tax purposes.

If the employer distributes transit passes to an employee in advance for not more than three months and at the time the transit passes are distributed there is an established date on which the employee's employment will terminate, and the employee's employment terminates before the beginning of the last month of the period for which the transit passes are provided, the value of transit passes provided for months beginning after the date of termination during which the employee is not employed by the employer is included in the employee's wages for employment tax purposes.<sup>453</sup> Therefore, in the example above, if T's May 31 termination date was established at the time the transit passes were provided, the value of the transit passes provided for June (\$100) would be included in T's wages for both income and employment tax purposes.

If transit passes are distributed in advance for more than three months, the value of the transit passes provided for the months during which the employee is not employed by the employer is includible in the employee's wages for employment tax purposes, regardless of whether at the time the transit passes were distributed, there was an established termination date.<sup>454</sup>

*Example:* Employer (F) has a qualified transportation fringe benefit plan under which its employees receive transit passes semi-annually in advance of the months for which the transit passes are provided. All employees of F, including Employee (X), receive transit passes from F with a value of \$600 on June 30 for the 6 months of July through December (of a year in which the monthly transit pass limit is \$100). X's employment terminates and

his last day of work is August 1. Employer F's other employees remain employed throughout the remainder of the year. The value of the transit passes provided to X for the months of September, October, November and December ( $\$100 \times 4$  months = \$400) of the year is included in X's wages for income and employment tax purposes. The value of the transit passes provided to F's other employees is excludible from the employees' wages for income and employment tax purposes.

*Note:* The de minimis and working condition fringe rules apply for transit passes provided to partners, 2% shareholders of S corporations and independent contractors.<sup>455</sup>

An employer may provide qualified transportation fringes directly or through a bona fide cash reimbursement arrangement.<sup>456</sup> What constitutes a bona fide reimbursement arrangement may vary depending on the facts and circumstances, including the method of payment utilized within the mass transit system.<sup>457</sup> The employer must implement reasonable procedures to ensure that an amount equal to the reimbursement was incurred for transportation in a commuter highway vehicle, transit passes, or qualified parking.<sup>458</sup>

An employee certification at the time of, but not before, reimbursement in either written or electronic form may be a reasonable reimbursement procedure depending on the facts and circumstances.<sup>459</sup> Cash reimbursements for transit passes qualify for the exclusion in general only if employers that make cash reimbursements establish a bona fide reimbursement arrangement (as discussed above) and no voucher or similar item, including a terminal-restricted debit card, that may be exchanged only for a transit pass is readily available for direct distribution by the employer to employees.<sup>460</sup>

<sup>455</sup> Reg. §1.132-9(b), Q&A-24(b). For example, tokens or farecards provided by a partnership to an individual who is a partner that enable the partner to commute on a public transit system (not including privately operated vanpools) are excludible from the partner's gross income if the value of the tokens and farecards in any month does not exceed the dollar amount specified in Reg. §1.132-6(d)(1). However, if the value of a pass provided in a month exceeds the dollar amount specified in Reg. §1.132-6(d)(1), the full value of the benefit provided (not merely the amount in excess of the dollar amount specified in Reg. §1.132-6(d)(1)) is includible in gross income.

<sup>456</sup> §132(f)(3); Reg. §1.132-9(b), Q&A-16(a).

<sup>457</sup> Reg. §1.132-9(b), Q&A-16(c). See Rev. Rul. 2014-32, Rev. Rul. 2006-57; Notice 2010-94 (delaying effective date of Rev. Rul. 2006-57 until January 1, 2012; employers could rely on guidance prior to 2012).

<sup>458</sup> Reg. §1.132-9(b), Q&A-16(c). Reg. §1.132-9(b), Q&A-16(d), provides the following examples of reasonable reimbursement procedures: (1) an employee presents to the employer a parking expense receipt for parking on or near the employer's business premises, the employee certifies that the parking was used by the employee, and the employer has no reason to doubt the employee's certification; (2) an employee either submits a used time-sensitive transit pass (such as a monthly pass) to the employer and certifies that he or she purchased it or presents an unused or used transit pass to the employer and certifies that he or she purchased it and the employee certifies that he or she has not previously been reimbursed for the transit pass. In both cases, the employer has no reason to doubt the employee's certification; (3) if a receipt is not provided in the ordinary course of business (e.g., if the employee uses metered parking or if used transit passes cannot be returned to the user), the employee certifies to the employer the type and the amount of expenses incurred, and the employer has no reason to doubt the employee's certification.

<sup>459</sup> Reg. §1.132-9(b), Q&A-16(c). See Rev. Rul. 2014-32 (Situations 3 and 4), *modifying and superseding* Rev. Rul. 2006-57.

<sup>460</sup> See §132(f)(3) and Reg. §1.132-9(b), Q&A-16(b). See Rev. Rul. 2014-32 (Situation 8), *modifying and superseding* Rev. Rul. 2006-57.

<sup>453</sup> Reg. §1.132-9(b), Q&A-9(c)(2).

<sup>454</sup> Reg. §1.132-9(b), Q&A-9(c)(2).

A voucher or similar item is readily available for direct distribution by the employer to employees if and only if an employer can obtain it from a voucher provider that it:

- does not impose “fare media” charges that cause vouchers to not be readily available,<sup>461</sup> and
- does not impose other restrictions that cause vouchers to not be readily available.<sup>462</sup>

In PLR 201532016, the IRS considered whether, and to what extent, smartcards provided by a city to its employees were subject to federal income and employment taxes. The city purchased discounted annual smartcards for each of its full-time and part-time employees. The smartcards were usable only for transit on mass transit facilities. The city made the smartcards available to all employees at the beginning of each calendar year, and the smartcards expired the following December 31. The city would deactivate the smartcard for any employee who ceased to be eligible for the smartcard if, for example, the employee retired or otherwise discontinued employment. The IRS ruled that, because the smartcards were transit passes under §132(f)(5)(A), the monthly fair market value, up to the applicable statutory monthly limit, of each smartcard was not includible in an employee’s income or subject to employment taxes. Any amount in excess of the statutory monthly limit would be subject to income and employment taxes. The IRS also determined that for the purposes of determining whether the value of the smartcard exceeded the applicable statutory monthly limit, it would attribute one-twelfth of the fair market value of the annual smartcard to each month for which it was valid. Finally, the IRS stated that, provided the smartcard would be deactivated for any employee who ceased to be eligible, the value would not be subject to income or employment taxes for the month during which it was deactivated.

### (c) Qualified Parking

Consistent with long-standing rules that employer-provided parking should not be income to employees, under §132(f)(1)(C), employees may exclude up to the current exclusion ceiling of benefits provided for qualified parking. The monthly limitation is adjusted for inflation.<sup>463</sup> Qualified parking may be provided in addition to the exclusion available for commuter highway vehicle commuting benefits and transit passes.<sup>464</sup>

Qualified parking is defined as parking provided to an employee on or near the business premises of the employer,<sup>465</sup> and also includes parking on or near a location from which the employee commutes to work by mass transit in a commuter highway vehicle or by carpool so that the employee can drive to a satellite parking location and take alternative transportation to work.<sup>466</sup> Qualified parking includes parking for which an employer pays (directly to a parking lot operator or by reimbursement to the employee) or that an employer provides on premises it owns or leases.<sup>467</sup> However, qualified parking does not include (1) the value of parking provided to an employee that is excludible from gross income under §132(a)(3) (as a working condition fringe), or (2) reimbursement paid to an employee for parking costs that is excludible from gross income as an amount treated as paid under an accountable employee expense reimbursement plan.<sup>468</sup>

The need for the special statutory rule appears to have arisen from the concern that employee parking expenses related to commuting, rather than business use of a vehicle, might not otherwise have met the §162 deductibility test for exclusion as a working condition fringe benefit. The statutory exclusion can also be supported by considerations of tax equity (i.e., not discriminating against urban versus suburban and rural workers) and by a view of the employer-provided parking as an amelioration of a burden imposed on the employee (by virtue of the employer’s choice of work location), rather than as a compensatory employee benefit.

However, §132(f)(5)(E) provides that for purposes of the qualified transportation fringe exclusion, the term “employee” does not include a self-employed person as defined in §401(c)(1).

*Comment:* There is some difference of opinion as to the effect of this definitional exclusion relative to commuter parking. A partner and 2% shareholders of S corporations clearly are not entitled to any exclusion for parking as a “qualified transportation fringe.” The IRS has indicated a willingness to accept exclusion of the value of commuter parking which otherwise qualifies as a de minimis fringe for both partners, and 2% shareholders of S corporations.<sup>469</sup> However, the IRS also has taken the position that a self-employed person, such as a partner, is not entitled to any exclusion from income for a commuter parking transportation fringe provided by the partner-

<sup>461</sup> Vouchers are considered to not be readily available if the average annual fare media charges that the employer reasonably expects to incur for transit system vouchers purchased from the voucher provider (disregarding reasonable and customary delivery charges imposed by the voucher provider, e.g., not in excess of \$15) are more than 1% of the average annual value of the vouchers for a transit system. Fare media charges relate only to fees paid by the employer to voucher providers for vouchers. Internal administrative costs do not affect whether vouchers are readily available. See Reg. §1.132-9(b), Q&A-16(b)(5).

<sup>462</sup> Certain nonfinancial restrictions, such as a voucher provider not making vouchers available for purchase at reasonable intervals or failing to provide the vouchers within a reasonable period after receiving payment for the voucher, cause vouchers to not be readily available. In addition, if a voucher provider does not provide vouchers in reasonably appropriate quantities, or in reasonably appropriate denominations, vouchers may not be readily available. See Reg. §1.132-9(b), Q&A-16(b)(6). Any delivery charges incurred by an employer in obtaining transit passes are not taken into account in determining whether vouchers are readily available for direct distribution. Rev. Rul. 2014-32 (Situation 6).

<sup>463</sup> §132(f)(2)(B). For the current and previous amounts, see Worksheet 10 of this Portfolio.

<sup>464</sup> Rev. Proc. 97-57; §132(f)(2)(B).

<sup>465</sup> §132(f)(5)(C); Reg. §1.132-9(b), Q&A-4. The regulations also clarify that parking on or near the employer’s business premises includes parking on or near a work location at which the employee provides services for the employer. In CCA 200105007, the Chief Counsel’s Office advised that an expense reimbursement arrangement that reimburses employees for parking expenses incurred at a non-temporary work location away from the employee’s usual location are qualified transportation fringes so long as the other requirements of §132(f) are satisfied.

<sup>466</sup> §132(f)(5)(C); Reg. §1.132-9(b), Q&A-4(a)(2). The exclusion, however, does not apply to any parking facility or space located on property owned or leased by the employee for residential purposes. Reg. §1.132-9(b), Q&A-4(c).

<sup>467</sup> Notice 94-3; Reg. §1.132-9(b), Q&A-1(d).

<sup>468</sup> Reg. §1.132-9(b), Q&A-4(b). See IRS Info. Letter 2017-0007 (arrangements where employer purchases parking spots from parking vendor and then, in turn, permits employees who wish to use parking spots to pay employer for parking spots using employees’ own after-tax compensation do not meet definition of qualified parking); IRS Info. Letter 2014-0017 (providing overview of taxation of employer-provided parking).

<sup>469</sup> Reg. §1.132-9(b), Q&A-24(c) and (d); Notice 94-3, Q&A-7b.

ship.<sup>470</sup> This interpretation means that, for example, the full value of commuter parking paid for by the partnership and which did not satisfy the de minimis fringe exclusion tests would be included in the income of each partner. Under a second interpretation, because former §132(h)(4) was merely a safe harbor, in the absence of any statutory rule specifically requiring partners to include the value of parking in income, partners should continue to be entitled to exclude the full value of parking from income but would do so under the rule applicable to working condition fringes. This latter interpretation is consistent with the approach of the 1984 Act, which was to codify much of what had been historical practice and existing law (under long-standing perception paid parking was not income)<sup>471</sup> and gains certain support from Notice 94-3.<sup>472</sup>

It is also at least open to argument that the repeal of the special former §132(h)(4) parking rule necessarily effected a repeal of the special limitations imposed in connection with that rule. This, in turn, obsoleted not only Reg. §1.132-5(p), which implemented the working condition parking exclusion, but also the Reg. §1.132-1(b) definition of “employee” as it applies to parking provided to independent contractors, who should not be prevented from treating parking that otherwise satisfies the working condition fringe as excludible. The IRS has not indicated a willingness to go so far. However, in Notice 94-3, the IRS indicated that an independent contractor could exclude the value of parking that otherwise qualified as a de minimis fringe.<sup>473</sup>

Although the 1992 Energy Act eliminated the unlimited exclusion available under the special rule of former §132(h)(4) (i.e., the working condition fringe exclusion for commuter parking), the working condition and de minimis fringe exclusions remain available to partners and independent contractors to the extent such parking is not commuter parking. Thus, for example, if a partner performing services for a partnership or as a director of a corporation would be able to deduct the cost of parking as a trade or business expense under §162, the value of free or reduced-cost parking also would be excludible as a working condition fringe. The de minimis fringe rules also remain available for parking provided to partners, 2% shareholders of S corporations and independent contractors.<sup>474</sup>

The valuation rules of Reg. §1.61-21(b) apply in determining whether the amount of qualified transportation fringes exceeds the excludible amount and for determining the actual amount (if any) includible in income. Generally, the value of qualified parking provided by an employer to an employee is based on the cost (including taxes or other added fees) that an individual would incur in an arm’s-length transaction to obtain comparable parking privileges at the same site. If that cost is not ascertainable, the value of the qualified parking is based on the cost that an individual would incur in an arm’s-length transaction for a space in the same lot or a comparable lot in

the same general location under the same or similar circumstances.<sup>475</sup>

An employee’s subjective perception of the value of the qualified parking is not relevant to the determination of its fair market value. The value of the parking subject to tax is the right of access on any given day (or month if monthly rates are available to the public) to such employer-provided parking and not the actual use of the parking by the employee. Qualified employer-provided parking that is available primarily to customers of the employer, free of charge, is deemed to have a fair market value of \$0. This rule does not apply, however, if an employer maintains preferential reserved spaces for employees. A reserved space is preferential if it is more favorably located than the spaces available to the employer’s customers.<sup>476</sup>

The IRS also has a special rule for car pools, which it set forth in Notice 94-3. If an employee obtains a qualified parking space as a result of membership in a car or van pool, the monthly limit for qualified parking applies to the individual to whom the parking space is assigned — the “prime member” — who accordingly bears the tax consequences attributable to that space. If the space is not assigned to a particular individual, the employer that provides access to the space must designate one of its employees as the prime member who will bear the tax consequences. The employer of the prime member is responsible for reporting any taxable income, including the value of qualified parking in excess of the monthly limit in the prime member’s income for both income and employment tax purposes. An amount of money (reasonably calculated to cover actual costs, including taxes) received by a prime member from fellow car or van pool members for their share of transporting them to and from work constitutes reimbursement by them for the operation of the vehicle for their mutual convenience. This money is not includible in the gross income of the prime member for federal income tax purposes. Members of a car or van pool are not permitted to combine their parking exclusions for the pool.<sup>477</sup>

The IRS has indicated that an employee is not precluded from rolling unused transit benefit amounts into a separate qualified transportation fringe, such as qualified parking, to the extent it is offered by the employer’s plan and does not exceed the maximum monthly amount for the respective qualified transportation fringe benefit.<sup>478</sup>

#### (d) *Pre-2018 Qualified Bicycle Commuting Reimbursement*

For taxable years 2009 through 2017, employees could exclude from income an amount received as a fringe benefit in the form of their employer’s reimbursements for the employee’s “qualified bicycle commuting reimbursement” as a qualified transportation fringe. The qualified bicycle commuting reimbursement rules applied to reasonable expenses incurred by the

<sup>470</sup> Reg. §1.132-9(b), Q&A-24(c).

<sup>471</sup> Joint Committee Summary at p. 3; Second Discussion Draft, Reg. §1.61-19(b)(2) and §1.61-19(c) *Ex.* (6); First Discussion Draft, Reg. §1.61-16(f) *Exs.* (7), (10). See also discussion at II.A.3., above.

<sup>472</sup> Q&A-7b.

<sup>473</sup> Notice 94-3, Q&A-8.

<sup>474</sup> Reg. §1.132-9(b), Q&A-24(a).

<sup>475</sup> Reg. §1.132-9(b), Q&A-20; Notice 94-3, Q&A-10.

<sup>476</sup> Notice 94-3, Q&A-10.

<sup>477</sup> Reg. §1.132-9(b), Q&A-21(f); Notice 94-3, Q&A-13. Other carpool members may choose to reimburse the costs of the prime member, in which event, under Rev. Rul. 55-555, the reimbursements are not includible in the prime member’s gross income. See 65 Fed. Reg. 4388, 4390, n. 2, also citing Rev. Rul. 80-99.

<sup>478</sup> See, e.g., IRS Info. Letter 2020-0024 (Sept. 25, 2020).

employee for the purchase of a bicycle and bicycle improvements, repair, and storage, provided such bicycle was regularly used for travel between the employee's residence and place of employment.<sup>479</sup>

*Note:* Reimbursement had to be made within the 15-month period beginning with the first day of the calendar year after the expenses were incurred.<sup>480</sup> Additionally, the benefit was relatively unique in that it applied to capital costs (the purchase and improvement of the bicycle) as well as operating expenses. It is not clear, however, particularly in view of the monthly component in determining the annual benefit limitation discussed below, whether to obtain the benefit of such allowance with respect to purchase or improvement costs an employee could carry capital costs forward or must structure the acquisition of the bike on some sort of lease or installment sale basis to take advantage of this unusual provision.

The reimbursement was limited on an annual basis for each calendar year with the annual amount being determined by multiplying \$20 times the number of "qualified bicycle commuting months" in that year. A qualified bicycle commuting month was defined as any month during which such employee regularly used the bicycle for a substantial portion of the travel between the employee's residence and place of employment; and did not receive any benefit for transit passes, parking, and transportation in a commuter highway vehicle.<sup>481</sup> Therefore, seasonal bicycle commuters were effectively limited to reimbursement for the months in which they were actually commuting by bicycle; and, for those months they had to forgo receiving any other qualified transportation fringe (benefits for parking, transit passes, or transportation in commuter highway vehicles). Unlike the other qualified transportation fringes, the \$20 per month limit on the qualified bicycle commuting reimbursement was not inflation adjusted.

Under the regulations generally applicable to all qualified transportation fringes, an employer could pay the reimbursements any time during the calendar year in which an expense was incurred, or during the 3-month period following the end of such calendar year.

However, the benefit may not be funded through employer salary reductions.<sup>482</sup>

*Comment:* A number of terms related to this benefit are unclear. For example, there was no definition of "reasonable expenses," nor was it clear whether "bicycle improvements"

could include helmets or other gear. Similarly, there was no definition of "substantial portion," creating some confusion with respect to employees who commuted partway by bicycle and partway by mass transit or other means. It was unclear how much of the commute had to be completed by bicycle to constitute a "substantial portion" of the commute and entitle the cyclist to the reimbursement.

#### f. Qualified Moving Expense Reimbursements

The reimbursement of employee expenses incurred in a relocation required by the employer is a benefit governed in part by statute following a long period of sometimes contradictory IRS administrative practice.<sup>483</sup> For taxable years beginning after December 31, 2017, qualified moving expense reimbursement is not excluded from income, except for certain active duty military and, after 2025, certain intelligence community employee or new appointee moves.<sup>484</sup> The unavailability of the exclusion applies only to payments or reimbursements for expenses incurred in connection with a move that occurred after December 31, 2017, not to all amounts received directly or indirectly after that date.<sup>485</sup>

*Example 1:* Individual T moved in 2017 and paid the moving expenses in 2017. The moving expenses would have been deductible by T, but T did not claim the deduction. T's employer reimbursed T for the amount of the expenses in early 2018. The reimbursement of the expenses is excludible from income in 2018 as a qualified moving expense reimbursement.

*Example 2:* Individual T moved in 2017. The moving expenses would have been deductible by T if they had been paid by T in 2017. T's employer pays the moving company in 2018 for the moving services provided to T in 2017. The reimbursement of the expenses is excludible from income as a qualified moving expense reimbursement.

The early authorities held that the reimbursement by the employer of moving expenses did not constitute income to an existing employee.<sup>486</sup> IRS opposition to a similar exclusion for new employees<sup>487</sup> eventually resulted in a statutory relief provision, §217, which initially provided that such expenses would be treated as income to new employees, but could be deducted by the employee to the extent they met a statutory test. This approach was later extended to all employees who were then required to include such payments in income under §82.

<sup>479</sup> §132(f)(1)(D), added by Pub. L. No. 110-343, Div. B, §211(a), and repealed by OBBBA, Pub. L. No. 119-21, §70112(a)(1); §132(f)(8), added by TCJA, Pub. L. No. 115-97, §11047, applicable to tax years beginning after December 31, 2017, and repealed by Pub. L. No. 119-21, §70112(a)(5), effective for taxable years beginning after December 31, 2025. While employers could not deduct expenses for transportation and commuting benefits provided to employees for amounts paid or incurred after December 31, 2017, and before January 1, 2026, they could claim deductions for qualified bicycle commuting reimbursements during that period. §274(l)(2), added by TCJA, Pub. L. No. 115-97, §13304(c)(2), and repealed by Pub. L. No. 119-21, §70112(c)(2), effective for taxable years beginning after December 31, 2025.

<sup>480</sup> §132(f)(5)(F)(i), repealed by Pub. L. No. 119-21, §70112(a), effective for taxable years beginning after December 31, 2025.

<sup>481</sup> See §132(f)(5)(F)(iii), repealed by Pub. L. No. 119-21, §70112(a), effective for taxable years beginning after December 31, 2025.

<sup>482</sup> See, e.g., IRS Info. Letter 2013-0032 (Sept. 27, 2013) (allowing bike share programs to qualify as a pre-tax benefit under §132 would require legislative action).

<sup>483</sup> See generally 594 T.M., *Tax Implications of Home Ownership*.

<sup>484</sup> §132(g)(2), added by TCJA, Pub. L. No. 115-97, §11048, and amended by OBBBA, Pub. L. No. 119-21, §70113(c)-(d), effective for taxable years beginning after December 31, 2025. Qualified moving expense reimbursement is still excludible from income for a member of the Armed Forces on active duty who moves pursuant to a military order and incident to a permanent change in station or, for taxable years beginning after 2025, an employee or new appointee of the intelligence community (other than a member of the Armed Forces of the United States) who moves pursuant to a change in assignment that requires relocation. §132(g)(2).

<sup>485</sup> Notice 2018-75.

<sup>486</sup> Rev. Rul. 54-429; *England v. United States*, 345 F.2d 414 (7th Cir. 1965). Cf. Rev. Rul. 63-258 (special evacuation allowances).

<sup>487</sup> Rev. Rul. 55-140, *obsoleted* by Rev. Rul. 72-619; *United States v. Woodall*, 255 F.2d 370 (10th Cir. 1958).

Revenue considerations led to an overhaul of §217 in 1993, which, among other things, narrowed the allowable costs by eliminating deductions provided for a number of previously allowable moving expense items including the cost of pre-move house hunting trips, temporary living expenses, meals on house hunting trips or while living in temporary quarters, and settlement costs related to the sale of (or lease termination with respect to) an old residence and buying (or leasing) a new residence. Similarly, brokerage fees, property taxes, insurance, fix up expenses, and reimbursement for losses with respect to the sale of prior home are also includible in employee income if paid by the employer.<sup>488</sup>

To ease the reporting burden caused by the §82 requirement that moving expenses be included in income only to be deducted above the line pursuant to §217, the Revenue Reconciliation Act of 1993 added qualified moving expense reimbursements as a sixth general category of excludible benefits under §132(a).<sup>489</sup> As defined under §132(g), this includes any amount an individual receives (directly or indirectly) from an employer as a payment for (or reimbursement of) moving expenses that the individual could deduct under §217 (as narrowed by the 1993 RRA) if those expenses had been paid or incurred directly. To prevent timing abuses, §132(g) explicitly excludes any payment for (or reimbursement of) an expense that the individual deducted in a prior taxable year. However, an employer has no obligation to determine whether the employee deducted the expenses.<sup>490</sup> Accordingly, an employer should treat qualifying moving expenses as excludible unless it has actual knowledge that the employee deducted the expenses in a prior year.<sup>491</sup> The employer must treat the payment of moving expenses reimbursements in excess of the narrowed §217 definition as income to individual recipients.<sup>492</sup>

#### g. Qualified Retirement Planning Services

Qualified retirement planning services provided to an employee and his or her spouse by an employer maintaining a qualified plan are excludible from income and wages under §132(a)(7).<sup>493</sup> Section 132(m)(1) provides that the term “qualified retirement planning services” means any retirement planning advice or information provided to an employee and his spouse by an employer maintaining a qualified employer plan. For purposes of this rule, the term “qualified employer plan” means a plan, contract, pension or account described in §219(g) (5) (which includes qualified plans under §401(a), governmental plans, an annuity plan described in §403(a), an annuity contract described in §403(b), SEPs, and SIMPLE retirement accounts).<sup>494</sup>

The exclusion is not limited to information regarding the qualified plan, and, thus, for example, applies to advice and in-

formation regarding retirement income planning for an individual and his or her spouse and how the employer’s plan fits into the individual’s overall retirement income plan. On the other hand, the exclusion does not apply to more general financial services that may be related to or implement the retirement planning, such as tax preparation, accounting, legal or brokerage services.<sup>495</sup>

Section 132(m)(2) provides that the exclusion does not apply with respect to highly compensated employees unless the services are available on substantially the same terms to each member of the group of employees normally provided education and information regarding the employer’s qualified plan.<sup>496</sup>

#### h. Qualified Military Base Realignment and Closure Fringe

In 2003, Congress passed the Military Family Tax Relief Act<sup>497</sup> and added the 8th and currently last item on the list of general exclusions set forth in subsection (a) of §132. The provision excludes from gross income certain housing assistance payments (HAP) made with respect to military base realignment and closures.

The implementing provisions are relatively brief and include only two limitations. The first and most important limitation arises under the §132(n)(1) definitional provision, because under §132(a)(8), payments are excluded from gross income only if they are “qualified military base realignment and closure fringe” payments as defined under §132(n)(1). That provision, in turn, defines excluded payments by cross-reference to §1013 of the Demonstration Cities and Metropolitan Development Act of 1966 (“§3374 Payments”).<sup>498</sup>

Section 3374 was already in effect when MFTRA was enacted and sets forth a number of substantive criteria for applicable housing assistance payments. Moreover, pursuant to §3374, the Department of Defense (“DoD”) created a Homeowner’s Assistance Program to administer payments under §3374.<sup>499</sup>

<sup>495</sup> See H.R. Conf. Rep. No. 84, 107th Cong., 1st Sess. 188–189. See also discussion at II.B.2.a.(4)(i).

<sup>496</sup> In a ruling following the addition of the qualified retirement planning services exclusion to §132 by the 1993 RRA, the IRS considered whether the fair market value of financial counseling services provided to survivors of deceased eligible employees and family members of eligible employees diagnosed with a terminal illness could be excluded. The Service’s analysis ignored §132(a)(7), and proceeding entirely under §132(a)(3) applicable to working condition fringes, concluded that under Reg. §1.132-1(b)(2), such services could not be excluded from gross income as a working condition fringe because of the narrower definition of “employee” for purposes of such provision. PLR 199929043.

<sup>497</sup> “MFTRA” Pub. L. No. 108-121, §103, 117 Stat. 1135, 1137–38. The provision was originally introduced in the Foreign and Armed Services Tax Fairness Act of 2002, which was amended and renamed the Armed Services Tax Fairness Act of 2002, which passed both Houses of Congress but was never signed by the President.

<sup>498</sup> 42 U.S.C. §3374 (amended by American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5 §1001, 123 Stat. 115, 194–98), as amended (“ARRA §3374”). The authors gratefully acknowledge the research assistance of George C. Adams and Adam M. Wenner in connection with the discussion of MFTRA and ARRA.

<sup>499</sup> DoD Directive 4154.50E (2004). DoD Homeowners Assistance Program Frequently Asked Questions; see also <https://www.usace.army.mil/Missions/Military-Missions/Real-Estate/HAP/>.

<sup>488</sup> IRS Executive Compensation — Fringe Benefits Audit Techniques Guide (02-2005) (“Audit Guide”).

<sup>489</sup> §132(a)(6), added by Pub. L. No. 103-66, §13213(d).

<sup>490</sup> H.R. Rep. No. 213, 103d Cong., 1st Sess. 103 (1993).

<sup>491</sup> Guidance on how employers report qualified moving expense reimbursements on an employee’s Form W-2 are provided in the Instructions to Form W-2.

<sup>492</sup> §82. See discussion of excess moving expense reimbursements at IV.A.8.

<sup>493</sup> See §132(a)(7), added by Pub. L. No. 107-16, §665(a).

<sup>494</sup> §132(m)(3).

*(1) Historical Exclusion of Payments**(a) Eligibility for Traditional Base Realignment or Closure Payments, Historically*

Under §132(n)(1) as initially enacted, the definition of “qualified military base realignment and closure fringe” created two substantive limitations on the §132(a)(8) gross income exclusion for §3374 Payments. Section 132(n)(1) provided the following definition:

The term “qualified military base realignment and closure fringe” means 1 or more payments under the authority of section 1013 of the Demonstration Cities and Metropolitan Development Act of 1966 (42 U.S.C. 3374) [1] *(as in effect on the date of the enactment of this subsection)* [and 2] *to offset the adverse effects on housing values as a result of a military base realignment or closure.* [Emphasis added.]

Thus, the first definitional requirement was that the payment be made under the authority of §3374 as such section was in effect on November 11, 2003, the date of enactment of MFTRA (the “§3374 Conformity Requirement”). The second definitional limitation was that the §3374 Payments had to have been made to offset an adverse effect on housing values as a result of a military base realignment or closure (the “§132 Causal Requirement”).

HAP payments under §3374 as originally effective when MFTRA was enacted (referred to herein as “MFTRA §3374”) came to be referred to as Base Realignment or Closure or “BRAC HAP” payments by HAP officials,<sup>500</sup> and were payments to federal civilian employees, non-appropriated fund instrumentality (“NAFI”) employees, and members of the Armed Forces employed by or assigned to an affected base at the time of the base closure<sup>501</sup> or the announcement of the closure.<sup>502</sup> NAFI employees were defined under Traditional-BRAC HAP and continue to be defined under ARRA §3374 as employees of instrumentalities that are operated for the comfort, pleasure, contentment, or physical or mental improvement of members of the Armed Forces.<sup>503</sup> Although Coast Guard members are not members of the Armed Forces during normal operations, Coast Guard personnel were also eligible for the same HAP payments as members of the Armed Forces eligible for under Traditional-BRAC HAP and continue to be so eligible under ARRA §3374.<sup>504</sup>

Further, Traditional-BRAC HAP applicants were and, under ARRA §3374, must still be employed by or in connection with the affected base and continue to be required to show that a base closure caused either job termination, if the applicant was a federal civilian employee, or prevented reassignment to the base, if the applicant was a military member.<sup>505</sup> Addition-

ally, a Traditional-BRAC HAP applicant must have been and is still required to be the owner-occupant of the affected home and have been required to move or become unemployed as a result of the base closure.<sup>506</sup>

Under MFTRA §3374, the Secretary of Defense was given discretion to determine the eligibility of persons for such HAP payments, the amount to be paid to each applicant, and which military installations met the requirements of the statute.<sup>507</sup>

*(b) Decline in Local Housing Values Requirement*

Additionally, in order to obtain Traditional-BRAC HAP payments, the Secretary of Defense must also have found that the military base closure, or announcement of such a closure, caused a decline in the local housing values (“§3374 Causal Requirement”).<sup>508</sup> This requirement essentially paralleled and reinforced the §132 Causal Requirement provided under §132(n)(1), as quoted and discussed above.

*Comment:* From the enactment of MFTRA through the 2009 ARRA amendments discussed below, the Secretary had only once determined that a base closure announcement caused a decline in the surrounding locality’s housing values, therefore qualifying that locality only for Traditional-BRAC HAP payments under MFTRA §3374.<sup>509</sup>

Both Causal Requirements have now been lifted as discussed below.

*(2) Expansion of Eligibility for Base Realignment or Closure Payments*

In 2009, the American Recovery and Reinvestment Act<sup>510</sup> (ARRA) amended §3374 (as amended “ARRA §3374”) to significantly expand the eligibility for and nature of §3374 Payments. Additionally, Traditional-BRAC HAP payments also remain available, although the eligibility for such HAP payments was also temporarily expanded by removing the §3374 Causal Requirement. This temporary expansion was accomplished by inserting an alternative basis for qualification if the Secretary of Defense determined both that the Traditional-BRAC HAP requirements discussed above (other than the §3374 Causal Requirement) had been met<sup>511</sup> and additionally that:

- (1) the closing or realignment of the base or installation resulted from a realignment or closure carried out under the 2005 round of defense base closure and realignment under the Defense Base Closure and Realignment Act of 1990;<sup>512</sup>
- (2) the applicable property was purchased by the owner before July 1, 2006;

<sup>500</sup>This is the terminology used by HAP officials. It is used here to familiarize the reader with the terminology used by the HAP office or affected personnel who are not generally tax professionals.

<sup>501</sup>Unless otherwise noted, any following reference to a “base closure” also applies to a reduction in scope of operations or realignment of a base.

<sup>502</sup>MFTRA §3374(a)(1), now ARRA §3374(a)(1)(A)(i) and ARRA §3374(a)(1)(B)(i); MFTRA and ARRA §3374(b)(1)(A).

<sup>503</sup>MFTRA §3374(o)(4), now ARRA §3374(p)(4).

<sup>504</sup>MFTRA and ARRA §3374(n).

<sup>505</sup>MFTRA §3374(a)(2), now ARRA §3374(a)(1)(A)(ii); ARRA §3374(a)(1)(B)(ii).

<sup>506</sup>MFTRA and ARRA §3374(b)(4)–(5).

<sup>507</sup>32 C.F.R. §239.4(a) (2009).

<sup>508</sup>MFTRA §3374(a)(3).

<sup>509</sup>The only one eligible base area for Traditional-BRAC HAP payments was Brunswick, ME.

<sup>510</sup>See Pub. L. No. 111-5, §1001 (amending 42 U.S.C. §3374 (2006)).

<sup>511</sup>ARRA §3374(a)(1)(B)(i).

<sup>512</sup>Part XXIX of Pub. L. No. 101-510; 10 U.S.C. §2687.

(3) the applicable property was sold by the owner between July 1, 2006, and September 30, 2012, or an earlier end date designated by the Secretary of Defense;

(4) the applicable property was the primary residence of the owner; and

(5) the owner had not previously received benefit payments authorized under this subsection.<sup>513</sup>

ARRA §3374 also created two new categories of personnel eligibility for §3374 Payments: (i) civilian federal employees and members of the Armed Forces injured while on deployment in support of the Armed Forces and (ii) members of the Armed Forces permanently reassigned to a new base during the 2008 financial crisis.<sup>514</sup>

In the first new category, HAP benefits similar to Traditional-BRAC HAP are now provided without any requirement of base realignment or closure for wounded members of the Armed Forces, Department of Defense and United States Coast Guard civilian employees, and their spouses. Accordingly, the Secretary of Defense is authorized to acquire title to, hold, manage, and dispose of, or, in lieu thereof, to reimburse for certain losses upon private sale of, or foreclosure against, any property improved with a one- or two-family dwelling that was at the time of the relevant wound, injury, or illness, the primary residence of:

(A) any member of the Armed Forces in medical transition who:

(i) incurred a wound, injury, or illness in the line of duty during a deployment in support of the Armed Forces;

(ii) is disabled to a degree of 30 percent or more as a result of such wound, injury, or illness, as determined by the Secretary of Defense; and

(iii) is reassigned in furtherance of medical treatment or rehabilitation, or due to medical retirement in connection with such disability;

(B) any civilian employee of the Department of Defense or the United States Coast Guard who:

(i) was wounded, injured, or became ill in the performance of his or her duties during a forward deployment occurring on or after September 11, 2001, in support of the Armed Forces; and

(ii) is reassigned in furtherance of medical treatment, rehabilitation, or due to medical retirement resulting from the sustained disability; or

(C) The spouse of a member of the Armed Forces or a civilian employee of the Department of Defense or the United States Coast Guard if:

(i) the member or employee was killed in the line of duty or in the performance of his or her duties during a deployment on or after September 11, 2001, in support of the Armed Forces or died from a wound, injury, or

illness incurred in the line of duty during such a deployment; and

(ii) the spouse relocates from such residence within 2 years after the death of such member or employee.

In the second new eligibility category, HAP benefits similar to Traditional-BRAC HAP are now provided without any requirement of base realignment or closure for members of the Armed Forces permanently reassigned during the so-called mortgage crisis at the end of the first decade of the 21st century. Accordingly, the Secretary of Defense is authorized to acquire title to, hold, manage, and dispose of, or, in lieu thereof, to reimburse for certain losses upon private sale of, or foreclosure against, any property improved with a one- or two-family dwelling situated at or near a military base or installation if:

(A) the owner is a member of the Armed Forces serving on permanent assignment;

(B) the owner is permanently reassigned by order of the United States Government to a duty station or home port outside a 50-mile radius of the base or installation;

(C) the reassignment was ordered between February 1, 2006, and September 30, 2012, or an earlier end date designated by the Secretary;

(D) the property was purchased by the owner before July 1, 2006;

(E) the property was sold by the owner between July 1, 2006, and September 30, 2012, or an earlier end date designated by the Secretary;

(F) the property is the primary residence of the owner; and

(G) the owner has not previously received benefit payments authorized under this subsection.

Notably, §3374 payments pursuant to both the relaxation of the §3374 Causal Requirement for Traditional-BRAC HAP payments and the mortgage crisis expansion are limited to properties purchased prior to July 1, 2006, and sold prior to September 30, 2012, in effect prospectively sunsetting those expansions, while the expansion for wounded or ill individuals or surviving spouses is not so limited.

*Comment:* Collectively, the ARRA expansions of §3374 make the §132(a)(8) exclusion's title of "qualified military base realignment and closure fringe" somewhat of a misnomer as base closure or realignment is now not required for two of the three categories of events eligible for HAP payments.

ARRA did not make any change to the original definitional provisions in §132(n)(1) and therefore §132(a)(8) continued after ARRA's enactment to provide an income tax exclusion only for Traditional-BRAC HAP payments under §3374 as it was in effect when §132(n)(1) was enacted on November 11, 2003, therefore including the §3374 Causal Requirement in effect pre-ARRA as well as the §132 Causal Requirement. This created a significant issue with respect to the extent of the §132(a)(8) gross income exclusion to §3374 Payments made under §3374 as amended by ARRA, particularly because when Congress increased the scope and nature of HAP payments in ARRA, it in effect declined to make any corresponding change in §132(n)(1). Accordingly, §132(n)(1) continued to limit the §132(a)(8) exclusion to §3374 Payments under §3374 as in ef-

<sup>513</sup> ARRA §3374(a)(1)(B)(ii) through (vi).

<sup>514</sup> ARRA §3374(a)(2), (3).

fect before the date of enactment of ARRA, thus continuing application for tax purposes of both the MFTRA and the §132 Causal Requirements, i.e., only Traditional-BRAC HAP payments were entitled to tax exclusion.

Further complicating the situation, in May 2009, HAP officials removed the §3374 Causal Requirement (which paralleled the §132 Causal Requirement) from DoD forms for all applications for HAP payments making it impossible for even personnel meeting the Causal Requirements to document such compliance, and therefore putting their eligibility for the tax exclusion at risk.<sup>515</sup>

The oversight of failing to enact a conforming change to §132(n)(1) as part of ARRA was, however, subsequently corrected with retroactive effect in the Worker, Homeownership, and Business Assistance Act of 2009.<sup>516</sup> In it, Congress amended §132(n)(1) to revise the §3374 Conformity Requirement by striking the reference to §3374 “as in effect on the date of enactment of MFTRA” (November 11, 2003) and replacing it with a cross-reference to §3374 “as in effect on the date of enactment of ARRA” (February 18, 2009). Additionally, the legislation struck all the text of original §132(n)(1) following the cross-reference to §3374, which text had imposed the §132 Causal Requirement and pursuant to which a §3374 Payment previously had to be made “to offset an adverse effect on housing values as a result of a military base realignment or closure,” thus eliminating the §132 Causal Requirement for purposes of §132(a)(8).

*Comment:* The foregoing creates an interesting future conundrum. As previously noted, under §3374 as amended, the suspension of the §3374 Causal Requirement with respect to Traditional-BRAC HAP payments is scheduled to expire on October 1, 2012 but excludibility as under §132(n)(1) is now provided for all §3374 Payments without any §132 Causal Requirement and without a date for reversion to the prior rule. Thus, when the §3374 Causal Requirement springs back to life in October 2012 it will apply to Traditional-BRAC HAP payments, notwithstanding that other §3374 Payments such as those for wounded personnel may be permitted under §3374 without documentation of any Causal Requirement under either §3374 or §132.

It is also notable that because §132(n)(1) as amended defines excluded payments under §132(a)(8) as only those payments under §3374 as in effect on the date of the enactment of ARRA (February 18, 2009), by virtue of §132(n)(1), §132(a)(8) will not, without further legislation, apply to any §3374 HAP Payments made pursuant to any further amendment of §3374 that does not also include a further amendment of §132(n)(1).

### (3) *Payment Amounts and Limits*

Individuals eligible for HAP either receive a cash payment as compensation for losses sustained in a private sale or foreclosure of their home, or, alternatively, the Secretary of Defense may choose to purchase the property from the individual

for an amount not to exceed 90% of the fair market value prior to the base closure announcement.<sup>517</sup> If a cash payment is made, the amount may not exceed the difference between: (a) 95% of the prior fair market value of the property and (b) the fair market value of the property at the time of the sale.<sup>518</sup>

Additionally, §132(n)(2) limits the gross income exclusion under §132(a)(8) to the same amounts as are described under ARRA §3374(c).

*Comment:* In summary, the combination of the §132 and §3374 Causal Requirements as well as the additional restrictions placed on eligibility make the military base closure fringe a very limited benefit. Even with the relaxation of these Causal Requirements and expansion of eligibility in ARRA it remains a very limited benefit and seems misplaced as a “general rule” of exclusion under subsection (a) rather than as a special rule located elsewhere under §132.

There is no statutory limitation of recipients and thus the exclusion would appear to apply to any recipient entitled to a payment, irrespective of military or civilian rank. Likewise, there are no special documentation rules, suggesting that the rules generally applicable to maintenance of taxpayer federal tax records would be sufficient.

### 3. *Special Exclusions*

In addition to the general exclusion categories established by §132(a), §132 also contains a number of special rules that provide terms for the exclusion of certain incidental fringe benefits that Congress determined merited full or limited exclusion, but that did not fit the general rules of §132.

#### a. *Cafeterias and Dining Rooms*

An employer’s furnishing of free meals to employees for the employer’s convenience is excluded under long-standing statutory rules embodied in §119. However, unless the meal benefit is exempt under those rules, an employee who receives an employer-provided meal realizes taxable income.<sup>519</sup> Beginning in 2026, employers are not permitted to deduct the cost of meals furnished to employees on the employer’s premises for the employer’s convenience.<sup>520</sup> This change in tax treatment for employers does not affect the excludibility of the benefit to the employees under §119 though.

The more difficult question had been treatment of indirect employer expenses that effectively reduce or subsidize the cost of meals provided to employees in an on-premises dining room

<sup>517</sup> MFTRA and ARRA §3374(c).

<sup>518</sup> MFTRA and ARRA §3374(c).

<sup>519</sup> Reg. §1.61-2(d)(3); Rev. Rul. 71-411. For instance, in TAM 201903017, the National Office advised that snacks provided in an employer’s designated snack areas are not meals prepared for consumption at meal time and, therefore, are not furnished for the convenience of the employer. Accordingly, the value of those snacks are not excludible from the gross income of employees under §119.

<sup>520</sup> §274(o), added by Pub. L. No. 115-97, §13304(d), and amended by OBBBA, Pub. L. No. 119-21, §70305(a), effective for amounts paid or incurred after December 31, 2025. Under a limited exception, employers may deduct expenses for meals that the employer sells in a bona fide transaction for full and adequate consideration (such as sales to employees or meals provided to employees at a restaurant or catering worksite). Another limited exception applies for certain meals provided in the fishing industry. For discussion of these exceptions, see 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses*.

<sup>515</sup> During the hiatus, even Traditional-BRAC HAP payments could no longer satisfy either the §132(n)(1) Causal Requirement or the §3374 Causal Requirement, which was still a component of §3374 as in effect on November 11, 2003.

<sup>516</sup> Pub. L. No. 111-92, enacted November 6, 2009.

or employee cafeteria. The employer costs related to such a facility may be significant and, in part, for this reason the issue has been one of substantial revenue and administrative importance. Employee income consequences of such a benefit had been unclear until the fringe benefit rules included a special rule that treats the provision of qualifying eating facilities as being within the §132(a)(4) de minimis exclusion.

### (1) Requirements for Exclusion

The value of meals provided at a qualifying “employer-operated eating facility” may be excluded by employees as a de minimis fringe benefit. In order to qualify for the exclusion, the eating facility must meet the specific tests of §132(e)(2). Alternatively, if such meals are not excludible, the regulations provide a special meal valuation rule to minimize disputes with respect to amounts includible in employee income as a consequence of the benefit.

Section 132(e)(2) requires that:

- an employer-operated eating facility be located on or near the employer’s business premises; and
- the revenue from the facility’s operations normally equal or exceed the direct operating costs. In addition, the statute imposes a variation of the nondiscrimination rule applicable to discounts and no-additional-cost services, notwithstanding that de minimis fringe benefits are not generally subjected to a nondiscrimination requirement.<sup>521</sup>

The regulations impose a number of additional conditions related primarily to the determination of whether a dining room or cafeteria is an employer-operated eating facility.<sup>522</sup> To qualify, in addition to the foregoing statutory requirements:

- the facility must be owned or leased by the employer;
- the facility must be operated by the employer;
- the facility must be located on or near the business premises of the employer; and
- meals may be served only during or immediately before or after the employee’s workday.

*Comment:* The last condition above appears to be an error in the regulations. Read literally, an otherwise qualifying 24-hour cafeteria at a factory running on three 8-hour shifts would fail to satisfy the regulations because as to any recipient employee, most meals would be served during other shifts and therefore would not meet the requirement that meals be furnished only during or immediately before or after the employee’s work day. As this requirement is regulatory rather than statutory, an employer eating facility would appear to be in compliance with the thrust of the statute so long as it did not

<sup>521</sup> §132(e)(2) (flush language); Reg. §1.132-6(f); see also a discussion of the nondiscrimination rules at II.B.5. For purposes of the revenue/direct operating costs rule of §132(e)(2)(B), an employee entitled under §119 to exclude the value of a meal at an employer-operated eating facility is treated as having paid an amount for such meal equal to the direct operating costs of the facility attributable to that meal. Thus, meals that are excludible from employees’ incomes because they are provided for the convenience of the employer are fully deductible by the employer (before 2026) and, more importantly, if the relevant §132 rules are satisfied, count toward the cost base the employer must recover. See H.R. Rep. No. 220, 105th Cong., 1st Sess. at 482 (1997) (Conf. Rep.).

<sup>522</sup> Reg. §1.132-7(a)(2).

provide meals during any period substantially before or after the hours when any significant number of employees are at work (including all shifts and scheduled overtime operations in appropriate cases).

The regulations impose one additional condition for highly compensated employees. With respect to any highly compensated employee, an exclusion is available under the special rules for employer-operated eating facilities only if the condition that revenues equal or exceed direct operating costs is met and, in addition, access to the facility is available on substantially the same terms to each member of a group of employees that is defined under a reasonable classification set up by the employer that does not discriminate in favor of highly compensated employees.<sup>523</sup> For purposes of this special rule for highly compensated employees, each dining room or cafeteria in which meals are served is treated as a separate eating facility, irrespective of whether each such dining room or cafeteria has its own kitchen or other food-preparation area. Thus, a separate “executive dining room” served by the same kitchen would fail the special non-discrimination rule.

For purposes of the foregoing regulatory tests, “meals” consist of food, beverages and related services provided at the facility.<sup>524</sup> A facility is considered to be “operated by an employer” if the employer operates it with its own employees or contracts with a catering service or similar vendor to operate the facility.<sup>525</sup> The regulations specify that the tests must be applied separately to each cafeteria or dining room.<sup>526</sup> However, a shared facility operated by multiple employers is considered to be operated by each of them for qualification purposes.<sup>527</sup>

In *Jacobs v. Commissioner*,<sup>528</sup> the U.S. Tax Court held that the Boston Bruins’ provision of pregame meal to its players and personnel at away city hotels qualified as a de minimis fringe under §274(n)(2)(B), and therefore the cost of such meals was not subject to the 50% limitation of §274(n)(1). In concluding that the provision of meals was a de minimis fringe, the Tax Court first concluded that the eating facility was leased by the Bruins. In this case, although the contracts entered into by the Bruins and the hotels were not specifically identified as leases, the Tax Court thought they still operated as such. The Tax Court reached this decision even though the Bruins didn’t pay for the rental of any of the rooms in which meals were provided. The court relied on a definition of lease that provided that the right to use and occupy property must be conveyed in exchange for consideration. Despite the fact that the banquet room where meals were served was provided for free, the Tax Court concluded that there was ample consideration because the Bruins did pay for lodging and food and the banquet room was provided for free as an enticement to secure that payment. Secondly, the Tax Court found that the requirement that an eating facility be located on or near the business premises of the employer was met. The Tax Court decided that inquiries con-

<sup>523</sup> Reg. §1.132-8 is cross-referenced for this purpose. Interestingly, the Audit Guide instructs agents (at p. 3) to check for such discrimination in examinations involving highly compensated employees.

<sup>524</sup> Reg. §1.132-7(a)(2).

<sup>525</sup> Reg. §1.132-7(a)(3).

<sup>526</sup> Reg. §1.132-7(a)(1)(ii).

<sup>527</sup> Reg. §1.132-7(a)(3).

<sup>528</sup> 148 T.C. 490 (2017). See §132(e)(2); Reg. §1.132-7(a).

cerning business premises inferred functional rather than spatial unity and were not limited by questions of geography or the quantum of business activities. The Tax Court reiterated that it is not necessary for an eating facility to be located in an employer's principal structure for it to be considered on the business premises. The Tax Court concluded that away city hotels were part of the Bruins' business premises because significant business duties were performed there and staying at away hotels was an integral part of the Bruins' professional hockey business.

Note that §274(n)(2)(B) was stricken from the I.R.C. by TCJA.<sup>529</sup> Thus, the Bruins would not have obtained the same result because the de minimis fringe benefit exclusion under which the team owners prevailed no longer exists. Instead, they would be limited to the 50% deduction under §274(n)(1). For amounts paid or incurred after December 31, 2025, no deduction is permitted.<sup>530</sup>

Determination of the employer's direct operating costs related to each facility is a critical element in meeting the statutory exclusion requirements. Direct operating costs are composed of two elements: (1) the cost of food and beverages; and (2) the cost of labor performed primarily on the premises. Thus, the cost of a cafeteria cook's labor is included, but the cost of a building manager whose authority includes supervision of the cafeteria space is not. An allocation of costs is made for employees performing services both on and off premises.<sup>531</sup>

Special rules discussed below apply in making the calculations above when the facility also services employees entitled to exclude meals provided by the employer under §119.

### (2) *Income Inclusion for Nonqualifying Facilities*

If a dining room or cafeteria fails to satisfy the criteria for exclusion of meals provided to employees, the employee recipients of the benefit must include the value of any meals received in income.<sup>532</sup> However, the regulations provide an alternative special valuation rule to be used for purposes of employee income inclusion. The rule includes an option to use one of two methods, each of which utilizes a regulatory presumption that the value of all meals provided at each dining room or cafeteria is equal to 150% of the facility's direct operating costs (applying the definition provided in the regulations with respect to the §132(e)(2) exclusion).<sup>533</sup>

*Comment:* The regulations do not address the treatment of the value of the benefit provided to "recipients" who are not employees, such as a visiting independent contractor. Because the regulations require that substantially all the use of the facility be by employees, the IRS may have implicitly concluded

that any such permitted use by business guests of the employer would qualify alternatively under the de minimis exclusion.

#### (a) *Individual Meal Subsidy Method*

Under this approach, an employee's taxable income for the year is the sum of that employee's individual meal subsidy amounts.<sup>534</sup> The subsidy for each meal is calculated by multiplying each meal's price by a fraction, the numerator of which is the total meal value (150% of direct operating costs) and the denominator of which is total gross receipts, and subtracting the amount actually paid.<sup>535</sup> Thus, the fraction represents the employer's overall subsidy percentage and the calculation effectively apportions the total subsidy among all individual meals on the basis of relative meal cost.

#### (b) *Allocation of Total Meal Subsidy Method*

As an alternative, an employer may allocate the total meal subsidy "in any manner reasonable under the circumstances."<sup>536</sup> The total meal subsidy is the total meal value (150% of direct operating costs) less total gross receipts. It appears that such allocations may, under appropriate circumstances, include a flat allocation to each employee of a fixed amount for each meal consumed (appropriate for a fixed-price dining room) or other methods consistent with an employer's administrative and accounting capabilities.

*Comment:* The recordkeeping and administrative burdens involved in applying the special valuation formulas, and particularly the "individual meal subsidiary method" could be significant for many employers. This should be a strong incentive for employers to adjust dining room and cafeteria operations to ensure recovery of all direct costs and thereby qualify to utilize the administratively simpler §132(e)(2) exclusion. Moreover, although circumstances may vary, any necessary meal price increases may be offset by the benefit to employees of the full tax exclusion.

#### (3) *Special Rules for Convenience of the Employer*

If an employer can reasonably determine the number of meals that are excludible from income by the recipient employees under §119, the employer may, in determining whether the revenue from the facility equals or exceeds the direct operating costs of the facility, disregard all costs and any revenues attributable to such meals provided to such employees.<sup>537</sup> In TAM 9841001–TAM 9841002, the IRS advised that if "substantially all," e.g., approximately 90%, of the taxpayer casinos' employee meals were reasonably believed to be provided for the convenience of the employer, the employee dining rooms were reasonably believed to be employer-operated eating facilities under §132(e)(2), and the value of the employee meals was excludible from wages for FICA and income tax withholding purposes.

However, under §119(b)(4), when more than one-half of the employees to whom meals are furnished on an employer's business premises are furnished such meals for the convenience of the employer, all such meals furnished to employees at that

<sup>529</sup> Pub. L. No. 115-97, §13304(b)(1), effective for amounts paid or incurred after December 31, 2017.

<sup>530</sup> §274(o), added by Pub. L. No. 115-97, §13304(d), and amended by OBBBA, Pub. L. No. 119-21, §70305(a) (allowing limited exceptions for restaurant and catering industry and fishing industry).

<sup>531</sup> Reg. §1.132-7(b)(1).

<sup>532</sup> Reg. §1.132-7(c). See, e.g., TAM 201903017 (free employer-provided snacks consumed in designated employer snack areas and at employees' desks do not qualify as meals provided in employer-operated eating facilities, and employees may not exclude the value of such snacks from gross income under §132(e)(2) and Reg. §1.132-7).

<sup>533</sup> Reg. §1.61-21(j)(2)(i).

<sup>534</sup> Reg. §1.61-21(j)(2)(ii).

<sup>535</sup> Reg. §1.61-21(j)(2)(i).

<sup>536</sup> Reg. §1.61-21(j)(2)(iii).

<sup>537</sup> Reg. §1.132-7(a)(2).

premises are treated as provided for the convenience of the employer under §119.<sup>538</sup>

The employer may not deduct costs paid or incurred after 2025 for meals furnished on the employer's business premises for the convenience of the employer, except for meals provided in connection with a sale to customers in a bona fide transaction for adequate and full consideration or meals provided on certain fishing boats and at certain fish processing facilities.<sup>539</sup> For costs paid or incurred before 2026, if meals satisfy the requirements of §119, the employer is entitled to deduct the costs as a trade or business expense under §162, but §274 limits the deduction to 50% of these costs.<sup>540</sup> For amounts incurred and paid in 2018 through 2025, the employer similarly is limited to a 50% deduction if the expenses are excludible as de minimis fringe benefits under §132(e).<sup>541</sup> Expenses paid or incurred before 2018 were excepted from the 50% limitation if they

<sup>538</sup> See also Announcement 99-77 and Announcement 99-116, where the IRS announced that it would acquiesce in the Ninth Circuit's decision in *Boyd Gaming Corp. v. Commissioner*, 177 F.3d 1096 (9th Cir. 1999), in which the court held that meals furnished onsite by a casino to its employees were not includible in the employees' gross income. The IRS stated that it would not challenge whether meals provided to employees of casino businesses similar to that in *Boyd Gaming* meet the §119 convenience of the employer test where the employer's business policies and practices would otherwise preclude employees from obtaining a proper meal within a reasonable meal period. The IRS reasoned that a bona fide and enforced policy that requires employees to stay on the employer's business premises during their normal meal period is only one example of the type of business practice that could justify the employer's providing of meals that would qualify for §119 treatment. Further, the IRS stated that in applying §119 and Reg. §1.119-1, it would not attempt to substitute its judgment for the business decisions of an employer as to what specific business policies and practices were best suited to addressing the employer's business concerns. Thus, the IRS would consider whether the policies decided upon by the employer were reasonably related to the needs of the employer's business (apart from a desire to provide additional compensation to its employees) and whether those policies were in fact followed in the actual conduct of the business.

In 2018, the IRS Office of Chief Counsel released a memorandum providing additional advice on the prevailing standards and substantiation requirements necessary to determine whether an employer has a substantial noncompensatory business reason for furnishing meals to its employees. The memorandum highlighted the continued relevance of the "Kowalski test" from *Commissioner v. Kowalski*, 434 U.S. 77 (1977), which focuses on the "convenience of the employer" as an important element of the broader inquiry into the existence of a substantial noncompensatory business reason. Furthermore, post-*Boyd Gaming*, the employer continues to bear the burden of establishing a substantial noncompensatory business reason for employer-provided meals. An employer's policies are a critical part of this analysis, and the memorandum reminds employers that they must substantiate the policies that make it necessary for meals to be furnished. For example, an emergency on-call policy for police, firefighters, or medical personnel might be a substantial noncompensatory business reason for employer-provided meals, which could be substantiated by a written policy, an on-call schedule, or even disciplinary records involving violations of the policy. The IRS will continue to make determinations about employers' policies, including the underlying purpose, and whether the employer actually follows its policies. Consequently, the IRS will still apply its own judgment when deciding whether there is a legitimate business reason for a policy that necessitates the employer to provide meals to its employees. To illustrate, the memorandum states that an emergency on-call policy would not justify employer-provided meals in a business that rarely or never experiences emergencies, as the IRS will conclude that there is no legitimate business reason for that policy. See AM 2018-004.

<sup>539</sup> §274(o), added by TCJA, Pub. L. No. 115-97, §13304(d), and amended by OBBBA, Pub. L. No. 119-21, §70305(a) (adding limited exceptions), effective for amounts incurred or paid after December 31, 2025.

<sup>540</sup> §274(n)(1), before amendment by Pub. L. No. 115-97, §13304.

<sup>541</sup> §274(n)(1) and §274(n)(2), as amended by Pub. L. No. 115-97, §13304(a)(2)(D)-(E), effective for amounts incurred or paid after December 31, 2017.

were excludible as de minimis fringe benefits under §132(e).<sup>542</sup> In CCA 201151020, the IRS Chief Counsel's Office advised that the conclusion that meals are excludible under §119 is not dispositive of the issue of whether they are excludible under §132(e). In this ruling, the Chief Counsel's Office concluded that although airline flight crew members' catered meals were excludible under §119, they were not excludible under §132(e) because they were not provided at eating facilities. Acknowledging that neither the I.R.C., regulations, nor cases explicitly define the term "eating facility," the Chief Counsel's Office stated that they do imply that an eating facility means an identifiable location that is designated for the preparation and/or consumption of meals, and further, that the regulations contemplate that an eating facility is a location at which individuals are employed to prepare and/or serve food. Thus, the employer was only allowed a 50% deduction under §162.<sup>543</sup>

#### b. Athletic Facilities

Under §132(j)(4), the value of the use or availability of a gym or other athletic facility may be excluded by employees from gross income if the following three specific conditions are met:

- the facility is located on the employer's premises;
- it is operated by the employer; and
- substantially all the use is by employees of the employer or by employees' spouses and dependent children.<sup>544</sup>

*Comment:* The employer-premises requirement for athletic facilities differs from the similar requirement for employer cafeterias in that it does not require location on or near the employer's business premises. Thus, facilities may be located away from the employer's office or factory at a site that is more cost-effective for the employer and/or more convenient for employees to use.<sup>545</sup>

The statutory term "athletic facility" is defined broadly. In addition to gymnasiums, it includes pools, tennis courts and golf courses.<sup>546</sup> However, the regulations restrict the exclusion so that it is not available for a facility if there is public access through rental or membership purchases,<sup>547</sup> or if it has residential capability (such as a resort).<sup>548</sup> Likewise, the dual requirements of: (1) location of the facility on employer premises; and

<sup>542</sup> §274(n)(2)(B), before amendment by Pub. L. No. 115-97, §13304.

<sup>543</sup> For further discussion of CCA 201151020, see *Flight Crew Meals Not Excludible as De Minimis Fringe Benefits Under §132(e)(2)*, 53 Tax Mgmt. Memo. No. 2, 38 (Jan. 16, 2012).

<sup>544</sup> Before the enactment of §132(j)(4), the Tax Court had held that an employer could deduct payments for employee recreational facilities. *Slaymaker Lock Co. v. Commissioner*, 18 T.C. 1001 (1952), acq., 1953-2 C.B. 6, vac'd and rem'd, 208 F.2d 313 (3d Cir. 1953); and the IRS had ruled similarly. Rev. Rul. 77-406; PLR 8003070. However, when the health benefit rose to the level of maintaining a yacht or lodge for executive use, or a fully paid vacation for an executive at a health resort, the benefit was held to be compensation deductible by the employer but includible in the employee's income. *Ashby v. Commissioner*, 50 T.C. 409 (1968); *Challenge Mfg. Co. v. Commissioner*, 37 T.C. 650 (1962), acq., 1962-2 C.B. 4; *American Properties, Inc. v. Commissioner*, 28 T.C. 1100 (1957), aff'd per curiam, 262 F.2d 150 (9th Cir. 1958); *Riss & Co., Inc. v. Commissioner*, T.C. Memo 1964-190, aff'd, 374 F.2d 161 (8th Cir. 1967); Rev. Rul. 57-130.

<sup>545</sup> Reg. §1.132-1(e)(2).

<sup>546</sup> Reg. §1.132-1(e)(1). Cf. §274(a)(3).

<sup>547</sup> Reg. §1.132-1(e)(1).

<sup>548</sup> Reg. §1.132-1(e)(2).

(2) substantially all use by employees (and their families) effectively precludes application of the exclusion to employer-owned memberships in facilities such as town or country clubs, which are owned and operated as separate membership organizations.<sup>549</sup> However, an employer-owned country club operated exclusively for employees (and their families) would appear to qualify.

Under the regulations, a facility is considered to be operated by an employer if the employer operates the facility with its own employees or if it contracts with a professional athletic services provider. In addition, a shared facility operated by multiple employers is considered to be operated by each of them for qualification purposes.<sup>550</sup>

The general statutory nondiscrimination rules of §132(j)(1) do not apply to employer on-premises athletic facilities<sup>551</sup> and no special rule is provided in §132(j)(4). However, the legislative history underlying the rule states that the rules of §274 requiring nondiscrimination with respect to facilities apply.<sup>552</sup> Thus, a deduction may be denied for costs attributable to an athletic facility that is found to be primarily for the benefit of highly compensated employees.<sup>553</sup>

### c. Demonstration Automobiles

Section 132(j)(3) excludes as a working condition fringe the benefit of significant, but not unlimited, personal use of demonstration autos by certain auto sales employees. Thus, the value of “qualified automobile demonstration use” is excludible from the income of a “full-time automobile salesman” as a working condition fringe under §132(a)(3).<sup>554</sup> To qualify, the automobile use must:

- be in the sales area in which the automobile dealer’s sales office is located;
- be provided primarily to facilitate the salesman’s performance of services for the dealer; and
- be subject to substantial restrictions on personal use by the salesman.<sup>555</sup>

The IRS has placed certain additional restrictions on the availability of the exclusion in addition to setting forth the standards necessary to meet the statutory requirements. The principal additional limitation imposed by the regulations is the restriction of the exclusion to the use of a qualifying “demonstration automobile.”<sup>556</sup> This is defined as an automobile that is:

- currently in the inventory of the automobile dealership, and
- available for test drives by customers during the normal business hours of the employee.<sup>557</sup>

Thus, use of vehicles acquired or held by the dealership for administrative or other purposes and not carried in dealer inventory would not qualify. However, the term is not limited to new automobiles and it therefore appears that the use of used automobiles held in used car inventory would qualify for the exclusion.

“Full-time” salesman is defined to mean any individual who:

- is employed by an automobile dealer;
- customarily spends at least half of a normal business day performing the functions of a floor salesperson or sales manager;
- directly engages in substantial promotion and negotiation of sales to customers;
- customarily works a number of hours considered full-time in the industry (but at a rate not less than 1,000 hours per year); and
- derives at least 25% of his or her gross income from the automobile dealership directly as a result of the activities described above.<sup>558</sup>

The regulations make clear that a qualifying individual may perform other duties as well, and thus, the exclusion may be available to a dealership owner or general manager.<sup>559</sup> However, any such person must independently meet all of the tests of the definition so that an individual such as a sales manager who merely receives a commission override is not automatically qualified.<sup>560</sup> Part-time sales staff and individuals principally employed in other capacities (e.g., a mechanic or bookkeeper), do not qualify.<sup>561</sup>

The statutory requirement of “substantial restrictions on personal use” is satisfied if the following four conditions are met:

- use by individuals other than the full-time automobile salesmen (e.g., the salesman’s family) is prohibited;
- use for personal vacation trips is prohibited;
- the storage of personal possessions in the automobile is prohibited; and
- the total use (by mileage) of the automobile by the salesman outside the salesman’s normal working hours is limited.<sup>562</sup>

*Note:* Because qualified demonstration use must be in the sales area in which the dealer’s sales office is located, the regulations afford a helpful safe harbor. With respect to any qualifying salesperson, the automobile dealer’s sales area may be treated as the larger of the area within a 75-mile radius of the dealer’s sales office, or the one-way commuting distance (in miles) of the particular salesperson.<sup>563</sup>

Reg. §1.132-5(o)(6) provides that, notwithstanding anything in Reg. §1.132-5 to the contrary, the value of the use of

<sup>549</sup> Reg. §1.132-1(e)(3). Cf. §274(a)(3).

<sup>550</sup> Reg. §1.132-1(e)(4). Cf. PLR 9029026 for a discussion of an on-premises athletic facility operated by multiple employers. See also PLR 9430029 (for employees of employers that jointly lease the facility).

<sup>551</sup> Reg. §1.132-1(e)(5).

<sup>552</sup> See 1984 Act Supplemental House Report at p. 1605.

<sup>553</sup> §274(e)(4); Reg. §1.274-2(f)(2)(v).

<sup>554</sup> §132(j)(3)(A).

<sup>555</sup> §132(j)(3)(B).

<sup>556</sup> Reg. §1.132-5(o)(3).

<sup>557</sup> Reg. §1.132-5(o)(3).

<sup>558</sup> Reg. §1.132-5(o)(2)(i).

<sup>559</sup> Reg. §1.132-5(o)(2)(i).

<sup>560</sup> Reg. §1.132-5(o)(2)(i).

<sup>561</sup> Reg. §1.132-5(o)(2)(ii).

<sup>562</sup> Reg. §1.132-5(o)(4).

<sup>563</sup> Reg. §1.132-5(o)(5)(ii).

a demonstration automobile may not be excluded from gross income as a working condition fringe, by either the employer or the employee, unless, with respect to the restrictions on personal use under Reg. §1.132-5(o)(4), the substantiation requirements of §274(d) and the regulations thereunder are satisfied. Further, Reg. §1.132-5(o)(6) indicates that the general and safe harbor rules relating to the applicability of the substantiation requirements of §274(d) apply.<sup>564</sup> If the §274(d) substantiation requirements are not satisfied, the use of demonstration vehicles may fail as qualified automobile demonstration use within the meaning of §132(j)(3) and may not be excludible from gross income as a working condition fringe under §132(a)(3). In addition, the employer may not be entitled to use the automobile lease valuation rule in Reg. §1.61-21(d) for purposes of valuing the personal use of the vehicles.<sup>565</sup>

In Rev. Proc. 2001-56,<sup>566</sup> the IRS provides optional simplified methods that new car and used car dealerships may use in determining the value of employee use of demonstration automobiles. The revenue procedure, which is in question-and-answer format, provides a comprehensive framework for addressing the tax treatment of demonstration automobiles provided by dealers to employees. The optional methods include: (1) a simplified method for the full exclusion of qualified automobile use; (2) a simplified method that allows that partial exclusion if the full exclusion does not apply; and (3) a simplified method for the full inclusion in income of nonqualified use. The methods are structured sequentially such that if an employee's use does not qualify for exclusion under one method, the use may be taken into account under another method without the need for additional recordkeeping or change in determination period. Rev. Proc. 2001-56 also provides model qualified demonstrator vehicle policies, which are reproduced in the Worksheets of this Portfolio.

#### 4. Operating Rules and Definitions

##### a. Permissible Recipients

###### (1) Special Definition of Recipient

The term “recipient” of a benefit is defined broadly as “the person performing the services in connection with which the fringe benefit is furnished.”<sup>567</sup> Under this definition, an employee may be the “recipient” of a benefit, for purposes of the regulations, even though the benefit itself was actually provided to another person. For example, an employee is treated as the recipient of the benefit of an employer automobile being provided to the employee's spouse. Recipients need not be employees of the employer or benefit provider in a common law or state law sense, and the term also generally includes partners, direc-

tors and independent contractors.<sup>568</sup> It does not, however, ordinarily include shareholders of a corporation.<sup>569</sup>

###### (2) Special Definition of Employee

The income exclusions afforded by §132 are generally available only to individuals who are “employees.” Thus, a benefit recipient, such as a customer who is not also an employee within the definitions provided by the regulations, is not entitled to the benefit of a §132 exclusion. As a result, the value of a benefit provided to such a recipient is taxable under the general rule of inclusion unless it is addressed elsewhere in the I.R.C. The regulations do *not* adopt a common law or state law definition of employee that might introduce geographic differences in the rules, which could make them difficult to administer. Instead, special definitions are provided that vary in scope with the statutory classification applicable to the particular incidental fringe benefit provided. Thus, an employee whose spouse is the recipient of a benefit may be entitled, for example, to exclude from income the value of a discount extended by the employer to the spouse, but not the value of the spouse's personal use of an employer-provided vehicle.

###### (a) Current and Former Employees

For purposes of each of the original general and special exclusion rules of §132 enacted as part of the 1984 codification, the regulations provide that an “employee” includes any individual who is currently employed by the employer,<sup>570</sup> and Treasury can be expected to eventually conform the regulations to specifically include qualified moving expense reimbursements, qualified retirement planning services and qualified military base realignment and closure fringe benefit payments.

In addition, §132(h)(1) provides a statutory expansion of the term “employee.” Under the special rule of that section, former employees separated by reason of retirement or disability are treated as employees for purposes of the exclusions for no-additional-cost services and qualified employee discounts. Widows or widowers of individuals who died as employees (or as former employees qualified by retirement or disability) are also included.

###### (b) Spouses, Dependent Children and Parents

Section 132(h)(2) provides another statutory expansion of the term “employee.” Under the special rule of that section, certain additional persons, principally spouses and dependent children, are treated as employees for purposes of no-additional-cost services and qualified employee discounts.<sup>571</sup> In addition,

<sup>568</sup> Reg. §1.61-21(a)(4)(ii).

<sup>569</sup> See GCM 39482 (IRS refused to extend §132 exceptions to the corporate shareholder context as its explanation for the holding in PLR 8611069).

<sup>570</sup> Reg. §1.132-1(b)(1)(i) (no-additional-cost services and qualified employee discounts); Reg. §1.132-1(b)(2)(i) (working conditions); Reg. §1.132-1(b)(3)(i) (athletic facilities); Reg. §1.132-1(b)(4) (de minimis fringes including cafeterias and dining rooms); and Reg. §1.132-9(b), Q-5 (qualified transportation fringes).

<sup>571</sup> See Rev. Proc. 2008-48 (circumstances under which IRS will treat a child of parents who are divorced, separated or living apart as the dependent of both parents for purposes of §132(h)(2)(B), among other provisions). See also *Mihalik v. Commissioner*, T.C. Memo 2022-36 (value of airline tickets provided to an employee's children does not qualify for gross income exclusion as a no-additional-cost service because the children are adult relatives and not dependent children).

<sup>564</sup> These requirements are set forth in Reg. §1.274-5T and §1.274-6T, respectively. See 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses*, for further discussion of the limitations that apply to listed property.

<sup>565</sup> See TAM 9801002. *Whitehead v. Commissioner*, T.C. Memo 2001-317; *Cox v. Commissioner*, T.C. Memo 2001-196. See generally discussion at II.C.3.a.(3), with respect to special valuation rules.

<sup>566</sup> Effective for taxable years beginning on or after January 1, 2002.

<sup>567</sup> Reg. §1.61-21(a)(4)(i).

the special rule of §132(j)(4)(B)(iii) also includes use by spouses and dependent children within the definition of qualifying use of an employer gym or athletic facility. Finally, a spouse and dependent children may be entitled to exclude the benefit of qualifying employer security expenditures,<sup>572</sup> notwithstanding that such persons generally are not treated as employees for purposes of the working condition exclusion.

In addition, §132(m)(1), which provides the definition of qualified retirement planning services, states that the term means such advice or information provided “to an employee and his spouse,” thereby statutorily expanding the application of the §132(a)(7) exclusion to include spouses.

Parents generally are not included within the term “employee,” except for a special rule applicable to parents of airline employees with respect to no-additional-cost services.<sup>573</sup>

#### (c) Partners and LLC Members

For purposes of the general and special exclusion rules of §132, other than the qualified transportation fringe exclusion, a partner is generally treated as an employee of the partnership, provided such partner performs services for the partnership.<sup>574</sup> In addition, an inactive or investment partner may qualify for the de minimis exclusion.<sup>575</sup> The rules for service-providing and inactive partners would extend to similarly situated members of a limited liability company (LLC) that is treated for federal income tax purposes as a “partnership” under the entity classification rules.<sup>576</sup>

#### (d) Independent Contractors

Independent contractors who perform services for an employer are treated as employees only for certain purposes. They are fully entitled to the benefit of exclusion under §132(a)(4) for de minimis fringe benefits,<sup>577</sup> and most working condition fringes under §132(a)(3) also may be excluded.<sup>578</sup> However, the regulations specifically deny independent contractors the special exclusion under §132(a)(3) with respect to working condition parking benefits and the use of goods or for qualified consumer product testing.<sup>579</sup>

#### (e) Directors

Any director of a corporate employer is fully entitled to the benefit of the exclusion under §132 for de minimis fringe benefits<sup>580</sup> and generally is entitled to the exclusion for working condition fringe benefits (including parking provided other than as a qualified transportation fringe).<sup>581</sup> However, the regu-

lations deny directors the working condition exclusion for qualified consumer product testing.<sup>582</sup>

#### (f) Self-Employed Recipients

In a revenue-driven departure from the rules that apply to the other general categories of §132 fringe benefits, §132(f)(5)(E) specifically provides that a self-employed person, as defined by §401(c)(1), is not an employee for purposes of the qualified transportation fringe benefit.<sup>583</sup> Therefore, partners (including members of an LLC classified as a partnership for federal tax purposes), 2% shareholders of S corporations, sole proprietors, and independent contractors are not employees for purposes of §132(f). An individual who is both a 2% shareholder of an S corporation and an officer or a common law employee of that S corporation is not considered an employee for purposes of §132(f).<sup>584</sup>

#### (g) Volunteers

A bona fide volunteer (including a director or officer) who performs services for a tax-exempt organization or a government employer is entitled to exclude working condition fringe benefits provided by that organization or government employer from income.<sup>585</sup> An individual qualifies as a bona fide volunteer if the individual does not have a profit motive for purposes of §162. For example, an individual is a bona fide volunteer if the value of the fringe benefits provided to the volunteer is substantially less than the value of the services provided by the volunteer to the exempt organization or government employer.<sup>586</sup> The value of liability insurance or an exempt organization or government employer’s undertaking to indemnify the volunteer for liability does not by itself confer a profit motive on the volunteer if the insurance coverage or indemnification relates to acts performed in connection with official duties or the performance of services on behalf of the exempt organization or government employer.<sup>587</sup> The rule was provided<sup>588</sup> to address concerns that the value of directors’ and officers’ liability insurance could not be excluded from the income of a volunteer serving as a director or an officer of a tax-exempt organization.<sup>589</sup>

For purposes of the rule, a government employer is defined as any federal, state or local government unit and any agency or instrumentality thereof.<sup>590</sup>

The special rule may not be used to support treatment of a bona fide volunteer as having a profit motive for purposes of any provision of the I.R.C. other than the working condition fringe exclusion. Further, the rule may not be used to determine the employment status of a volunteer for any other section of the I.R.C.<sup>591</sup>

<sup>572</sup> Reg. §1.132-5(m)(3).

<sup>573</sup> See §132(h)(3); Reg. §1.132-1(b)(1).

<sup>574</sup> Reg. §1.132-1(b)(1) (no-additional-cost services and qualified employee discounts); Reg. §1.132-1(b)(2)(ii) (working conditions including parking and demonstration auto use); Reg. §1.132-1(b)(3) (athletic facilities); and Reg. §1.132-1(b)(4) (de minimis fringes including cafeterias and dining rooms). But see §132(f)(5)(E); Reg. §1.132-9(b), Q&A-24, limiting the definition of employee for purposes of the qualified transportation fringe exclusion.

<sup>575</sup> Reg. §1.132-1(b)(4).

<sup>576</sup> Reg. §301.7701-1 *et seq.*

<sup>577</sup> Reg. §1.132-1(b)(4).

<sup>578</sup> Reg. §1.132-1(b)(2)(iv).

<sup>579</sup> Reg. §1.132-1(b)(2).

<sup>580</sup> Reg. §1.132-1(b)(4).

<sup>581</sup> Reg. §1.132-1(b)(2)(iii).

<sup>582</sup> Reg. §1.132-1(b)(2).

<sup>583</sup> §132(f)(5)(E). See discussion at II.B.4.a.(2).

<sup>584</sup> Reg. §1.132-9(b), Q&A-10; Notice 94-3, Q&A-5(b).

<sup>585</sup> Reg. §1.132-5(r)(1).

<sup>586</sup> Reg. §1.132-5(r)(3)(i).

<sup>587</sup> Reg. §1.132-5(r)(3)(ii). *Cf.* Rev. Rul. 69-491.

<sup>588</sup> 56 Fed. Reg. 48,465 (Sept. 25, 1991).

<sup>589</sup> See, e.g., Rev. Rul. 82-223.

<sup>590</sup> Reg. §1.132-5(m)(7).

<sup>591</sup> Reg. §1.132-5(r)(2).

### b. Expanded Definition of Employer

A special expanded definition of employer applies for purposes of §132 pursuant to which certain related entities may be treated as a single employer. Those entities that may be combined for this purpose are: (1) all corporations that are members of a controlled group under §414(b); (2) all unincorporated trades or businesses of a partnership (including limited liability companies classified as “partnerships” for federal income tax purposes)<sup>592</sup> or proprietorships under common control under §414(c); and (3) all members of an affiliated service group under §414(m).<sup>593</sup>

The principal practical consequence of such aggregation is in applying the exclusions for no-additional-cost services and qualified employee discounts. Assuming the line of business requirements imposed in connection with those exclusions are satisfied, the aggregation of employers permits an employee of any one of the employers comprising the aggregate group to receive benefits from any other employer in the aggregated group. Thus, for example, an employee of one airline owned by a common parent would be able to take advantage of a stand-by flight offered by a sister airline also owned by the common parent if such benefit otherwise qualified as a no-additional-cost service.<sup>594</sup> Similarly, an employee of a separately incorporated hardware store that is one of a chain of such separately incorporated stores all wholly owned by a common parent, may be entitled to treat all such stores as “the employer” and therefore be able to exclude an otherwise qualifying discount at any of the other separately incorporated stores in the chain.<sup>595</sup>

The expanded definition of “employer” also appears to avoid petty allocation and other problems that might otherwise result where a parent and its subsidiaries or other related employers share common office space or other facilities and the parent or one member of the group owns the office or facility and makes on-premises benefits such as parking or a gymnasium available to employees of its related-company employers using that location.

Finally, this enlarged definition, as limited by application of the line of business requirements, applies for purposes of testing for satisfaction of the nondiscrimination requirements applicable to certain fringe benefit exclusion categories.<sup>596</sup>

### c. Line-of-Business Limitations

To be excluded under the applicable subsection of §132, a no-additional-cost service or a qualified employee discount made available to employees must be both the same type of services or property that are offered for sale by the employer in the ordinary course of the employer’s business and the same type of services or property that are offered for sale in the line of business in which the employee works.<sup>597</sup> This limitation has two principal functions. First, it precludes use of the §132 exclusions to provide employees with benefits in the form of tax-

free services or discounted property or services that are unrelated to any actual substantial ongoing business of the employer.<sup>598</sup> Further, in making this determination, employees are not counted as customers for purposes of this rule.<sup>599</sup> Thus, for example, a manufacturer could not establish a company store for which it purchased merchandise for resale to employees at below market prices. This rule also operates to preclude exclusion of benefits such as free personal use of an empty seat on a corporate plane, because (except for airlines) the employer would not be engaged in the sale of air transportation services.<sup>600</sup> The second principal function of this limitation is that, except for certain statutorily grandfathered activities,<sup>601</sup> it restricts the goods or services that multiple line of business enterprises may make available to employees to those goods or services provided in the employer’s business line in which the employee works. Thus, for example, if an employer provides both airline and hotel services to the public, an employee of the airline generally may not exclude as a no-additional-cost service the benefit of being provided free space-available hotel accommodations.<sup>602</sup> This latter limitation was included for the policy reasons of not introducing a competitive imbalance between larger conglomerate enterprises and smaller single line of business operations based on an ability for larger enterprises to offer greater tax-free incidental fringe benefits. The limitation was also perceived to be helpful in preventing expansion of noncash compensation in a way that would increase inequities among employees of different types of businesses.<sup>603</sup>

A special rule provides that, for purposes of the no-additional-cost services exclusion, the transportation of cargo and the transportation of passengers are treated as the same service.<sup>604</sup> This rule reversed an IRS ruling that an air carrier’s offering of free flights to employees (on jumpseats) could not be excluded under §132(a)(1) because the carrier’s business was not the offering of passenger flights.<sup>605</sup> Therefore, an employee working in cargo transportation for an airline may receive free air passenger travel from such individual’s employer.

Employees who provide services that directly benefit more than one line of business of an employer are treated as performing services in all such lines of business.<sup>606</sup> The regulations require that service for such line of business be “substantial.”<sup>607</sup> Accordingly, such employees may be provided with no-additional-cost services or qualified employee discounts in each such line. A corporate chief executive officer would generally be an example of an employee meeting this standard, as would other “headquarters” employees with functions servicing multi-

<sup>598</sup> Supplemental House Report at p. 1594.

<sup>599</sup> §132(k).

<sup>600</sup> Supplemental House Report at p. 1597. *Cf.* PLR 8712021 (employee trips on “maintenance flights” on corporate airplane do not qualify as no-additional-cost services because such flights are not offered for sale to customers in the ordinary course of business).

<sup>601</sup> 1984 Act §531(e), (f); Conf. Rep. at p. 1170–71; 1984 Bluebook at p. 851–52.

<sup>602</sup> Supplemental House Report at p. 1594.

<sup>603</sup> Supplemental House Report at pp. 1591–92 and 1594–95.

<sup>604</sup> §132(j)(7).

<sup>605</sup> PLR 8741007.

<sup>606</sup> Supplemental House Report at p. 1595.

<sup>607</sup> Reg. §1.132-4(a)(1)(iv).

<sup>592</sup> Reg. §301.7701-1 *et seq.*

<sup>593</sup> Reg. §1.132-1(c).

<sup>594</sup> Supplemental House Report, fn. 5 at p. 1595.

<sup>595</sup> Supplemental House Report at p. 1607.

<sup>596</sup> Supplemental House Report at p. 1607; see discussion of nondiscrimination rules at II.B.5.

<sup>597</sup> §132(b)(1), §132(c)(4).

ple lines of business such as a consolidated payroll or accounting department.<sup>608</sup>

In drafting the 1984 Act, it was clear to Congress that the determination of what constituted a line of business would become a critical element of applying the limitation. Accordingly, the legislative history provided certain specific directions<sup>609</sup> that Treasury amplified in the regulations.<sup>610</sup> The determination consists of two steps and ignores formal employing entities. First, all affiliated entities, as described above, constituting a single “employer” are determined and aggregated. Then, considering all of the business activities of the combined “employer,” it is determined whether such employer is engaged in more than one line of business. It is so engaged if it sells products or services in more than one industry group to its customers. The second part of the inquiry is essentially factual and, in making this determination of employer industry groups, the legislative history authorized Treasury regulations to refer to either employer business segments as reported for financial accounting purposes or Standard Industrial Classifications.<sup>611</sup> The regulations adopted the latter approach and define line of business as any two-digit code classification in the Enterprise Standard Industrial Classification (“ESIC”) Manual<sup>612</sup> (e.g., general retail merchandise stores; hotels and other lodging places; auto repair, services and garages; and food stores).<sup>613</sup>

A proposed rule published in August 2025 would define line of business using the four-digit code classification in the most recent version of the North American Industry Classification System (“NAICS”) that is available on the first day of the taxable year in which the no-additional-cost service or qualified employee discount exclusion is being applied, instead of using the two-digit code classification in the ESIC Manual.<sup>614</sup> The ESIC Manual is not updated regularly and does not account for many current industries. An employer would be considered to have more than one line of business if the employer offers for sale to customers goods or services in more than one NAICS industry group (e.g., general merchandise stores, including warehouse clubs and supercenters; traveler accommodation; auto repair and maintenance; and grocery stores).<sup>615</sup> The change would apply for taxable years beginning on or after the date the final rules are published in the Federal Register.<sup>616</sup>

The regulations also provide an aggregation rule pursuant to which two or more lines of business may be combined if one or more of the following conditions are met.<sup>617</sup>

- it is uncommon in the industry to operate any of the employer’s lines of business separately;
- it is common for a substantial number of nonheadquarters employees to perform substantial services in more than one line of business; or
- for otherwise separate lines of retail business operations that are located on the same premises, such lines would be considered one line of business if the merchandise were sold in a department store.

The example provided in the regulations regarding the second condition is a situation where employees work in a delicatessen with both carry-out and counter service and most employees serve both types of customers. The example provided regarding the third condition above is a situation where both women’s apparel and jewelry are sold together in one shop.<sup>618</sup>

A second alternative rule permitting combination of otherwise separate lines of business is provided for “significantly interrelated minor” lines of business. This is a line of business the activity of which is directly related to, but a minor part of, a major line of business.<sup>619</sup> The examples provided in the regulations include laundry services offered at a hospital and repair or catalog services offered at a retail merchandise store.<sup>620</sup> When an employer operates a significantly interrelated minor line of business, employees of that line of business are treated as employees of both the minor and major lines of business for purposes of the fringe benefit exclusions under §132 only if they provide substantial services that directly benefit the major line of business. Employees whose services in the minor line of business do not have such a direct benefit are not so treated. In the case of a hospital laundry, laundry employees performing substantial services of benefit to the hospital would be within the significantly interrelated minor line of business combination rule, but laundry employees servicing only the hospital laundry’s outside customers (such as an outside delivery person) would not.

Section 132(j)(5) deals with employees who are directly engaged in performing airline-related services for an airline within an affiliated group. Airline-related services include catering, baggage handling, ticketing and reservations, flight planning and weather analysis, and restaurants and gift shops located in an airport. Employees who perform airline-related services are treated as being in the same line of business as the airline and are entitled to no-additional-cost service treatment with respect to any air transportation they receive.<sup>621</sup>

The regulations provide guidance as to grandfather rules with respect to line of business treatment of certain retail

line of business, including changing “department store” to “general merchandise store.” Prop. Reg. §1.132-4(a)(3), REG-132805-17.

<sup>618</sup> Reg. §1.132-4(a)(3). The 2025 proposal would change the retail operations aggregation example to a situation in which an employer sells specialty foods and small kitchen appliances on the same premises, explaining that the operations are treated as one line of business because they would be part of the same line of business if they were sold together at a general merchandise store. Prop. Reg. §1.132-4(a)(3)(iii), REG-132805-17.

<sup>619</sup> Reg. §1.132-4(a)(1)(iv)(A).

<sup>620</sup> Reg. §1.132-4(a)(1)(iv)(B).

<sup>621</sup> Reg. §1.132-4(d). The following private letter rulings confirm that certain types of airline-related services come within this rule: PLR 8637129 (in-flight catering operations), PLR 8638030 (services at gift shop), PLR 8638033 (services at restaurant).

<sup>608</sup> Supplemental House Report at p. 1595. Cf. PLR 8936041 (headquarters employees entitled to discounts at general merchandise stores and specialty stores).

<sup>609</sup> Supplemental House Report at p. 1594.

<sup>610</sup> Reg. §1.132-4.

<sup>611</sup> Supplemental House Report at p. 1594.

<sup>612</sup> Reg. §1.132-4(a)(2)(i).

<sup>613</sup> Reg. §1.132-4(a)(2)(ii).

<sup>614</sup> Prop. Reg. §1.132-4(a)(2)(i), REG-132805-17, 90 Fed. Reg. 37,824 (Aug. 6, 2025).

<sup>615</sup> Prop. Reg. §1.132-4(a)(2)(ii), REG-132805-17.

<sup>616</sup> Prop. Reg. §1.132-4(a)(4), REG-132805-17.

<sup>617</sup> Reg. §1.132-4(a)(3). Cf. PLR 9025068 (vehicle manufacturing line of business and financial services line of business may be treated as a single line of business), PLR 8708048 (vertically integrated oil and gas organization may be treated as a single line of business). The 2025 proposed rule would modify the aggregation rule to conform to the proposed change to the definition of

stores;<sup>622</sup> telephone service provided to retirees before the AT&T divestiture;<sup>623</sup> affiliated groups operating airlines;<sup>624</sup> and qualified air transportation organizations.<sup>625</sup> In addition, the regulations refer to the special elective grandfather rule provided in §4977.<sup>626</sup>

### 5. Nondiscrimination Rules

#### a. Background

Before the enactment of statutory rules for incidental fringe benefits as part of the 1984 Act, there had been only occasional and inconsistent application of anti-discrimination requirements in connection with determining the tax status of incidental employee fringe benefits. The theoretical basis for the application of such rules in the context of incidental fringe benefits is the concern that the excludibility of incidental fringe benefits not be turned into a vehicle for rewarding highly compensated executives with tax-favored cash compensation substitutes. This approach has strong parallels in the qualified plan and other statutory benefit areas.<sup>627</sup>

For various reasons, including administrability, the nondiscrimination rules were not made applicable to all categories of incidental fringe benefits. However, with respect to certain statutorily designated types of benefits, they became a mandatory prerequisite for exclusion of such benefits from any highly compensated employee's income. The benefit categories under §132 that are subject to the nondiscrimination rules include two of the eight general exclusions — the exclusion for no-additional-cost services and the exclusion for qualified employee discounts<sup>628</sup> — as well as the special exclusion for employer-provided cafeterias and dining rooms.<sup>629</sup>

Notably, each program providing an incidental fringe benefit subject to the section's nondiscrimination requirements is tested separately.<sup>630</sup> This is true whether the benefits are identical or different. As a result, a determination that a particular benefit is discriminatory in favor of individual highly compensated employees will not automatically cause other fringe benefit programs in favor of those same highly compensated employees to be tainted.<sup>631</sup>

An exception to the separate testing rule applies to incidental fringe benefit programs that are “related.” The regulations do not define the term but provide as an example a 20% discount program maintained for all employees and an additional 15% (total 35%) discount program maintained for highly compensated employees. Under these circumstances, the 20% discount program is held to be related to the discriminatory 35% program, and each is therefore held to be discriminatory as to highly compensated employees.<sup>632</sup> Thus, it appears to be

the rule that fringe benefit plans are treated as “related” and aggregated for purposes of discrimination testing only in circumstances when the same classification of benefit is involved and the separation of the benefit plans appears to be a device to avoid the nondiscrimination rules.

### b. Determination of Discrimination — Operating Rules and Definitions

#### (1) Coverage Test

Section 132(j)(1) requires that benefits subject to the nondiscrimination requirements must be provided to all employees or to each member of a group that is a reasonable and nondiscriminatory classification of employees.<sup>633</sup>

The regulations apply the coverage requirement by aggregating the employees of all related employers,<sup>634</sup> but without inclusion of employees in different lines-of-business, except to the extent an employer makes benefits available beyond the ordinarily applicable line-of-business limitations.<sup>635</sup> Thus, the coverage requirements appear to be generally coextensive, with the operating rules limiting the groups to which specific benefits may be provided.

*Note:* Initially, temporary regulations specified the classes of employees that could be excluded in applying the nondiscrimination rules. Those that could be excluded included part-time and seasonal employees, certain employees covered by a collectively bargained agreement, most foreign employees, employees with less than one year of service, and separated employees.<sup>636</sup> Under §132(j)(1), as amended by the 1986 TRA, excludible employees became those excluded under former §89. When former §89 was repealed,<sup>637</sup> Section 132(j)(1) was restored to its pre-1986 TRA form. It thus appears that the classes of employees excluded under the temporary regulations continue to be the appropriate group of excludible employees.<sup>638</sup>

#### (2) Classification Test

Generally, a facts-and-circumstances rule applies in determining whether a classification discriminates in favor of highly compensated employees. For this purpose, the principles applicable in qualified plan determinations under §410(b)(2)(A) (i) apply.<sup>639</sup> Moreover, the regulations establish a safe harbor pursuant to which any classification that would be nondiscriminatory under the qualified plan nondiscrimination standards will be deemed to be nondiscriminatory for incidental fringe benefit purposes.<sup>640</sup> Thus, for example, if an employer wanted to institute an incidental fringe benefit program of a type subject to a nondiscrimination requirement, such as an employee discount program, it could do so without considering the separate nondiscrimination rules if it limited the discount to only those employees constituting a group determined to be nondiscrimi-

<sup>622</sup> Reg. §1.132-4(b).

<sup>623</sup> Reg. §1.132-4(c); see Explanation of Technical Corrections to the Tax Reform Act of 1984 and Other Recent Tax Legislation, Staff of the Joint Committee on Taxation, JCS 11-87 (May 13, 1987) at 145–147.

<sup>624</sup> Reg. §1.132-4(e).

<sup>625</sup> Reg. §1.132-4(f).

<sup>626</sup> Reg. §1.132-4(g); cross-referencing Reg. §54.4977-1T.

<sup>627</sup> See, e.g., §401(a)(4), §127(b)(2), and §129(d)(2).

<sup>628</sup> §132(j)(1).

<sup>629</sup> §132(e)(2) (flush language).

<sup>630</sup> Reg. §1.132-8(a)(2)(i).

<sup>631</sup> Reg. §1.132-8(a)(2)(i).

<sup>632</sup> Reg. §1.132-8(a)(2)(ii)(A).

<sup>633</sup> Reg. §1.132-8(a)(1).

<sup>634</sup> Reg. §1.132-8(b)(1); see discussion at II.B.4.b.

<sup>635</sup> Reg. §1.132-8(b)(1); see discussion of Line of Business requirements at II.B.4.c.

<sup>636</sup> Reg. §1.132-8T(b)(3).

<sup>637</sup> Pub. L. No. 101-140, §203.

<sup>638</sup> Reg. §1.132-8(b)(3).

<sup>639</sup> Reg. §1.132-8(d)(1).

<sup>640</sup> Reg. §1.132-8(d)(1).

natory in a current retirement plan determination; such classification would automatically be deemed nondiscriminatory.

On the other hand, certain classifications effectively are prohibited under rules that hold them to be per se discriminatory. In addition to any classification that makes benefits available only to highly compensated employees, those classifications include any classification based on either the amount or the rate of an employee's compensation if those with the higher amount or rate are favored.<sup>641</sup> Classifications based on seniority and job description are not per se discriminatory but must operate nondiscriminatorily in the context of the employer's workforce.<sup>642</sup>

### (3) "Substantially the Same Terms" Test

To satisfy the §132 exclusion requirements, each benefit must be available to employees in a nondiscriminatory classification "on substantially the same terms." The regulations provide that this test is a facts and circumstances determination.<sup>643</sup> Thus, discounts available to all employees of 20% on regular merchandise but only 10% on sale merchandise would be acceptable. However, a discount that increased from 10% to 20% with seniority would fail to satisfy the requirement. Any discount that varies with an employee's amount or rate of compensation is deemed to fail to satisfy the requirement (in addition to being discriminatory).<sup>644</sup>

*Note:* The temporary regulations provided that a discount that varied with an employee's volume of purchases failed to satisfy the requirement.<sup>645</sup> This latter limitation had no specific support in the statute and appeared to extend the prohibition past the rationale of the rule. The final regulations do not include this rule, thus implying that such discounts do not violate the nondiscrimination rules.

The IRS utilized its regulatory authority to develop special "same terms" requirements applicable to benefits that an employer may be able to provide only in limited quantities such as "space-available" accommodations. A nondiscriminatory means of allocating such benefits is necessary whenever demand exceeds availability.<sup>646</sup> The regulations specifically sanction a lottery and a first-come first-served allocation provided the latter is not discriminatory in practice.

*Comment:* As "first-come first-served" and "lottery" allocation systems are fundamentally dissimilar in most respects (except for the randomness of the benefit award), the regulations effectively offer no help for the employer attempting to determine whether other more controlled systems would qualify in particular situations. For example, an alternative nondiscriminatory means to allocate a scarce benefit might be to assign first or highest priority to employees who have never previously received or utilized the benefit, then to other employees in order of decreasing time from the last receipt or use of the benefit. Such a system should operate neutrally; however, the status of any such allocation method is unclear.

Allocations based on seniority, full-time or part-time employment or job description are not per se discriminatory but may be discriminatory as applied to the workforce of a particular employer.<sup>647</sup> The regulations provide that the employer does not violate the "same terms" test if the employer allocates benefits among employees on a seniority basis if:

- notice of the terms of availability of the benefit is given to all employees in the group; and
- the average value of the benefit provided for each non-highly compensated employee is at least 75% of that provided to each highly compensated employee.<sup>648</sup> For purposes of calculating the average value, the fair market values of the benefits provided to each group (determined under Reg. §1.61-21) are totaled and divided by the total number of employees in that group. All nonexcludible employees are counted, even if they are not eligible for the particular benefit.<sup>649</sup>

### (4) Definition of Highly Compensated Employee

In applying the special nondiscrimination provisions applicable to incidental benefits excludible under §132, the §414(q) definition of highly compensated employee (HCE) applies. An employee is highly compensated if the employee:

- was a 5% owner of the employer at any time during the year or the preceding year; or
- had compensation for the preceding year in excess of \$80,000 (indexed for inflation); and
- if the employer so elects, the employee was in the top 20% employees by compensation for such year.<sup>650</sup>

### c. Effect of Discrimination

Under the nondiscrimination rules, the §132 exclusion from income is available to highly compensated employees only if such benefits also are available on substantially the same terms to all employees or each member of a group that is a reasonable and nondiscriminatory classification of such employees.<sup>651</sup> Thus, if a benefit is provided discriminatorily, the §132 exclusion is denied to highly compensated employees who receive the benefit, although the benefit remains excludible for employees who are not highly compensated.

Accordingly, a consequence of providing benefits under a plan that is determined to be discriminatory is that the full value of the benefit, not just the discriminatory benefit portion, is includible in the income of highly compensated employees who receive it.

*Example:* An airline that permits space-available travel for employees generally charges employees a supplemental fee of \$50 when the available space is in first-class, but does not impose this charge on corporate officers for

<sup>641</sup> Reg. §1.132-8(d)(2).

<sup>642</sup> Reg. §1.132-8(d)(2).

<sup>643</sup> Reg. §1.132-8(c)(1).

<sup>644</sup> Reg. §1.132-8(c)(1).

<sup>645</sup> Reg. §1.132-8T(d)(1).

<sup>646</sup> Reg. §1.132-8(c)(2).

<sup>647</sup> Reg. §1.132-8(d)(2).

<sup>648</sup> Reg. §1.132-8(c)(2)(ii).

<sup>649</sup> Reg. §1.132-8(c)(2)(ii).

<sup>650</sup> §414(q); Reg. §1.414(q)-1T, §1.132-8(f)(1). For current and previous limits under §414(q)(1)(B), see Tables, Charts & Lists, *Pension and Retirement Plans — IRC Cost of Living Adjustments*.

<sup>651</sup> §132(j)(1).

space-available travel in first-class. This disparity would violate the “substantially the same terms” requirement and officers receiving the benefit would recognize income equal to the full fair market value of the space-available first-class transportation, not just the \$50 cost avoided.

#### d. *Specific Benefits Covered*

##### (1) *No-Additional-Cost Services*

The §132(j)(1) requirement that no-additional-cost services be fully subjected to the special §132 nondiscrimination rules is specifically implemented by the regulations.<sup>652</sup>

##### (2) *Qualified Discounts*

The §132(j)(1) requirement that qualified employee discounts be fully subjected to the special §132 nondiscrimination rules is also specifically implemented by the regulations.<sup>653</sup> However, the legislative history points up the opportunity to provide reasonable nondiscriminatory categories that include less than all employees, noting, for example, that coverage that includes a store’s sales personnel and executives but not office, maintenance and other non-sales categories may be acceptable if otherwise nondiscriminatory.<sup>654</sup>

##### (3) *Dining Rooms and Cafeterias*

Under the special rule of §132(e)(2), meals provided at employer-operated eating facilities, like qualified discounts and no-additional-cost services, must be available on substantially the same terms to each employee who is a member of a reasonable nondiscriminatory classification.

Accordingly, the regulations’ coverage, classification and “same terms” tests generally are applicable<sup>655</sup> subject to certain modifications necessary to accommodate the practical limitations to food service provision. Thus, a special coverage rule requires aggregation of all employees who regularly work at or near the premises on which the eating facility is located, except that employees in different lines of business are not aggregated. Moreover, for this purpose each dining room or cafeteria is treated as a separate eating facility and tested separately for discrimination, notwithstanding that they may be served by a common kitchen.<sup>656</sup> This latter test may have the effect of disqualifying a separate executive dining room limited to officers or selected highly compensated employees but run in conjunction with a kitchen serving an unrestricted employee cafeteria.

Similarly, a special classification rule liberalizes permissible restrictions so that an eating facility may discriminate in favor of highly compensated employees so long as the facility is not used more than a de minimis amount by any “executive group” employee. Executive group employee for this purpose means a highly compensated employee as defined in §414(q).<sup>657</sup>

<sup>652</sup> See Reg. §1.132-2(a)(4), §1.132-8(a)(1).

<sup>653</sup> Reg. §1.132-3(a)(6), §1.132-8(a)(1).

<sup>654</sup> Supplemental House Report at pp. 1606–07.

<sup>655</sup> Reg. §1.132-8(a)(1).

<sup>656</sup> Reg. §1.132-8(b)(2).

<sup>657</sup> See discussion of definition of highly compensated employee and inflation adjustment at II.B.5.b.(4).

except that only the top 1% of employees earning over \$50,000 are in the top-paid group.<sup>658</sup>

##### (4) *Other Benefits*

Two incidental fringe benefits that are not subject to the specific §132(j)(1) nondiscrimination requirements are nonetheless subject to other discrimination limitations. These restrictions apply to consumer products testing programs that are otherwise exempt as a working condition fringe benefit and to employer athletic facilities and are each discussed below.

##### e. *Benefits Excluded from Nondiscrimination Rules*

The anti-discrimination requirements expressly provided by §132(j)(1) are applicable only to specified incidental fringe benefits, and those benefits not enumerated are, in general, not subject to a nondiscrimination requirement.

##### (1) *Working Conditions*

“Working condition” fringe benefits generally are not subject to a nondiscrimination requirement.<sup>659</sup> The theoretical basis for exemption from the nondiscrimination rules is that such working conditions are being provided to aid in job performance and are therefore less subject to abuse than other incidental benefits that might be skewed to highly compensated employees. Thus, for example, the congressional reports indicated that if security conditions required, a bodyguard could be provided to a senior executive and not to other employees without being discriminatory.<sup>660</sup>

Consumer product testing programs that otherwise qualify for exclusion as working condition fringe benefits are subject to a special nondiscrimination requirement. The IRS has announced its intention to examine the extent to which employer products have been furnished to highly compensated employees. If it finds that products under a testing and evaluation program are furnished only to highly compensated employees, this fact may be taken into account in determining whether the plan qualifies for the working condition exclusion, unless the employer can demonstrate a business reason for the classification.<sup>661</sup>

##### (2) *De Minimis Fringe Benefits*

De minimis fringe benefits generally are not subject to a nondiscrimination requirement.<sup>662</sup> For example, an employer may reimburse supper money in connection with late night work to only salaried employees and exclude hourly employees whom it paid overtime wages at time and a half for such work.

The theoretical basis for exemption from the nondiscrimination rules is that such benefits generally are too insignificant to justify accounting for them. Because any measuring of such benefits to determine excess use by highly compensated employees or any other classification could be determined only from detailed records with respect to the amounts of use of all de minimis benefits and by all recipients, it follows that a

<sup>658</sup> Reg. §1.132-8(d)(5).

<sup>659</sup> Reg. §1.132-5(q).

<sup>660</sup> Supplemental House Report at p. 1602.

<sup>661</sup> Reg. §1.132-5(n)(3); Supplemental House Report at p. 1602.

<sup>662</sup> Reg. §1.132-6(f).

nondiscrimination rule would be extremely burdensome to apply.

Employer-provided eating facilities that are deemed to be a de minimis fringe benefit nonetheless are subjected by §132(e)(2) to the nondiscrimination rules described above.

### (3) *Qualified Transportation Fringes*

Qualified transportation fringe benefits generally are not subject to a nondiscrimination requirement. Such benefits are, however, effectively subjected to a reverse nondiscrimination rule by the dollar limitations of §132(f)(2).

### (4) *Qualified Moving Expense Reimbursements*

Qualified moving expense reimbursements generally are not subject to a nondiscrimination requirement. This is consistent with the origin of the exclusion (which is suspended for 2018 through 2025 except for certain active duty military moves), as items deductible under §162 in connection with employee relocation make such provision analogous to a working condition fringe.

### (5) *Demonstration Automobiles*

Qualified use of demonstration automobiles is not subject to a nondiscrimination requirement in view of its status as a “deemed” working condition fringe benefit.<sup>663</sup>

### (6) *Gyms and Recreational Facilities*

Employer-provided gyms and on-premises athletic facilities are not subject to the §132(j)(1) nondiscrimination requirements.<sup>664</sup> However, the application of the §274(e)(4) rules with respect to facilities found to be primarily for the benefit of officers, owners or highly compensated employees<sup>665</sup> was specifically noted in the legislative history regarding the fringe benefit rules.<sup>666</sup>

### (7) *Qualified Retirement Planning Services*

Qualified retirement planning services are subject to a special statutory non-discrimination rule pursuant to §132(m)(2), which provides that the exclusion does not apply with respect to highly compensated employees unless the services are available on substantially the same terms to each member of the group of employees normally provided education and information regarding the employer’s qualified plan.

### (8) *Qualified Military Base Realignment and Closure Fringes*

The Military Family Tax Relief Act of 2003,<sup>667</sup> which added the Qualified Military Base Realignment and Closure Fringe, did not include any special non-discrimination rule applicable to the benefit, and none were added by the subsequent ARRA amendments to the §132(n) definitional provisions.<sup>668</sup> Accordingly, Qualified Military Base Realignment and Closure

Fringe benefit payments are not subject to a nondiscrimination requirement.

## C. *Valuation of Incidental Benefits*

### 1. *Background*

The 1984 Act statutory “clarification” of §61 made simultaneously with the §132 codification of exclusions does not address valuation. Nonetheless, the legislative history indicates strong concern with reinforcing fair market value as the appropriate standard for determining the amount of income represented by an employee’s receipt of a taxable fringe benefit, and included directions for Treasury to issue regulations setting forth appropriate and helpful rules for the valuation of taxable fringe benefits,<sup>669</sup> although references to the fair market value standard were essentially declaratory of current law.<sup>670</sup> Treasury responded to the legislative direction and included a number of special rules and certain safe harbors in the regulations. Nonetheless, for situations for which rules were not provided, case law and other general authority apply.<sup>671</sup>

The difficulty with the fair market value standard is that many benefits arise in connection with employment under circumstances where the traditional measure of a “willing buyer-willing seller” price set in an open market is not available. For example, some benefits, such as discounts and no-additional-cost services, ordinarily are not publicly available. Other benefits, such as limited personal use of an employer vehicle or other property, ordinarily are not saleable or transferable and often are subject to various restrictions as to use. Moreover, some benefits have a dual character of benefiting both the employer and the employee.

*Example:* A designer dress store employee is provided with free or discount clothes that the employee is expected to wear at work and to appropriate social occasions. The wearing of these clothes benefits both the employer’s business and the employee. However, the employee might otherwise choose less expensive nondesigner clothing, perhaps even garments from a discount store.

As the example illustrates, often the employer may realize some benefit in the form of advertising, better performance of duties or quicker solution of a problem.<sup>672</sup> Likewise, in many cases the perceived value of the benefit an employee receives is not the price that the employee would pay for the same service in the marketplace, because in many instances the individual simply would not have made the expenditure at all<sup>673</sup> or at least might have waited for a sale. Thus, notwithstanding recognition of the fair market value standard, the absence of marketplace transactions, the existence of value-affecting restrictions and the presence of elements of employer value continue to

<sup>663</sup> Reg. §1.132-5(q).

<sup>664</sup> Reg. §1.132-1(e)(5).

<sup>665</sup> Reg. §1.274-2(f)(2)(v).

<sup>666</sup> Supplemental House Report at p. 1605.

<sup>667</sup> Pub. L. No. 108-121.

<sup>668</sup> See discussion at II.B.2.h.

<sup>669</sup> Supplemental House Report at p. 1609; 1984 Act Bluebook at p. 842.

<sup>670</sup> Task Force Staff Report at p. 12; Second Discussion Draft, §1.61-20(b); First Discussion Draft, §1.61-16(d).

<sup>671</sup> See, e.g., *Wade v. Commissioner*, T.C. Memo 1988-118.

<sup>672</sup> Supplemental House Report at p. 1591; *Demor, Inc. v. Commissioner*, T.C. Memo 1968-279 (income equal to employer wholesale cost of providing merchandise as alternative to disallowance of employer’s deduction).

<sup>673</sup> *McCoy v. Commissioner*, 38 T.C. 841 (1962); *Turner v. Commissioner*, T.C. Memo 1954-38.

make determination of fair market value of many fringe benefits a persistently difficult problem.

These problems were also recognized in Treasury's development of valuation principles in the Second Discussion Draft regulations,<sup>674</sup> in the Task Force Staff Bill<sup>675</sup> and to a lesser extent in the First Discussion Draft.<sup>676</sup> Notably, the Second Discussion Draft expressly sanctioned reference to the price effect of applicable restrictions and the conditions under which the benefit was provided. Moreover, this draft was also important for its public recognition by Treasury that, for some benefits, there may be several fair market values.

## 2. General Valuation Approaches

While the regulations provide detailed valuation rules for a number of special valuation situations, they offer very little additional help in valuing fringe benefits that do not have the benefit of special rules. The regulations confirm, consistent with prior law, that "fair market value" is the amount a hypothetical person would have to pay a hypothetical third party to obtain (i.e., purchase or lease) the particular fringe benefit.<sup>677</sup> However, as discussed above, this formulation is helpful only in circumstances where the employee receives 100% of a benefit free of employer restrictions or employer joint use and a market for similar items exists.

Recognizing this, the regulations also specify that fair market value is determined on the basis of all the facts and circumstances.<sup>678</sup> Thus, with one significant exception discussed below, the regulations do not displace the general pre-1984 Act valuation rules.

A number of different approaches are possible in determining the fair market value of those incidental fringe benefits that are not excluded under §132 (or another I.R.C. section) and are not the subject of one of the special valuation rules under the regulations. The application of different approaches can result in a different amount being included in income with respect to a particular benefit.

*Example:* Corporation (C), in a financial services industry subscribes to an on-line financial data base and information service available only to industry members. The cost to C is \$10,000 per year plus \$10 per inquiry. C's employees use this service and its data base frequently in C's business. C also permits its employees to use the service, without charge, for their own financial and investment purposes but only when it is not being used for C's business purposes. In the aggregate, such employee use is less than 10% of the total use of the service and the equipment required to access it.

C's employees make the following use of the service and database: (1) S, a secretary, uses the service once a quarter (four times a year) to check a small personal investment; and (2) T, a senior technical employee (not an officer or director), uses the

service frequently (several times a week) in finding information for T's personal portfolio trading.

It seems probable that S's use should be regarded as excludible under the general exclusion for de minimis benefits.<sup>679</sup> T's use appears to be too frequent to be so excluded; thus, the question arises as to whether and how "the benefit" to T should be valued.

The nominal standard of the regulations is to include in the employee's income the entire retail cost of the benefit, i.e., the amount that an unrelated person would have to pay in the open market to obtain the same benefit. However, there is no market in which an actual willing-buyer-willing-seller price can be established. T is not qualified to buy access to the restricted service, and if qualified would be unwilling to pay the \$10,000 annual subscription fee. Moreover, the value of T's access is reduced by C's priority in system use. Thus, an actual willing-buyer-willing-seller market price cannot be determined and a method of approximation is required.

### a. Retail or Charter Cost

Under case law before the regulations, there was authority for approximating the value of a benefit by referring to the cost of a roughly comparable benefit. For example, the value of employee use of an employer's aircraft might be approximated to the charter cost for a comparable aircraft.<sup>680</sup> Similarly, the value of use of a company car had been held to be the allocable cost of leasing a comparable vehicle.<sup>681</sup> Using the information in the above example, the retail or charter cost method of valuation may be applied as follows:

*Example 1:* Under an extreme, literal application of the retail cost approach, the annual benefit to T of the use of C's service (as described above in the immediately preceding example) is C's full \$10,000 cost of subscribing to the service plus the sum of T's inquiries to the database at \$10 each.

The example illustrates the strong role that particular facts and circumstances play in determining the appropriateness of the valuation method employed. It is intuitively unfair to charge T with the entire cost of the employer's system. The key to reasonable application of retail or charter cost valuation is identification of a factually fair equivalent in the marketplace. This is illustrated by the following example (which is based on the facts in the above example, modified as indicated below):

*Example 2:* Individuals may subscribe to a commercial on-line retail service that includes limited access to a database comparable to that to which C subscribes for \$100 per month plus \$20 per inquiry. Under the retail cost approach, the annual benefit to T of the use of C's service may be the amount T would have to pay to subscribe and obtain ac-

<sup>674</sup> Compare Second Discussion Draft, §1.61-20(c) Exs. (1) and (2) with Exs. (3) and (4).

<sup>675</sup> Task Force Staff Report at p. 12.

<sup>676</sup> First Discussion Draft, Treasury Summary and Explanation at p. 11.

<sup>677</sup> Reg. §1.61-21(b)(2).

<sup>678</sup> Reg. §1.61-21(b)(2).

<sup>679</sup> See discussion at II.B.2.d.(4)(a); cf. PLR 9442003 regarding the value of the services of an electronic filer for employee tax returns.

<sup>680</sup> *Ireland v. United States*, 621 F.2d 731 (5th Cir. 1980); *Vesco v. Commissioner*, T.C. Memo 1979-369.

<sup>681</sup> See *Whipple Chrysler-Plymouth v. Commissioner*, T.C. Memo 1972-55; *Riss & Co., Inc. v. Commissioner*, T.C. Memo 1964-190 (1964), *aff'd*, 374 F.2d 161 (8th Cir. 1967); *Dole v. Commissioner*, 43 T.C. 697 (1965) (reviewed opinion), *aff'd per curiam*, 351 F.2d 308 (1st Cir. 1965).

cess to a comparable database through the commercial information service. T would disregard the \$10,000 C pays for the commercial access to its database. T would include, instead, the \$100-per-month subscription fee charged by the commercial service, plus an amount equal to the \$20 of individual inquiry fees that the service would have charged for T's individual inquiries.

In *Example 2*, unlike *Example 1*, the facts and circumstances suggest that use of the retail or charter cost method would fairly approximate the benefit's value. Note that a peculiar characteristic of the retail or charter cost method of valuation is that it breaks the traditional linkage of parallel tax treatment for both parties to the compensation transaction.<sup>682</sup> To the extent incidental fringe benefits are includible in income, they are like salary, another form of compensation, and ordinarily an employer is entitled to a deduction for compensation paid equal to the amount included in income by the employee. However, when an employee is treated as receiving income measured by the retail or charter cost of an incidental benefit, the income inclusion may differ from the employer's deduction. Such deduction is limited to the employer's cost in providing the benefit.<sup>683</sup>

*Example 3*: Employer C's deductions are its \$10,000 fixed cost of subscribing to the service and the amount of variable costs associated with its own use of the service plus those related to T's personal inquiries (and those of S and other employees). This is true regardless of whether the retail or charter cost method is used to determine the income that T must recognize as described above or the incremental employer cost or value to the employee methods described below are used.

#### b. Allocated Employer Cost

A second way to determine the fair market value is to measure the benefit by making an allocation of the employer's costs in providing the benefit. The regulations specifically recognize the continuing relevance of employer cost as a possible measure of fair market value and thus implicitly approve the use of valuation approaches based on employer costs in appropriate circumstances. However, consistent with the all-facts-and-circumstances approach, the employer's costs are not determinative.<sup>684</sup>

An allocated employer cost method valuation requires a division of the employer's actual total costs related to the property or service between business use and the personal element provided as a benefit. This approach has been administratively employed by the IRS in valuation of nonincidental personal use of employer facilities.<sup>685</sup> Moreover, there is a strong case law basis for the allocation of employer cost approach. Although special valuation rules provided in the regulations apply

to most transportation benefits, the allocation principles developed under case law with respect to use of corporate cars,<sup>686</sup> planes,<sup>687</sup> and recreational facilities<sup>688</sup> continue for benefits not subject to a special rule in the regulations.<sup>689</sup>

*Example 4*: Allocation of C's entire costs to T as in *Example 1* is rejected as excessive and unreasonable. Also, contrary to the assumption in *Example 2*, assume there is no comparable commercial financial service and database and that T's use constitutes 2% of the total use by C and all C's employees for the year. Under an allocated cost approach, the benefit allocated to T of the use of C's service and database would be \$200 per year, which amount is equal to 2%, T's share, of C's \$10,000 fixed costs. T would also be allocated the \$10.00 charge for each inquiry made by T.

*Example 4* illustrates that an allocation of employer costs approach may achieve a fair and intuitively reasonable measure of the amount of personal benefit in a shared-use situation and may readily be applied in circumstances where comparable market transactions cannot be found.

The allocated employer cost approach implicitly gives the employee a proportional share in the benefit of any employer discount obtained in acquiring the property or service for the employer's business. However, offsetting this probably nominal benefit is the fact that the allocation to T was not reduced to reflect C's ability to choose the provider of the service as well as its priority in system use (although some adjustment for this latter limitation might have been appropriate). Another effect of an allocated cost approach is to charge the employee with income for part of the fixed cost the employer presumably would incur in any event. Thus, an allocation of employer costs approach, although usually beneficial to the employee, may be more favorable to the IRS than a charter cost approach in situations where the employer's costs are high.

Unlike the computation of income to an employee based on retail or charter cost, an allocated cost approach has the desirable effect of maintaining the linkage between the tax treatment of both parties in the compensation transaction. That is, while the employer's total deductible costs do remain fixed as described in *Example 3*, such costs are allocated, and the employer's total deduction equals the employer's nonallocated costs plus the compensation component for which the employer's deduction equals the amount included in employee income.

#### c. Incremental Employer Cost

A third approach to determining the fair market value of a benefit received by an employee is allocation of only the employer's incremental or additional cost in making the benefit of use of employer property or service available to employees.

<sup>682</sup> Cf. Reg. §1.61-21(b)(3).

<sup>683</sup> T.D. 8061, 50 Fed. Reg. 46,006 (Nov. 6, 1985); Reg. §1.162-25T(a); 1984 Act Bluebook at p. 864.

<sup>684</sup> Reg. §1.61-21(b)(2).

<sup>685</sup> The proposed Second Discussion Draft regulations adopted an allocation approach for all nonbusiness use of working conditions although the examples were not entirely consistent. Second Discussion Draft, §1.61-18(b). See also Nixon Tax Return Report at p. 162.

<sup>686</sup> *Henry Schwartz Corp. v. Commissioner*, 37 T.C. 650 (1962) at p. 663; *Rodgers Dairy Co. v. Commissioner*, 14 T.C. 66 (1950); *acq.*, 1950-2 C.B. 4.

<sup>687</sup> *Riss & Co., Inc. v. Commissioner*, T.C. Memo 1964-190, (1964), *aff'd*, 374 F.2d 161 (8th Cir. 1967); *Hitchcock v. United States*, 63-2 USTC ¶9756 (E.D. Wash. 1963); *Cowing v. Commissioner*, T.C. Memo 1969-135.

<sup>688</sup> *Riss & Co., Inc. v. Commissioner*, T.C. Memo 1964-190 (1964), *aff'd*, 374 F.2d 161 (8th Cir. 1967); *Ashby v. Commissioner*, 50 T.C. 409 (1968).

<sup>689</sup> *Wade v. Commissioner*, T.C. Memo 1988-118; cf. Reg. §1.132-9(b), Q&A-9(d) Ex. 6.

Use of this method has long been required by the Securities and Exchange Commission in connection with public disclosure of compensation of key executives because such disclosure must include the value of executive perquisites to the extent they exceed \$10,000.<sup>690</sup> Although this method has not been used as extensively for tax purposes as full allocation of the employer's cost, there is authority for such an approach.<sup>691</sup> For example, incremental valuation was employed by the Joint Committee in determining the amount of income that should be realized by President Nixon in connection with the highly publicized inquiry regarding his personal tax returns. Thus, when the cost of improvements to his home that were necessary for security reasons was increased in order to make such changes more attractive and to suit the president's taste, the president was charged with income only to the extent of the cost increase.<sup>692</sup> The following illustrates the application of the incremental employer cost approach.

*Example 5:* Under an incremental cost approach, the income to T of the use of C's information service and database would be the sum of the additional \$10 inquiry charges incurred in connection with T's personal use of the service and database, but would not include any part of C's \$10,000 of fixed subscription cost, because it would have been incurred by C for its business use in any event.

As *Example 5* demonstrates, an incremental cost approach is similar to the fully allocated cost approach but generally more favorable to the employee. Like the allocated total cost approach, it maintains full linkage between the tax treatment of both parties to the compensation transaction. However, incremental cost differs from fully allocated cost in that it avoids charging the employee with income representing any more of the employer's costs than the additional personal use actually requires the employer to incur. Thus, it bears a resemblance to the no-additional-cost services exclusion under §132(a)(1).<sup>693</sup>

#### d. Value to Employee

A fourth method for determining fair market value of incidental fringe benefits would be by reference to an employee's perception of value. This approach had been used occasionally before promulgation of the regulations. However, this method is expressly rejected by the regulations.<sup>694</sup>

The method is unusual in that it ignores both the cost of purchasing or acquiring the particular benefit in the marketplace and the employer's cost in making the benefit available. The focus on the subjective value to the employee seemed fair, because, unlike other standards, it recognized that a particular employer-provided benefit may have had attendant restrictions

<sup>690</sup> SEC Release No. 33-8732A (July 3, 2006) at pp. 71–72 continuing the approach of prior SEC Release No. 33-6962 (Oct. 21, 1992). See Instruction 1 to Item 402(b)(2)(iii)(C) of Regulation S-K, 17 C.F.R. §229.402 requiring use of the incremental valuation approach with inflation adjusted reporting thresholds.

<sup>691</sup> See, e.g., *Durgom v. Commissioner*, T.C. Memo 1974-58; *Vesco v. Commissioner*, T.C. Memo 1979-369 (no income from spouse's travel because no additional cost).

<sup>692</sup> Nixon Tax Return Report at pp. 178, 197–98.

<sup>693</sup> Cf. Reg. §1.132-9(b), Q&A-9(d) Ex. 6.

<sup>694</sup> Reg. §1.61-21(b)(2); Notice 94-3, Q&A-10a.

and that an item provided might not have been the item the employee would otherwise have chosen.<sup>695</sup>

Thus, before the regulations, some courts held that an employee did not receive income in the full amount of the cost of a new Cadillac sales prize when the employee would not have wanted to acquire such a car<sup>696</sup> and that a contest winner did not have income in the full amount of first-class tickets.<sup>697</sup> In a similar vein, the IRS previously ruled that the recipient of new windows installed in a promotion realized income only to the extent the value of the new windows exceeded the value of the windows replaced.<sup>698</sup> Moreover, the Joint Committee stated before the 1984 Act that value to the recipient was the "correct standard" and made extensive use of this approach in its examination of President Nixon's tax returns.<sup>699</sup>

However, the highly subjective aspect of such an approach makes application of the value-to-the-employee standard a potential administrative nightmare. It would essentially require both employers and potentially the IRS to engage in a factual inquiry into the circumstances, motivations, needs and state of mind of each employee benefit recipient.

The following example illustrates the effect application of the value-to-the-employee method of valuation would have if permitted under the regulations.

*Example 6:* T would have been willing to pay no more than \$35 per month and \$5 per inquiry for access to either C's financial service and database or a comparable commercial database and service. Under a value-to-the-employee approach, the benefit to T of the use of C's service and database would be \$35 per month plus the sum of \$5 for each of the inquiry fees with respect to the number of T's inquiries. This represents the perceived value to T of the access and information.

### 3. Special Valuation Rules Applicable to Employer-Provided Transportation

#### a. Employer-Provided Automobiles

##### (1) Overview of Valuation Rules

Employees who use employer-provided automobiles solely for business purposes or whose personal use is de minimis are not required to include the value of such use in gross income.<sup>700</sup> If an employee's use may not be excluded, however, the employee is required to report personal use as a taxable fringe benefit. In this case, the value of the availability for personal use of the employer-provided automobile may be determined under the general valuation rule or one of the four special valuation rules provided by the §61 regulations (i.e., the lease valuation rule, the cents-per-mile rule, the commuting valuation rule and the fleet valuation rule), as discussed at

<sup>695</sup> Chapoton and Egger Joint Statement at pp. 4–5.

<sup>696</sup> *McCoy v. Commissioner*, 38 T.C. 841 (1962).

<sup>697</sup> *Turner v. Commissioner*, T.C. Memo 1954-38.

<sup>698</sup> Rev. Rul. 56-181.

<sup>699</sup> Nixon Tax Return Report at pp. 162, 173, 177–78, 182–84, 196–97.

<sup>700</sup> See Reg. §1.132-5, §1.132-6. See also the discussion at II.B.2.a.(4)(a) (i).

II.C.3.a.(2)(b), II.C.3.a.(2)(c), II.C.3.a.(2)(d), and II.C.3.a.(2)(e), respectively.

If none of the special valuation rules are elected, the value of the provision of the vehicle is the amount that an individual would have to pay in an arm's-length transaction to lease the same or a comparable vehicle on the same or comparable conditions in the geographic area in which the vehicle is available for use. An example of a comparable condition is the amount of time that a vehicle is available to the employee for use (e.g., a 1-year period).<sup>701</sup> The regulations specifically prohibit general valuation of the availability of the vehicle to be made on a cents-per-mile basis applied to the number of miles the vehicle is driven unless the employee can show that the same or comparable vehicle in fact could have been leased on a cents-per-mile basis.<sup>702</sup>

The fair market value of specialized equipment is not included in the fair market value of the automobile if that equipment is not susceptible to personal use. In addition, any telephone that is in the vehicle is also not included. These exclusions apply only if the presence of the equipment or telephone is "necessitated by, and attributable to, the business needs of the employer." The value of specialized equipment is included, however, if the employee uses the specialized equipment in a trade or business of the employee other than the employee's trade or business of being an employee of the employer. This latter rule apparently does not apply to telephones.<sup>703</sup>

Under the valuation regulations,<sup>704</sup> an employer may not use a special valuation rule unless one of the following conditions is satisfied:

- the employer treats the value of the benefit as wages for reporting purposes within the time for filing the return for the taxable year (including extensions) in which the benefit is provided;
- the employee includes the value of the benefit in income within the time for filing the return for the taxable year (including extensions) in which the benefit is provided;
- the employee is not a control employee as defined in Reg. §1.61-21(f)(5) (with respect to non-government employees) or §1.61-21(f)(6) (with respect to government employees); or
- the employer demonstrates a good faith effort to treat the benefit correctly for reporting purposes. An employee may always use the general valuation rule, even if the employer uses one of the special valuation rules.<sup>705</sup> However, an employee may use a special valuation rule only if: (1) the employer uses that rule; or (2) with respect to special rules other than the fleet valuation rule, that rule is not used by the employer, and the employer also does not treat the value of the benefit as wages for reporting purposes within the filing period described above but one of the other conditions described above is met.<sup>706</sup>

<sup>701</sup> Reg. §1.61-21(b)(4)(i).

<sup>702</sup> Reg. §1.61-21(b)(4)(i).

<sup>703</sup> Reg. §1.61-21(b)(4)(ii).

<sup>704</sup> Reg. §1.61-21(c)(3)(ii).

<sup>705</sup> Reg. §1.61-21(c)(3)(ii).

<sup>706</sup> Reg. §1.61-21(c)(2)(ii).

## (2) Special Valuation Rules

### (a) Consequences of Use of Special Rules

The use of the special valuation rules is optional, and different methods may be used for different vehicles of the employer. Where one of the special rules is properly used by the employer, and elected by the employee, however, the use of the rule is determinative of the value of the benefit for income tax, employment tax and reporting purposes.<sup>707</sup>

Under Reg. §1.61-21(d)(7), once an employer chooses an automobile lease valuation method for a particular vehicle, it is generally locked into that method for that vehicle, i.e., the election is binding for all later periods in which the vehicle is made available to any employee. In CCA 201147029, the IRS Office of Chief Counsel clarified when changes in valuation methods may be made by employers for vehicles used by employees. The advice indicated that a change in valuation methods for income tax purposes can be made at the discretion of the employer, even for existing vehicles, which clarifies regulations that might have been read to indicate a different result. The precise question raised was whether an employer could change from the commuting valuation method to the lease value method for the vehicles placed in service in prior years. First, CCA 201147029 clarified that the change was possible. Although, under the regulations, an employer may adopt the automobile lease valuation rule for an automobile only if the rule is adopted to take effect by the later of January 1, 1989, or the first day on which the automobile is made available to an employee of the employer for personal use, if the commuting valuation rule was initially used, the regulations allow employers to switch to the annual lease value method, but only on the first day on which the commuting valuation rule is not used. This switch in methods is possible even though the vehicle was previously available for personal use. CCA 201147029 permitted the change in method to the annual lease value method only on a prospective basis. It would not be possible to adjust prior open years, and thus, the employer could not choose to retroactively alter the valuation method.

CCA 201147029 also addressed when a vehicle is made "available" for personal use. Under the lease valuation method, this is the day the method must be implemented. Generally, under the commuting valuation method, vehicles are not permitted to be available for personal use except for de minimis amounts. CCA 201147029 advised that availability is defined as access to the vehicle, not whether personal use is allowed. Thus, a vehicle would be available for personal use under the commuting valuation method, even though it is generally not permitted. In spite of this determination, CCA 201147029 concluded that the regulations permitted a change to the lease value method after the vehicle had already been available for personal use.

The valuation formulas contained in the special rules apply only to the proper use of those rules. Thus, when a special rule cannot be used, the benefit in question must be valued using the general valuation rules and principles previously discussed.<sup>708</sup>

<sup>707</sup> Reg. §1.61-21(c)(3)(ii).

<sup>708</sup> Reg. §1.61-21(c)(5).

*Comment:* Employers should carefully consider whether they are using an objective fair market value when using the special valuation tables for determining the value of certain fringe benefits. Failure to do so may result in the IRS's successful application of a more severe method of determining the value of the benefit. A case in point is *BMW of North America, Inc. v. United States*,<sup>709</sup> regarding the method BMW used to value the use of BMW cars that the company made available as a fringe benefit to its employees. The IRS asserted that the values that BMW adopted as the fair market values of the cars were too low, such that when BMW applied the "fair market value" to the special valuation tables, it obtained an artificially low amount. Accordingly, the IRS assessed and collected federal employment taxes on the underreported value of the fringe benefits. In assessing the amount due from BMW, the IRS completely ignored the special valuation tables, asserting that once BMW abused the right to use the tables, it could determine the fair market value of the annual lease using any reasonable valuation method that the revenue agent determined was appropriate. BMW argued that it should be permitted to use the special valuation tables rather than being subjected to the ad hoc one-year lease formula that the revenue agent used to determine the under-reported amounts. BMW admitted that it did not use the manufacturer's suggested retail price (MSRP) as the fair market value of the cars when applying the special valuation table but, rather, used the wholesale price of the base model vehicle for each vehicle "series," without regard to the model within the series that was assigned to particular employees or the different options and equipment on particular vehicles. BMW also used the base model price in situations where an "M" model car (which was worth about \$15,000 more than a base model car) was assigned. BMW argued that the wholesale, base model price was appropriate because it took into account the employee's lack of choice as to color or options available on the automobile that was provided for the employee's use. BMW also argued that the cars were unpopular models or "end of model year" leftovers. The IRS rejected these arguments and concluded that the fair market values used as a starting point for determining the lease rate under the special valuation table were too low. The IRS argued that, based on the language in the regulations, because BMW had improperly used the special valuation tables, BMW could not use the tables at all in determining the value of the fringe benefit. BMW argued that it should be permitted to use the special valuation tables, only with the revised fair market values.

The district court concluded that Reg. §1.61-21(c)(5) is a penalty provision that the IRS may invoke to prevent taxpayers who have improperly applied a special valuation rule to a fringe benefit from using any special valuation rule to determine the value of that fringe benefit. A taxpayer that improperly applies a special valuation rule must apply the general valuation rules, the court concluded.<sup>710</sup>

If one of the special valuation rules is used by both employer and employee, the employer is required to report, and the employee must include in gross income, the amount determined by the employer under the special rule, less any reimbursement to the employer by the employee. In such case,

<sup>709</sup> 39 F. Supp. 2d 445 (D.N.J. 1998).

<sup>710</sup> *BMW of North America, Inc. v. United States*, 39 F. Supp. 2d 445.

the amount of the reimbursement may be determined under the special rule, as well, if the parties so choose.<sup>711</sup>

Neither the employer nor the employee is required to report the election to the IRS.<sup>712</sup>

#### (b) Lease Valuation Rule

One option for valuing the includible use of an automobile by an employee is the "annual lease value" (ALV) of the automobile. The ALV concept may be used in instances when an employer provides an automobile to an employee for an entire year. If the automobile is supplied for less than an entire year, the ALV is prorated, on a "daily lease value," as defined below, is used.<sup>713</sup>

The ALV may be used only to determine the amount to be included in gross income for the use of an "automobile," which, for this purpose, is defined as any four-wheeled vehicle manufactured primarily for use on public streets, roads or highways.<sup>714</sup> The method does not apply to other types of vehicles provided to an employee, such as a motorcycle or a tractor.

*Note:* For 2020, an employer could switch to the cents-per-mile rule to determine the value of an employee's personal use of an employer-provided automobile beginning on March 13, 2020, if the employer reasonably expected that an automobile valued at no more than \$50,400 would be regularly used in the trade or business throughout 2020, but was not regularly used due to the Covid-19 pandemic. The employer, however, was required to prorate the value of the vehicle using the automobile lease valuation rule through March 12, 2020. Employers who switched to the cents-per-mile rule under this temporary relief could continue to follow this rule for 2021 or could revert to the automobile lease valuation rule as long as they meet the requirements of Reg. §1.61-21(e), other than the consistency rules. The consistency rules apply as of January 1, 2021, as if January 1, 2021, were the first day the vehicle was used by, or made available to, the employee for personal use; thus, the special valuation rule used for 2021 must be used for all subsequent years, except to the extent the employer uses the commuting valuation rule.<sup>715</sup>

The ALV is calculated by first referring to the Annual Lease Value Table set forth in Reg. §1.61-21(d)(2)(iii) and using the fair market value of the automobile as of the first date it was made available to the employee for personal use to find the ALV in the table.<sup>716</sup> The ALV table value is then multiplied by the fraction of the total mileage driven by the employee that is devoted solely to personal purposes to arrive at the amount includible in the employee's income.<sup>717</sup>

<sup>711</sup> Reg. §1.61-21(c)(2)(ii).

<sup>712</sup> The rule of Reg. §1.61-21(c)(3)(i) in effect for benefits provided before January 1, 1993, appears to continue to apply for later periods in the absence of further guidance by the IRS requiring such reporting.

<sup>713</sup> Reg. §1.61-21(d)(1)(i).

<sup>714</sup> Reg. §1.61-21(d)(1)(ii).

<sup>715</sup> Notice 2021-7. Employees using a special valuation rule must use the same special valuation rule that is used by their employer. Employers making the switch in 2020 may report and withhold using the rules in Announcement 85-113 (discussed at V.A.1.b.), the §6413 adjustment process, or the §6402 refund claim process. Notice 2021-7.

<sup>716</sup> Reg. §1.61-21(d)(2)(i).

<sup>717</sup> Reg. §1.132-5(b)(1).

*Example:* An employer made available to an employee for 2012 an automobile valued at \$20,000, which the employee used for personal purposes 25% of the time. The ALV of the automobile under the table in the regulations was \$5,600. The amount the employee had to include as income was  $\$5,600 \times 25\%$ , or \$1,400.

The ALV table prescribed by the regulations only lists lease values for cars with a fair market value of up to \$59,999; vehicles with a fair market value in excess of \$59,999 are deemed to have an ALV of 25% of the fair market value plus \$500.<sup>718</sup>

Employers who lease automobiles may treat the manufacturer's suggested retail price less 8% as the fair market value of the automobile for purposes of calculating the ALV (sales tax and title fees attributable to the purchase of the automobile are treated as part of the automobile's retail price).<sup>719</sup> Under an alternative method set forth in Notice 89-110,<sup>720</sup> employers may use the manufacturer's invoice price plus 4% as the fair market value for vehicles provided after December 31, 1988.

In TAM 9816007, the employer was a distributor of vehicles made by an affiliated company and provided vehicles to certain of its employees for their use for a specified period of time. Thus, the employer owned, rather than leased, the vehicles provided to its employees. The IRS National Office pointed out that if an automobile owned by the employer is manufactured by an entity with which it is aggregated, Reg. §1.61-21(d)(5)(ii)(B) provides that the value of the automobile must be determined under Reg. §1.61-21(d)(5)(i) based on the amount that an individual would have to pay in an arm's-length transaction to purchase the particular automobile. Accordingly, the IRS National Office advised that the employer was not entitled to use the safe harbor provided in Notice 89-110 for determining the fair market value of the vehicles provided for the use of its employees for purposes of applying the automobile lease valuation rule. Because the employer was not entitled to use the automobile lease valuation rule provided in Reg. §1.61-21(d) for purposes of valuing the use of the vehicles at issue by its employees and, it had to value the use of the vehicles under the general valuation rules of Reg. §1.61-21(b). The employer's reliance on an erroneous interpretation of Notice 89-110 that was nonetheless consistent with the method used by the IRS in settling adjustments made during a prior audit cycle of the employer did not preclude the IRS from retroactively collecting any underwithheld taxes attributable to the erroneous interpretation. Here, the deficiency resulted from the employer's reliance on the method considered appropriate by an individual IRS agent in settling an adjustment for prior years, although in apparent direct conflict with the plain language of Reg. §1.61-21 and Notice 89-110. The IRS cited *Davis v. Commissioner*<sup>721</sup> and *Keel v. Commissioner*<sup>722</sup> in support of its conclusion.

<sup>718</sup> Reg. §1.61-21(d)(2)(iii).

<sup>719</sup> Reg. §1.61-21(d)(5)(ii)(C).

<sup>720</sup> As modified with respect to life insurance costs by REG-142695-05, 72 Fed. Reg. 43,938, 43,944 (Aug. 6, 2007).

<sup>721</sup> 65 T.C. 1014 (1976).

<sup>722</sup> T.C. Memo 1997-278.

Maintenance and insurance costs are included in the ALV,<sup>723</sup> but other costs (such as fuel or chauffeur services) are not.<sup>724</sup> Thus, if an employer provides fuel, the fair market value of the fuel must be computed separately for inclusion in income. For convenience, the employer or employee can elect to value such fuel at 5.5 cents per mile driven by the employee within the United States, its possessions and territories, Canada and Mexico,<sup>725</sup> or the amount of reimbursement by, or charge to, the employer for the arm's-length purchase of fuel.<sup>726</sup> Thus, under Reg. §1.61-21(d)(3)(ii), employer-paid fuel provided in-kind to employees for personal use may be valued at fair market value or at 5.5 cents per mile. If the cost of the fuel is reimbursed by or charged to the employer, the fair market value of the fuel generally is the amount of the reimbursement or the amount charged. However, certain employers with fleets of at least 20 automobiles may determine the fair market value of the fuel provided to employees by using the fleet-average cents-per-mile fuel cost.

Use of the special 5.5-cents-per-mile rule was extended by Notice 89-110, which provides that the 5.5-cents-per-mile option may be used: (1) when the fuel is provided in-kind; or (2) when the employer uses the fleet-average value for purposes of calculating the Annual Lease Values of the automobiles in the fleet.<sup>727</sup>

The value of specialized equipment in the automobile is not taken into account in the fair market value of the vehicle if its presence is necessitated by the business of the employer, but is included in the fair market value if the employee uses the equipment in a business separate from that of the employer.<sup>728</sup>

A prorated ALV may be used with respect to any periods that the car is available to the employee for at least 30 continuous days but less than the entire calendar year, as long as the reason the automobile is unavailable is not primarily for the reduction of federal income taxes (i.e., it should be for legitimate business reasons).<sup>729</sup> Further, if an automobile is unavailable to an employee because of personal reasons (such as a vacation), the prorated ALV method, if used, must not take into account such periods of unavailability.<sup>730</sup>

*Example:* The automobile in the previous example, which was worth \$20,000 on January 1, 2012, is only available to the employee for personal use from July 1, 2012, through

<sup>723</sup> Reg. §1.61-21(d)(3)(i).

<sup>724</sup> Reg. §1.61-21(d)(3)(ii), §1.61-21(d)(3)(iii). Although the cost of chauffeur services is not included in the calculation of ALV, the regulations provide guidance for valuing such services in Reg. §1.61-21(b)(5).

<sup>725</sup> Reg. §1.61-21(d)(3)(ii)(B). However, proposed regulations introduced in 1992 would limit the use of the 5.5-cents-per-mile rule to calendar years 1989 through 1992 and for subsequent calendar years apply a cents-per-mile rate set forth in the annual revenue procedure covering optional standard rates for computing the deductible costs of operating a passenger automobile for business. 57 Fed. Reg. 46,525 (Oct. 9, 1992).

<sup>726</sup> Reg. §1.61-21(d)(3)(ii)(C).

<sup>727</sup> The initial exception to Reg. §1.61-21(d)(3) was effective for 1990 and prior calendar years. However, the IRS announced in Notice 91-41 that for calendar year 1991 (and apparently for subsequent years during which the Notice has remained effective), employers may continue to use the 5.5-cents-per-mile option provided in Notice 89-110.

<sup>728</sup> Reg. §1.61-21(d)(5)(iv).

<sup>729</sup> Reg. §1.61-21(d)(4)(i).

<sup>730</sup> Reg. §1.61-21(d)(4)(iv)(B).

December 31, 2012. In that period, the automobile was driven 5,000 miles, of which 2,000 represented personal miles. If the prorated ALV method is elected and the safe harbor for fuel valuation is used, the employee's income inclusion would be computed as follows:

Value of auto at 1/1/2012	\$20,000
ALV (from table)	5,600
Prorated ALV	\$2,800
Personal use (2,000/5,000)	× .40
ALV inclusion	\$1,120
Fuel (2,000 miles at 5.5 cents per mile)	110
Total fringe benefit inclusion	\$1,230

For continuous periods of availability of one or more, but less than 30 days, a "Daily Lease Value" (DLV) can be used. This value is determined by multiplying the ALV by a fraction, the numerator of which is four times the number of days of availability and the denominator of which is 365.<sup>731</sup> However, an election may be made to treat the automobile as if it had been available for at least 30 days and use the appropriate prorated ALV amount, if this amount would result in a lower valuation than use of the DLV fraction.<sup>732</sup>

There are three situations in which the DLV may not be the appropriate measure of value. First, when an automobile is provided to an employee for a continuous period of at least 30 days, but the period of availability straddles two calendar years, the use of a prorated ALV is permitted.<sup>733</sup> Second, when a demonstration automobile is made available to an employee of an automobile dealership (for personal use beyond that permitted by the special §132(j)(3)(B) exclusion), but is not available to the employee for at least 30 consecutive days because it is included in the dealership's inventory (and thus subject to sale), the ALV or prorated ALV is used to value the automobile, as generally determined by the average of the fair market values of the automobiles available to the employee.<sup>734</sup> Third, when an employer uses the fleet-average valuation rule described below and makes fleet automobiles available to employees for a period of at least 30 consecutive days, the employee may be treated as having one of the fleet automobiles available for the entire period, with its fair market value treated as being equal to the fleet-average value.<sup>735</sup>

The figures in the ALV table apply for a four-year period starting on the date on which the special rule is applied by the employer or the employee to the car and ending on December 31 of the fourth full year following that date.<sup>736</sup> After that period, the automobile is revalued and the ALV for each subsequent four-year period is based on the fair market value of the car on the first January 1 following the preceding four-year period.<sup>737</sup> Also, the automobile may be revalued before this time if

<sup>731</sup> Reg. §1.61-21(d)(4)(ii).

<sup>732</sup> Reg. §1.61-21(d)(4)(iii).

<sup>733</sup> Reg. §1.61-21(d)(4)(i)(B).

<sup>734</sup> Reg. §1.61-21(d)(6)(ii)(B).

<sup>735</sup> Reg. §1.61-21(d)(6)(i).

<sup>736</sup> Reg. §1.61-21(d)(2)(iv).

<sup>737</sup> Reg. §1.61-21(d)(2)(iv).

it is transferred from one employee to another by the employer, except that such a transfer is ineffective for valuation purposes if the primary purpose of the transfer was to reduce federal taxes.<sup>738</sup> Fair market value in the case of any such revaluation, for purposes of redetermining ALV, may be fixed by reference to the "blue book" value at January 1 of the revaluation year.<sup>739</sup>

As previously noted, neither the employer nor the employee is required to use the safe harbor ALV method. However, if the employer uses this method, the employee must also use it or, as the only other alternative, the general valuation method. Moreover, if both the employer and the employee use the ALV method, the amount that is included in gross income by the employee must be the same amount included in the employee's income by the employer.<sup>740</sup>

For an alternative to determining the ALV for a large number of cars on a car-by-car basis, see the fleet-average valuation rule discussed at II.C.3.a.(2)(e).

### (c) Cents-per-Mile Method

The regulations permit the standard mileage rate to be used to determine the value of all personal miles driven by an employee in an employer-provided vehicle, including an automobile. The rate is readjusted by the IRS periodically.<sup>741</sup>

The difference between a "vehicle" and an "automobile" is that a "vehicle" is defined as a motorized vehicle manufactured primarily for use on public streets, roads and highways, while an "automobile" is defined as a four-wheeled vehicle.<sup>742</sup> Thus, the personal use of an employer-provided motorcycle or six-wheel (heavy duty) truck may be valued under the cents-per-mile method, but its availability may not be valued under the ALV method, which is limited to "automobiles."<sup>743</sup>

The use of the cents-per-mile method is permissible only in connection with the valuation of personal use of a vehicle that is either: (1) reasonably expected to be regularly used in the employer's business throughout the calendar year (or such shorter period if the vehicle is owned or leased by the employer); or (2) is actually driven (for either personal and business use) at least 10,000 miles in a calendar year, and the vehicle is used primarily by employees.<sup>744</sup> Also, to use this method, if

<sup>738</sup> Reg. §1.61-21(d)(2)(v).

<sup>739</sup> Reg. §1.61-21(d)(5)(iii).

<sup>740</sup> Reg. §1.61-21(c)(2)(ii). See discussion at II.C.3.a.(1).

<sup>741</sup> For 2026, the standard mileage rate is 72.5 cents-per-mile for all miles of business use. Notice 2026-10, §3. For 2025, the standard mileage rate is 70 cents-per-mile for all miles of business use. Notice 2025-5, §3. For the rates for prior years, see Tables, Charts & Lists, *Standard Mileage Rates*. Miscellaneous itemized deductions subject to the two-percent of adjusted gross income floor under §67, including unreimbursed employee travel expenses, are suspended for taxable years beginning after December 31, 2017. §67(h), added by TCJA, Pub. L. No. 115-97, §11045 (added as §67(g) to suspend miscellaneous itemized deductions through 2025), effective for taxable years beginning after December 31, 2017, and redesignated and amended by OBBBA, Pub. L. No. 119-21, §70110(a) and §70110(b)(2) (permanent disallowance), effective for taxable years beginning after December 31, 2025. As a result, no itemized deduction for unreimbursed employee travel expenses are allowed, although expenses deductible with regard to determining adjusted gross income (e.g., by reservists serving in the U.S. Armed Forces, certain state or local government officials, eligible educators, and certain performing artists) are permitted. See, e.g., Notice 2026-10.

<sup>742</sup> Compare Reg. §1.61-21(e)(2) with Reg. §1.61-21(d)(1)(ii).

<sup>743</sup> Reg. §1.61-21(d)(1).

<sup>744</sup> Reg. §1.61-21(e)(1).

the vehicle whose use is being valued is an automobile, it must have a fair market value as of the date first made available to an employee for personal use that does not exceed \$50,000, which is adjusted under §280F(d)(7) beginning with the 2019 calendar year.<sup>745</sup> The maximum value of an employer-provided vehicle first made available to employees for personal use is \$61,700 for calendar year 2026 and \$61,200 for calendar year 2025.<sup>746</sup>

*Note:* For 2020, certain employers could switch from the lease valuation rule to the cents-per-mile rule to determine the value of an employee's personal use of an employer-provided automobile beginning on March 13, 2020, as discussed in II.C.3.a.(2)(b), above.<sup>747</sup>

A transition rule could be applied for a vehicle first made available to any employee for personal use before calendar year 2018. If an employer did not qualify to adopt the vehicle cents-per-mile method on the first day on which the vehicle was used by the employee for personal use because the vehicle's fair market value exceeded the inflation-adjusted limitation announced in IRS guidance for the year the vehicle was first used by the employee for personal use, the employer could first adopt the vehicle cents-per-mile valuation rule for the 2018 or 2019 taxable year, provided the fair market value of the vehicle did not exceed \$50,000 on January 1, 2018, or \$50,400 on January 1, 2019, respectively.<sup>748</sup> Similarly, for a vehicle first made available to any employee for personal use before calendar year 2018, if the commuting valuation rule under Reg. §1.61-21(f) was in use and the employer did not qualify to switch to the vehicle cents-per-mile rule on the first day on which the commuting valuation rule could not be used because the vehicle had a fair market value in excess of the inflation-adjusted limit, the employer may adopt the vehicle cents-per-mile rule for the 2018 or 2019 taxable year, as long as the vehicle's fair market value does not exceed the limit for the year; however, the employer must continue using this rule for all subsequent years in which the vehicle qualifies for use of the rule, except for any year during which use the commuting valuation rule may be used for the vehicle.<sup>749</sup>

<sup>745</sup> Reg. §1.61-21(e)(1)(iii), as amended by T.D. 9893, 85 Fed. Reg. 6424 (Feb. 5, 2020), applying to taxable years beginning on or after February 5, 2020; Notice 2019-34, Notice 2019-08. See §280F(d)(7), as modified by TC-JA, Pub. L. No. 115-97, §11002(d)(8) (reflecting change to inflation adjusted formula) and §13202(a)(2)(B), effective for taxable years beginning after December 31, 2017. Before the amendment by T.D. 9893, the regulation provided that the automobile's fair market value as of the date first made available to an employee for personal use could not exceed the sum of the maximum recovery deductions allowable under §280F(a)(2) for a five-year period of use, limited to \$12,800, as adjusted by §280F(d)(7). For further discussion, see 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses*.

<sup>746</sup> Notice 2026-10, §6 (2026 amount), Notice 2025-5, §6 (2025 amount). For the maximum values for prior years, see Tables, Charts & Lists, *Maximum Vehicle Values*. Separate values for trucks and vans are not published for 2018 and subsequent years, and therefore the limits applicable to passenger automobiles also apply to trucks and vans. Employers that wish to use the valuation rule for 2018 and subsequent years based on these maximum values may correct any overpayment of federal employment taxes on these amounts by using the rules in Announcement 85-113 (discussed at V.A.1.b.), the §6413 adjustment process, or the §6402 refund claim process. Notice 2019-34, §5, Notice 2019-08, §5.

<sup>747</sup> Notice 2021-7.

<sup>748</sup> Reg. §1.61-21(e)(5)(vi), added by T.D. 9893, 85 Fed. Reg. 6424 (Feb. 5, 2020). A taxpayer could choose to apply this transition rule beginning on or after January 1, 2018. Reg. §1.61-21(e)(6), added by T.D. 9893; Notice 2019-34.

There are two safe harbor rules with respect to the requirement that the vehicle be regularly used in the employer's business. Under Reg. §1.61-21(e)(1)(iv)(A) and §1.61-21(e)(1)(iv)(B), the vehicle is considered to be regularly used in the employer's trade or business if either of the following conditions is satisfied: (i) at least 50% of the vehicle's total annual mileage is for the employer's business; or (ii) the vehicle generally is used each workday to transport at least three employees of the employer to and from work in an employer-sponsored commuting vehicle pool. However, infrequent business use of the vehicle (e.g., for occasional trips to the airport or between the employer's multiple business premises) does not constitute regular use.

An employee may take advantage of the cents-per-mile rule as long as the vehicle is driven 10,000-miles per year (and the other requirements of the rule are met), even if more than one employee makes use of that vehicle.<sup>750</sup> If the vehicle is owned or leased by the employer for less than a full calendar year, the 10,000-mile threshold is reduced proportionately.<sup>751</sup>

In determining the fair market value of an automobile for purposes of applying the dollar limitation as required by the vehicle cents-per-mile rule, there is a special rule that applies when a vehicle is owned or leased by both an employer and an employee. If the employee receives an ownership interest in the vehicle, the fair market value for purposes of the limitation is computed by deducting the amount of the employee's contribution (unless the interest is not proportionate to the contribution of the employee, in which case the reduction in fair market value is decreased).<sup>752</sup> If the employee contributes to the lease of a vehicle but does not receive a percentage interest in the vehicle lease, the fair market value is determined without regard to any amount contributed by the employee (although the amounts contributed will reduce the amount includable in the employee's income for the personal use of the vehicle).<sup>753</sup>

As in the case of the ALV method, maintenance and insurance costs are considered to be included in the cents-per-mile method.<sup>754</sup> However, unlike the ALV method, fuel provided by the employer is deemed included in the standard mileage rate, but only with respect to miles driven in the United States, U.S. territories, Canada and Mexico.<sup>755</sup> If fuel is not provided by the employer, the cents-per-mile inclusion may be reduced by 5.5 cents per mile or the amount specified in any IRS pronouncement.<sup>756</sup> For miles driven outside the United States, U.S. territories, Canada, and Mexico, the cents-per-mile method does not include fuel, so that the inclusion may be reduced by 5.5 cents per mile (or the amount to be specified by the IRS), or the amount of reimbursement by, or charge to, the employer for the arm's-length purchase of fuel.<sup>757</sup>

*Comment:* As a general rule, the more miles that an automobile is driven, and less valuable it is when provided to

<sup>749</sup> Reg. §1.61-21(e)(5)(vi); Notice 2019-34.

<sup>750</sup> Reg. §1.61-21(e)(1)(ii).

<sup>751</sup> Reg. §1.61-21(e)(1)(ii)(B).

<sup>752</sup> Reg. §1.61-21(e)(1)(iii)(B).

<sup>753</sup> Reg. §1.61-21(e)(1)(iii)(C).

<sup>754</sup> Reg. §1.61-21(e)(3)(i).

<sup>755</sup> Reg. §1.61-21(e)(3)(ii)(A).

<sup>756</sup> Reg. §1.61-21(e)(3)(ii)(A).

<sup>757</sup> Reg. §1.61-21(e)(3)(ii)(B).

an employee, the less likely the cents-per-mile method represents a savings to the employee. For example, if an automobile is worth only \$6,000, and an employee drives it 15,000 miles for personal purposes during the year, supplying the fuel, the ALV inclusion would be \$2,100 but the inclusion under the cents-per-mile method would be \$3,675 (15,000 × (30¢ – 5.5¢)). However, if the employee had use of an employer-provided automobile worth \$12,000 for a full calendar year and drove it for 5,000 personal miles during the year, supplying the fuel, the ALV inclusion would be \$3,600, but only \$1,225 under the cents-per-mile method.

While the use of the cents-per-mile method is optional, if the employer uses this method, an employee's ability to use an alternative other than the general valuation may be limited.<sup>758</sup>

#### (d) Commuting Valuation Rules

When an employer-provided vehicle is supplied to an employee and is not available to the employee for personal use other than commuting, a special valuation method is provided for determining the amount includible in the employee's income. Under this rule, an employee, other than a private sector control employee, may value the use of the vehicle at \$1.50 per 1-way commute for each time the vehicle is used for commuting.<sup>759</sup>

The special valuation rule for commuting is discussed further at II.B.2.a.(4)(a)(i).

A related rule was developed for valuation of commuting furnished or reimbursed by an employer to certain employees due to unsafe conditions. Under this special rule, qualified employees include in income only \$1.50 per commuting trip provided by an employer because of unsafe conditions. This special valuation rule is available only to nonexempt employees who are paid overtime under the Fair Labor Standards Act and who receive compensation of no more than the amount permitted for highly compensated employees under §414(q)(1) (as indexed for inflation).<sup>760</sup> Employer-provided transportation eligible for the special valuation rule is transportation furnished solely because of unsafe conditions, pursuant to the employer's written policy, to a qualified employee who would otherwise walk or use public transportation.<sup>761</sup>

The transportation may be furnished directly by an employer, through an independent taxi or car service company, or the employer may reimburse the employee for the cost of hiring a cab from an unrelated third party. Any reimbursements (such as for taxi fare) must be made under a bona fide reimbursement arrangement.<sup>762</sup>

"Unsafe conditions" exist if a reasonable person would, under the facts and circumstances, consider it unsafe for the employee to walk to or from home, or to walk to or use public transportation at the time of day the employee must commute. One of the factors to be considered is the history of crime in the geographic area surrounding the employee's workplace or residence at the time of day the employee must commute.<sup>763</sup>

<sup>758</sup> Reg. §1.61-21(c)(2)(ii). See generally discussion at II.C.3.a.(1).

<sup>759</sup> See generally Reg. §1.61-21(f).

<sup>760</sup> For the current and previous dollar amounts, see Tables, Charts & Lists, *Pension and Retirement Plans — IRC Cost of Living Adjustments*.

<sup>761</sup> Reg. §1.61-21(k).

<sup>762</sup> Reg. §1.61-21(k)(4).

#### (e) Fleet Valuation Rule

For employers utilizing large fleets of automobiles, the ALV of the separate automobiles within the fleet may be determined by using the average valuation of the entire fleet. The fleet-average valuation method is available only to employers with a fleet of 20 or more automobiles in a calendar year (or for the calendar year following the year in which the employer acquires 20 or more automobiles).<sup>764</sup> In addition, an employer may include in the fleet only automobiles the availability of which is valued under the automobile lease valuation rule.<sup>765</sup>

Once used, the ALV calculated for the qualifying automobiles in the fleet remains in effect for the period commencing on January 1 of the year the method is applied to the automobiles and ending December 31 of the next calendar year.<sup>766</sup> The same ALV applies to any automobiles qualifying for the use of the method that are added to the fleet within this period.<sup>767</sup>

The use of the average fleet valuation rule is permissible only for an automobile the fair market value of which, determined as of the first date on which the automobile is made available to any employee of the employer for personal use, exceeds \$50,000, which is adjusted under §280F(d)(7) beginning with the 2019 calendar year.<sup>768</sup>

The maximum value of an employer-provided vehicle first made available to employees for personal use is \$61,700 for calendar year 2026 and \$61,200 for calendar year 2025.<sup>769</sup>

A transition rule could be applied if an employer with a fleet of 20 or more vehicles consisting of passenger automobiles, including trucks or vans, did not qualify to use the fleet valuation rule before January 1, 2018, with respect to any automobile, including a truck or van, because the vehicle's fair market value exceeded the inflation-adjusted maximum value announced in IRS guidance for the year the vehicle was first made available to any employee. Under this rule, the employer could adopt the fleet-average valuation rule for 2018 or 2019 for the vehicle, as long as the fair market value of the vehicle did not exceed \$50,000 on January 1, 2018, or \$50,400 on January 1, 2019, respectively.<sup>770</sup>

<sup>763</sup> Reg. §1.61-21(k)(5).

<sup>764</sup> Reg. §1.61-21(d)(5)(v)(B).

<sup>765</sup> Reg. §1.61-21(d)(5)(v)(C).

<sup>766</sup> Reg. §1.61-21(d)(5)(v)(B).

<sup>767</sup> Reg. §1.61-21(d)(5)(v)(E).

<sup>768</sup> Reg. §1.61-21(d)(5)(v)(D), as amended by T.D. 9893, 85 Fed. Reg. 6424 (Feb. 5, 2020), applying to taxable years beginning on or after February 5, 2020; Notice 2019-34, Notice 2019-08. The base value increase from \$16,500 (under Reg. §1.61-21(d)(5)(v)(D) as in effect before the TCJA, Pub. L. No. 115-97 changes) to \$50,000 for the 2018 calendar year is intended to be consistent with the increase in depreciation limitations for passenger automobiles placed in service after December 31, 2017. See §280F(a) and §280F(d), as amended by Pub. L. No. 115-97, §13202 and §11002(d)(8).

<sup>769</sup> Notice 2026-10, §6 (2026 limit), Notice 2025-5, §6 (2025 limit). Separate values for trucks and vans are not published for 2018 and subsequent years, and therefore the limits applicable to passenger automobiles also apply to trucks and vans. Employers that wish to use the valuation rule for 2018 and subsequent years based on these maximum values may correct any overpayment of federal employment taxes on these amounts by using the rules in Announcement 85-113 (discussed at V.A.1.b.), the §6413 adjustment process, or the §6402 refund claim process. Notice 2019-34, Notice 2019-08.

<sup>770</sup> Reg. §1.61-21(d)(5)(v)(G), added by T.D. 9893, 85 Fed. Reg. 6424 (Feb. 5, 2020). A taxpayer could choose to apply this transition rule beginning on or after January 1, 2018. Reg. §1.61-21(d)(5)(v)(H), added by T.D. 9893; Notice 2019-34.

As noted above, the use of the ALV method does not include the value of fuel supplied to an employee, which may be valued at the safe harbor rate of 5.5 cents per mile or the cost charged to, or reimbursed by, the employer. The valuation of the fuel, where the cost is reimbursed by or charged to an employer, is the fair market value of the fuel. The “fair market value” generally is the amount of the actual reimbursement or the amount charged, provided that the purchase of the fuel is at arm’s length.<sup>771</sup>

An employee may not use the average fleet value of an automobile from the fleet unless the employer uses the fleet valuation method.<sup>772</sup> However, if the employer uses the method, and the employee uses the lease valuation rule, the employee must use the fleet-average value as the measure of ALV for the vehicle.<sup>773</sup>

When an employer uses the fleet-average valuation rule and makes fleet automobiles available to employees for a period of at least 30 consecutive days, the employees may be treated as having one of the fleet automobiles available for the entire period, with its fair market value treated as being equal to the fleet-average value.<sup>774</sup> In addition, when an employer uses the fleet-average valuation rule, it may value the fuel provided to the employees at 5.5 cents per mile (regardless of whether it is provided in-kind) if an unreasonable administrative burden would result by requiring the employer to determine the actual amount reimbursed or charged.<sup>775</sup>

### (3) Employer Election of Use of Special Valuation Rules and Recordkeeping Requirements

Recordkeeping requirements will vary based on the special valuation rule used by the employer and the employee. For example, if an employer intends to use the ALV method or cents-per-mile method, adequate records that substantiate the employee’s business use of the vehicle must be maintained.<sup>776</sup> On the other hand, if the commuting valuation rule is used, the employee need keep track only of the number of one-way commutes in the vehicle.

A particular special valuation rule is deemed to have been elected by the employer (and, if applicable, the employee) if the employer determines the value of the fringe benefit provided by applying the special valuation rule and treats that value as the fair market value of the fringe benefit for income, employment tax and reporting purposes. Neither the employer nor the employee must notify the IRS of the election, however.<sup>777</sup>

A requirement that employers notify employees of the employer’s use of a special valuation rule was removed retroactive to January 1, 1989, in final regulations issued on December 30, 1992.<sup>778</sup>

<sup>771</sup> Reg. §1.61-21(d)(3)(ii).

<sup>772</sup> Reg. §1.61-21(d)(5)(v)(F).

<sup>773</sup> Reg. §1.61-21(d)(5)(v)(F).

<sup>774</sup> Reg. §1.61-21(d)(6)(i).

<sup>775</sup> Reg. §1.61-21(d)(3)(ii)(D).

<sup>776</sup> See §274(d) and the regulations thereunder.

<sup>777</sup> The rule of Reg. §1.61-21(c)(3)(i) for benefits provided before January 1, 1993, appears to continue to apply for later periods in the absence of a different rule requiring such reporting.

<sup>778</sup> T.D. 8457, 57 Fed. Reg. 62,192 (Dec. 30, 1992).

## b. Aircraft Flights

### (1) Overview of Valuation Guidelines

The §61 regulations establish separate sets of special valuation rules for valuing flights by employees and their relatives on employer-provided aircraft and on commercial flights.<sup>779</sup> Absent the applicability of these valuation rules, the value of a flight on an employer-provided aircraft represents the cost of chartering the same or a comparable aircraft for the same or a comparable flight,<sup>780</sup> and, under the general valuation rule of Reg. §1.61-21(b)(2), the value of a commercial flight would presumably be the cost to a member of the public for that flight (at a fare subject to comparable restrictions), less any amount paid to the employer for the flight.

The fact that an employer incurs no additional cost in transporting an employee on a business flight of the employer has no bearing on the requirement that the employee include the value of the benefit in flying free or at a reduced cost if the employee may not otherwise exclude the value from income (e.g., as a working condition fringe or no-additional-cost service fringe)<sup>781</sup> or under another exclusion provision such as §105 if the transportation is for medical reasons.<sup>782</sup> As a limited exception to this general rule, however, the regulations provide that no inclusion is required for the value to an employee (and certain others) of flying on an employer’s noncommercial aircraft, the seating capacity of which is at least 50% occupied by individuals whose flights are primarily for the employer’s business.<sup>783</sup>

### (2) Employer-Provided Aircraft

In valuing personal flights provided to employees in an employer-provided aircraft, in lieu of using the fair market value of chartering the aircraft or of purchasing the flight as the measure of inclusion, the flight may be valued by using a valuation formula provided in the regulations that takes into account the weight of the aircraft and whether the employee receiving the benefit is a “control employee” (defined separately for government employees and for non-government employees).<sup>784</sup>

Under the aircraft valuation formula provided for in the regulations, the value of a flight is determined by a three-step calculation. First, on a per-individual basis, the number of miles flown is multiplied by the standard industry fare level (SIFL) cents-per-mile charge in effect for the period during which the flight was taken. This figure is then multiplied by the appropriate aircraft multiple from the table below, reproduced from Reg. §1.61-21(g)(7):

<sup>779</sup> Reg. §1.61-21(g), §1.61-21(h). As discussed below, the IRS finalized regulations under §61 relating to the use of business aircraft for entertainment. Reg. §1.61-21(g)(14)(iii), finalized by T.D. 9597, 77 Fed. Reg. 45,480 (Aug. 1, 2012), applicable to tax years beginning after August 1, 2012.

<sup>780</sup> Reg. §1.61-21(b)(6).

<sup>781</sup> Reg. §1.61-21(g), §1.61-21(h).

<sup>782</sup> Reg. §1.61-21(a)(2).

<sup>783</sup> Reg. §1.61-21(a)(2).

<sup>784</sup> Reg. §1.61-21(g)(7). See, e.g., PLR 200705010.

Maximum Certified Takeoff Weight of the Aircraft	Aircraft Multiple for a “Control Employee”	Aircraft Multiple for a “Noncontrol Employee”
6,000 lbs. or less	62.5%	15.6%
6,001–10,000 lbs.	125%	23.4%
10,001–25,000 lbs.	300%	31.3%
25,001 lbs. or more	400%	31.3%

Finally, the “terminal charge” in effect for the period during which the flight was taken is added to the product determined above for each flight.<sup>785</sup>

The SIFL cents-per-mile rates in the formula and the terminal charge are calculated by the Department of Transportation and are revised semiannually; the rates in effect on December 31 govern the determination of the value of the flights taken during the first six months of the following year, and the rates in effect on June 30 govern with respect to flights taken during the last six months of that year.<sup>786</sup>

*Example:* If a flight taken on April 30, 2026, by a non-control employee on an employer-provided aircraft with a maximum certified takeoff weight of 26,000 lbs. is 2,000 miles long, the value of the flight using the SIFL rates is \$206.41  $[(.313 \times ((\$0.2980 \times 500) + (\$0.2272 \times 1,000) + (\$0.2184 \times 500))) + \$54.48]$ .<sup>787</sup>

The term “control employee” is defined, in the case of non-government employees, to mean: (1) officers, whether appointed, elected or confirmed by the board or shareholders, limited to the lesser of (a) 1% of all employees or (b) 10 employees; (2) the top 1% of the most highly compensated employees, limited to a maximum of 50; (3) 5% or greater owners of equity, capital or profits interest in the employer; or (4) a director of the employer.<sup>788</sup>

In the case of employers who are federal, state or local government units (and any agency or instrumentality of such a unit), a “control employee” is any elected official, any federal employee who is appointed by the president and confirmed by the Senate (and comparable state or local executive officer) or any employee whose compensation equals or exceeds the compensation paid to a federal government employee holding a position at Executive Level V, as determined under Chapter 11 of Title 2 of the United States Code.<sup>789</sup>

<sup>785</sup> Reg. §1.61-21(g)(5).

<sup>786</sup> Reg. §1.61-21(g)(5), §1.61-21(g)(6). For current and prior terminal charges and SIFL mileage rates, see Tables, Charts & Lists, *Standard Industry Fare Level (SIFL) Rates*. The Covid-19 pandemic caused substantial increases in the SIFL rate for periods in 2021 and 2022. The CARES Act provided funds to offset airline industry expenses through the Payroll Support Program (PSP) (see Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116-136, §4113, as amended), prompting the Department of Transportation to provide alternatives that incorporate differing levels of the PSP into the SIFL rate calculations. For periods in 2022, employers could make the calculation using the unadjusted SIFL rate, the SIFL rate adjusted for PSP grants, or the SIFL rate adjusted for PSP grants and PSP promissory notes. Rev. Rul. 2022-19, Rev. Rul. 2022-6. The unadjusted charge and rates for the first half of 2022 were significantly higher than under the alternatives available, but they were lower than the alternatives for the second half of 2022.

<sup>787</sup> Reg. §1.61-21(g)(5). For the period January 1, 2026, through June 30, 2026, Rev. Rul. 2026-8 provides that the terminal charge is \$54.48, and the SIFL mileage rates are \$0.2980 per mile up to 500 miles, \$0.2272 per mile from 501 to 1,500 miles, and \$0.2184 per mile over 1,500 miles.

<sup>788</sup> Reg. §1.61-21(g)(8).

The term “control employee” is also used under the commuting valuation rules, but is defined differently than under the aircraft valuation rules in the case of non-governmental employers.<sup>790</sup>

The flight valuation formula may be used to value personal (i.e., nonexcludible) transportation on both domestic and international flights on all employer-provided aircraft, including helicopters, but is unavailable to value flights on any commercial aircraft on which flights are sold to the public on a per-seat basis.<sup>791</sup> See II.C.3.b.(3), however, for safe harbor rules regarding the valuation of commercial flights.

In the case of a flight having both a personal and business element, the formula is applicable to value the personal, nonexcludible element of the flight. If the primary overall purpose of the employee’s trip is the business of the employer, the includible amount is the excess of the value of all the flights that comprise the trip over the value of the flights that would have been taken had there been no personal flights but only flights entirely for business.<sup>792</sup> On the other hand, if the primary purpose of the flight is personal, the includible amount is the value of the personal flights that would have been taken had there been no business flights but only personal flights.<sup>793</sup>

*Example 1:* An employee flies on an employer-provided aircraft from San Francisco to Los Angeles for the employer’s business, then to Palm Springs for vacation, and then back to San Francisco. The primary purpose of the trip is personal. The amount includible in the employee’s income is the value of personal flights that would have been taken had there been no business flights but only personal flights (San Francisco to Palm Springs and Palm Springs to San Francisco).

*Example 2:* An employee flies on an employer-provided aircraft from New York City to Detroit for the employer’s business, from Detroit to Chicago for personal reasons, and back to New York City. If the primary purpose of the trip was the business of the employer, the includible amount would be the excess of the three flights (New York City to Detroit, Detroit to Chicago and Chicago to New York City) over the flights that would have been taken had there been no personal flights but only business flights (New York City to Detroit and Detroit to New York City). However, if the primary purpose of the trip had been personal, rather than the business of the employer, the amount includible would have been the value of the personal flights had there been no business flights but only personal flights (New York City to Chicago and Chicago to New York City).

If the noncommercial flight special valuation rule does not apply to a flight, the value of the flight is determined under the general valuation rules. The general valuation rules distinguish

<sup>789</sup> Reg. §1.61-21(g)(9).

<sup>790</sup> See Reg. §1.61-21(f)(5).

<sup>791</sup> Reg. §1.61-21(g)(2), §1.61-21(g)(4)(i).

<sup>792</sup> Reg. §1.61-21(g)(4)(ii). The “primary purpose” test is discussed in Reg. §1.162-2(b)(2).

<sup>793</sup> Reg. §1.61-21(g)(4)(iii).

between a piloted aircraft and an aircraft that is furnished without a pilot. The value of a flight on a piloted employer-provided aircraft solely for personal purposes is equal to the amount that an individual would have to pay in an arm's-length transaction to charter the same or a comparable piloted aircraft for that period for the same or a comparable flight.<sup>794</sup> The value of a flight on an employer-provided aircraft that is without a pilot solely for personal purposes is the amount that an individual would have to pay in an arm's-length transaction to lease the same or comparable aircraft on the same or comparable terms for the same period in the geographic area in which the aircraft is used.<sup>795</sup>

Regulations under §61 relating to the use of business aircraft for entertainment relax the consistency rule of Reg. §1.61-21(g)(14)(i) to permit taxpayers to value the entertainment use of aircraft by specified individuals under the fair market value rules of Reg. §1.61-21(b), but continue to value flights for other employees and for specified individuals not traveling for entertainment using either the SIFL formula of Reg. §1.61-21(g) or the general (fair market value) rule of Reg. §1.61-21(b).<sup>796</sup>

The regulations preserve the consistency rule with respect to particular groups of employees (specified and non-specified individuals) and with respect to non-entertainment flights.<sup>797</sup> Thus, if an employer values the entertainment use of aircraft by one specified individual under the fair market value rules of Reg. §1.61-21(b) in a calendar year, the employer must use the fair market value rules to value the entertainment use of aircraft by all specified individuals during that calendar year. The consistency rules of Reg. §1.61-21(g)(14)(i) continue to apply for valuing the entertainment use of aircraft for other employees (non-specified individuals) and for valuing the personal use of aircraft by specified individuals not traveling for entertainment purposes. Thus, if an employer values the personal use of aircraft by any specified individual using the SIFL formula of Reg. §1.61-21(g) in a calendar year, the employer would be required to use the SIFL formula to value the personal use of aircraft by all other employees and the non-entertainment personal use of aircraft by all specified individuals during that calendar year. Similarly, if the employer values the personal use of aircraft by any other employee or the non-entertainment personal use of aircraft by any specified individual using the fair market value rules of Reg. §1.61-21(b) in a calendar year, the employer would be required to use the fair market value rules to value the personal use of aircraft by all other employees and the non-entertainment personal use of aircraft by all specified individuals during that calendar year.

### (3) Commercial Flights

Under the commercial flight valuation rule created under the regulations, the includible value of flights on commercial airlines that are taxable to airline employees is 25% of the actu-

al carrier's highest unrestricted coach fare in effect for the particular flight being valued.<sup>798</sup> Because the restrictions applicable to the no-additional-cost service category of fringe benefits are engrafted onto the use of this method, it may only be used to value a flight: (1) that is provided on an airplane on which the employer offers, in the ordinary course of business, transportation to customers on a per-seat basis;<sup>799</sup> (2) for which the airline, by carrying an employee or guest of the employee, incurs no substantial additional cost (including forgone revenue) determined without regard to any amount paid for such flight;<sup>800</sup> and (3) that is subject to the types of restrictions customarily associated with flying on an employee standby basis.<sup>801</sup>

*Comment:* In practice, the 25% commercial flight variation rule generally applies where the flight is provided by a carrier other than the airline employee's employer. If the carrier is the employer, then the no-additional-cost service rule applies, resulting in no includible income.

For purposes of the commercial flight valuation rule, the date the flight is taken represents the time of inclusion of the benefit, rather than the date the ticket or pass is purchased or issued.<sup>802</sup>

### (4) Employer Election of Use of Special Valuation Rules and Recordkeeping Requirements

Because an aircraft is "listed property" under §280F(d)(4), the substantiation requirements with respect to its use are those applicable to other means of transportation, including automobiles, which are also listed property. Accordingly, the recordkeeping rules and the method in which the election to use a special valuation rule is made, are the same as those discussed at II.C.3.a(3) relating to the valuation of employer-provided automobiles.

### (5) Frequent Flyer Program Awards

The regulations provide no guidance regarding frequent flyer awards by airlines to travelers and no direct authority otherwise exists regarding the includibility in income or means of valuing the free travel or accommodations so derived. In Announcement 2002-18, the IRS announced that, consistent with prior administrative policy, it will not assert tax liability against taxpayers that convert frequent flyer miles or other in-kind promotional benefits attributable to business or official travel for personal use. Citing numerous technical and tax administrative issues relating to these benefits (such as the timing and valuation of income inclusions, and the basis for identifying personal use benefits attributable to business/official expenses versus those attributable to personal expenses), the IRS stated that any future guidance regarding the taxability of these benefits would be applied prospectively. The IRS cautioned that such administrative relief does not apply to travel or other promotional benefits that are converted to cash, to compensation that is paid

<sup>794</sup> Reg. §1.61-21(b)(6).

<sup>795</sup> Reg. §1.61-21(b)(7).

<sup>796</sup> Reg. §1.61-21(g)(14)(iii), T.D. 9597, 77 Fed. Reg. 45,480 (Aug. 1, 2012), applicable to tax years beginning after August 1, 2012, and obsoleting Notice 2005-45 as of August 1, 2012.

<sup>797</sup> Reg. §1.61-21(g)(14)(i), T.D. 9597, 77 Fed. Reg. 45,480 (Aug. 1, 2012), applicable to tax years beginning after August 1, 2012, and obsoleting Notice 2005-45 as of August 1, 2012.

<sup>798</sup> Reg. §1.61-21(h)(1). The 25% commercial flight valuation rule is available only to an individual described in Reg. §1.132-1(b)(1), i.e., an employee, an employee's spouse or dependent child, a retired or disabled former employee, or a retired or disabled former employee's surviving spouse. Reg. §1.61-21(h)(1).

<sup>799</sup> Reg. §1.61-21(h)(3).

<sup>800</sup> Reg. §1.61-21(h)(2).

<sup>801</sup> Reg. §1.61-21(h)(2).

<sup>802</sup> Reg. §1.61-21(h)(4).

in the form of travel or other promotional benefits, or in other circumstances where these benefits are used for tax avoidance purposes.

Foreshadowing Announcement 2002-18, the IRS previously ruled that an airline was not required to file information returns to report frequent flyer benefits issued to passengers because the income realized by passengers is not fixed and determinable.<sup>803</sup> It explained that it could not be determined in advance whether the airline's payment of cash and free tickets would result in income to the recipient in the form of a taxable fringe benefit, a purchase price adjustment, or as a recovery under the tax benefit rule.

The IRS does, however, view personal use of awards earned by business travel as a potentially taxable benefit. Thus, it has concluded in technical advice that a company's air travel business expense allowance and reimbursement plan that did not require surrender of frequent flyer awards, caused the plan to be a non-accountable plan for purposes of §62(c).<sup>804</sup>

*Comment:* The authors understand that the IRS is reconsidering the analysis supporting the non-accountable plan TAM. It is noteworthy that the IRS previously had sought comment on the taxability of such awards but never issued proposed regulations or aggressively pursued the issue against a broad base of taxpayers.

The frequent flyer award issue was also tangentially involved in *Charley v. Commissioner*<sup>805</sup> Taxpayer (T), who was president and a controlling shareholder of a testing corporation engaged a particularly egregious and complex scheme for conversion of frequent flyer awards into cash.

Under an arrangement with a travel agent, T's company would bill a client for round trip first-class air travel to the particular site, but the travel agent would arrange for him to fly coach-class. The employer would pay for the first-class air travel, but T would purchase coach-class tickets and use his frequent flyer program mileage, largely earned in connection with his business travel, to upgrade the coach service to first-class air travel. The travel agent would then credit to T's separate personal travel account the difference in price between the first-class ticket and the coach ticket. For example, if the first-class airfare was \$900 and the coach fare was \$400, the employer would pay for the \$900 ticket, which was also charged to the client. T's coach service would be upgraded to first-class, and the \$500 difference would be credited to T's personal travel account. T accumulated over \$3,000 in his account in this manner during 1988 and was assessed a deficiency.

The IRS argued alternatively that the travel credits were: (1) a taxable fringe benefit; (2) a gain from a sale of property (the frequent flyer miles); or (3) a constructive dividend. The Tax Court held that the deposits constituted taxable income under §61, and noted that there was no indication that T could not use the accumulated travel account credit balance for personal

purposes or redeem the credits for cash on demand. There was also no showing that the employer had any rights, interest or control over T's personal travel account. Importantly, the court declined to discuss or rest its opinion on the IRS's fringe benefit argument. Instead, it stated that whether it regarded the situation as a straight "rip-off" of the company by the executive (theft income) or a highly technical sale, the result was that T was wealthier after the transaction than before and held that the accretion of wealth is the receipt of income.

The Ninth Circuit affirmed the Tax Court's holding that the funds credited to T's account with his travel agent were taxable, regardless of whether they were characterized as a gain from the disposition of property (i.e., the frequent flyer miles) or as additional compensation paid by the employer, unless the taxpayer could show that he qualified for an exclusion. If the travel credits were deemed to belong to T, his disposition of them would be the disposition of property with a zero basis, the court noted. The court also stated that the travel credits converted to cash could be characterized as additional compensation because T received property from the employer in the form of an account upon which T could draw up to \$3,150, and such funds were provided by the employer. That the travel credits were exchanged for frequent flyer miles was not relevant to the court's analysis.

The court also pointed out that T could not maintain that the funds constituted a non-taxable gift because §102(c) provides that the exclusion for gifts does not apply to "any amount transferred by or for an employer to, or for the benefit of, an employee." The court further pointed out that the exclusion provided in §132(a) for a no-additional-cost service did not apply because the employer did not offer frequent flyer miles to customers in the ordinary course of its business. However, the Ninth Circuit held that the Tax Court erred in finding T liable for the \$6653 negligence penalty, pointing out that during 1988, the tax treatment of frequent flyer bonus programs was still under consideration.

*Comment:* While *Charley v. Commissioner* does not deal directly with the issue of the taxation of frequent flyer mileage in the business context, the scheme developed by T effectively converted the travel awards to cash to T's credit. Therefore it effectively resolved, for purposes of that particular case, many of the administrative problems that would plague a more generalized effort to tax frequent flyer awards. Unlike frequent flyer awards, the cash credits in T's account apparently were not restricted to use on a particular carrier, not subject to expiration dates, not restricted by capacity controls and blackout dates, nor was use of the credits exposed to subsequent airline program revisions affecting the value of the awards or even to airline bankruptcies, which could render the original awards worthless. Thus, the case clearly is distinguishable from conventional employee receipt and use of frequent flyer awards and the IRS's position in Announcement 2002-18, but also is a strong caution to employees who might attempt to sell or otherwise convert frequent flyer awards earned from employer flights into cash, and is consistent with the IRS's general view that benefits available to employees by election in lieu of cash are taxable.

<sup>803</sup> PLR 9340007.

<sup>804</sup> TAM 9547001.

<sup>805</sup> T.C. Memo 1993-558, *aff'd in part and rev'd in part*, 91 F.3d 72 (9th Cir. 1996).

### III. Other Statutory Fringe Benefit Exemptions

#### A. Educational Assistance Programs — §127

##### 1. Background and Purpose

Before the enactment of §127, employer-provided educational assistance could be excluded from an employee's income only if it was directly related to an employee's job skills. Education was job-related if it: (1) maintained or improved skills required by the individual's employment; or (2) met the express requirements of the individual's employer or the requirements of applicable law imposed as a condition to the retention of the individual's job, status or rate of compensation.<sup>806</sup> Educational assistance could not be excluded if it was provided to enable an individual to meet the minimum educational requirements for employment or for education that was part of a program of study to qualify the individual for a new trade or business.<sup>807</sup>

Section 127 was added to the I.R.C. in the Revenue Act of 1978.<sup>808</sup> An exclusionary provision for employer-provided educational assistance was added for three reasons. First, under then-current law, inequitable treatment meant that the higher the level of job held by an employee, the more likely it was that the employee would qualify for exclusion under the "job-related" test. Second, applying the job-related distinction added to the complexity of the tax system for the IRS, the employer and the employee. Finally, the law operated as a disincentive to initial training, retraining and career advancement because it required out-of-pocket payments for employer-provided educational assistance from those least able to pay.<sup>809</sup>

##### 2. Benefits Provided

###### a. In General

Section 127 provides that certain amounts paid by an employer under a qualified educational assistance program for the education of its employees are not includible in the employee's income. Section 127 applies whether or not an employer's program reimburses its employees for their educational expenses or pays directly the educational institution(s) its employees attend.<sup>810</sup> In addition, §127 provides that an employee does not have to include in income the value of educational assistance provided by the employer directly to the employee (i.e., free classes provided by the employer).<sup>811</sup>

<sup>806</sup> Reg. §1.162-5, §1.162-17(b)(1). See Rev. Rul. 76-71, Rev. Rul. 76-65, Rev. Rul. 76-62, all amplified by Rev. Rul. 76-352. Cf. *Love Box Co., Inc. v. Commissioner*, 842 F.2d 1213 (10th Cir. 1988) (seminars at which subjects such as individual freedom, responsibility, hard work, thrift, honesty and integrity were taught did not qualify under Reg. §1.162-5 as deductible educational expenses because the seminars did not maintain or improve employee job skills that directly contributed to the employer's trade or business).

<sup>807</sup> Reg. §1.162-5(b)(2), §1.162-5(b)(3). Rev. Rul. 78-184; Rev. Rul. 76-352. *Educational Fund of the Electrical Industry v. United States*, 426 F.2d 1053 (2d Cir. 1970).

<sup>808</sup> Pub. L. No. 95-600, §164(a).

<sup>809</sup> S. Rep. No. 1263, 95th Cong., 2d Sess. 100-101 (1978).

<sup>810</sup> Reg. §1.127-1(a)(1).

<sup>811</sup> Reg. §1.127-1(a)(2).

##### b. Permissible Benefits

The benefits provided under a qualified educational assistance program must consist solely of: (1) the employer's payment of expenses, such as tuition, fees, books, supplies and equipment, incurred by or on behalf of an employee for education; (2) the employer's provision of education to an employee; or (3) employer payments made after March 27, 2020, directly to an employee or directly to a third party such as an educational provider or loan servicer for principal or interest on a qualified education loan<sup>812</sup> under §221(d)(1) incurred by the employee for the employee's education.<sup>813</sup> Therefore, employer payments on loans for an employee's spouse or dependent's education are considered taxable income to the employee. Similarly, loan payments made by a parent on behalf of an employee for educational purposes may not be excluded from the parent's or the employee's gross income. A qualified educational assistance program, however, may not pay for or provide:

- tools or supplies that the employee may retain after completing a course of instruction (other than textbooks); or
- meals, lodging or transportation.<sup>814</sup>

*Note:* The qualified education loan benefit under §127 is only available as a tax-free benefit under an employer's educational assistance plan if the benefit is included under the terms of the employer's plan. Many existing plans may already cover this benefit without requiring changes. However, the language should be checked to determine if an amendment is needed. If the plan is written to provide generally for all allowed benefits, the employer may not need to amend their plan to provide for the qualified education loan benefit as a covered expense.<sup>815</sup>

It appears that an employer may reimburse the cost of tools, supplies, meals, lodging, and transportation outside of the program. The reimbursement will not be included in the employee's income if such costs would otherwise be deductible by the employee under §162.<sup>816</sup>

*Comment:* Why Congress decided to exclude reimbursements for the cost of or provision of meals, lodging and transportation from the benefits provided under a qualified educational assistance program is unclear. This creates a burden on an employee receiving job-related education away from home. For example, if an employer sends an engineer to another city three days a week to attend a university in that city to take job-

<sup>812</sup> §221(d)(1). A qualified education loan is for educational expenses incurred at an eligible institution, as determined by the Department of Education, and defined under §221(d)(2) and §25A(f)(2). To qualify, the loan does not have to be a federal student loan. See IRS Fact Sheet FS-2026-10, Q&A-4 (Apr. 2026), superseding IRS Fact Sheet FS-2024-22, Q&A-4 (June 2024).

<sup>813</sup> §127(c)(1), as amended by the Consolidated Appropriations Act, 2021, Pub. L. No. 116-260, Div. EE, §120 (extending exclusion for employer payment of qualified education loan from end of 2020 through end of 2025), and the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70412(a) (permanently extending exclusion for employer payments of qualified education loans), effective for payments made after December 31, 2025; Reg. §1.127-2(c)(1).

<sup>814</sup> §127(c)(1); Reg. §1.127-2(c)(3)(i), §1.127-2(c)(3)(ii).

<sup>815</sup> See IRS Fact Sheet FS-2026-10, Q&A-5.

<sup>816</sup> See Rev. Rul. 76-71 and Reg. §1.162-5(e), which provide that, if an individual travels away from home primarily to obtain education the expenses of which are deductible under Reg. §1.162-5, expenditures for travel, meals, and lodging while away from home are deductible.

related courses, the costs of the seminar may be paid out of the educational assistance program while the expenses of transportation, meals and lodging would be paid outside the program but would still be excluded from the employee's income.

The assistance provided by an educational assistance plan may be for any form of instruction or training that improves or develops the capabilities of an individual except instruction or training involving sports, games or hobbies not related to the business of the employer. Therefore, an educational assistance program may not provide benefits covering lessons or courses in such activities as tennis, racquetball, golf, swimming or painting unless such lessons or courses are occupationally related. For example, if an operator of ski slopes provided advanced ski instruction to its ski patrol employees, the cost of such education would be covered.<sup>817</sup>

Reg. §1.127-2(c)(3)(iii) also provides that: (1) courses involving sports, games or hobbies can be considered "educational assistance" provided such courses are required as part of a degree program; and (2) education that instructs employees in maintaining and improving health will not be considered sports or hobby instruction so long as such education does not involve the use of athletic facilities or equipment and is not recreational in nature.

Graduate-level courses beginning after June 30, 1996 and before January 1, 2002 were not eligible for the exclusion. Congress extended the exclusion for graduate-level courses, effective for courses beginning after December 31, 2001.<sup>818</sup> According to Notice 96-68, graduate level courses are those taken by an employee who has a bachelor's degree or is receiving credit toward a more advanced degree, if the particular course can be taken for credit by any individual in a program leading to a law, business, medical, or other advanced academic or professional degree.

The education paid for or provided under a §127 program may be provided either by: (1) the employer; (2) a group of employers; or (3) an educational institution. Therefore, an employer may either provide training to its employees itself or pay to send its employees to an unaffiliated educational institution. The regulations clarify that qualifying educational assistance is not limited to education provided by employers or educational institutions but may also include instruction provided by a third party.<sup>819</sup>

Reg. §1.127-2(i) requires an employee receiving payments under a qualified program to be prepared to provide substantiation to the employer showing that it is reasonable to believe

that the payments or reimbursements made under the program constitute qualifying educational assistance.

### c. Limitation on Amount Excludible

The maximum amount that an individual may exclude under §127 is \$5,250 (indexed annually for inflation beginning with taxable years after 2026) per calendar year.<sup>820</sup> This limit applies to the combined total of payments made towards principal or interest on qualified education loans; eligible educational expenses; and amounts paid, and expenses incurred by the employer during a calendar year. The educational assistance program is a "use-it-or-lose-it" benefit, meaning any unused portion cannot be carried forward to future years. Any amount received in excess of this annual limit becomes taxable income to the employee.<sup>821</sup> For purposes of this limit, the employee must take into account reimbursements received from an employer as well as the fair market value of educational assistance paid or provided directly by the employer. An employee may only seek reimbursement for expenses incurred after their start date and paid by the employee in the same year for which reimbursement is made by the employer. However, qualified education loan principal and interest payments may be made by the employer in a subsequent year, despite being incurred in prior calendar years, including those preceding the employee's start date.

Amounts that may be deducted by the employee as employee business expenses are not subject to the cap and are not counted in determining whether other educational benefits received during the year exceed the cap.<sup>822</sup>

The cap applies to the aggregate amount of educational assistance benefits received from all employers. Employers must report the value of educational assistance benefits received by the employee during the year to employees who separate from service during the taxable year.<sup>823</sup>

### 3. Requirements Under §127

#### a. Written Plan

An employer's educational assistance program must be evidenced by a separate written plan that does not provide any other form of employee benefits.<sup>824</sup> All requirements of the program (e.g., eligibility, amount and type of benefit provided) must be set forth in the plan document. The plan need not be funded.<sup>825</sup>

<sup>817</sup> §127(c)(1); Reg. §1.127-2(c)(3)(iii), §1.127-2(c)(4). Legislative history implies that education with respect to a subject commonly considered a sport, game or hobby, such as photography or gardening, is eligible for the exclusion from income if such education: (1) has a reasonable relationship to an activity maintained by the employee for profit; (2) has a reasonable relationship to the business of the employer; or (3) is required as part of a degree program. H.R. Conf. Rep. No. 1104, 100th Cong., 2d Sess. 79 (1988). However, there is no statutory language in §127 to such effect.

<sup>818</sup> §127(c)(1), as amended by EGTRRA, Pub. L. No. 107-16, §411(b). The tax exclusion for employer-provided educational assistance programs had been subject to various sunset provisions but was permanently extended by the American Taxpayer Relief Act of 2012. Pub. L. No. 112-240, §101(a)(1), striking EGTRRA §901, as amended. The exemption for graduate-level courses was also made permanent. *Id.*

<sup>819</sup> Reg. §1.127-2(c)(4).

<sup>820</sup> §127(a)(2); §127(d), added by OBBBA, Pub. L. No. 119-21, §70412(b), effective for payments made after December 31, 2025. See PLR 200624059 (although a plan may provide benefits in excess of \$5,250, only the first \$5,250 in educational assistance provided to an employee during a calendar year is excludible from the employee's income). In the case of a plan structured by the employer as a loan program, the exclusion may take the form of debt forgiveness by the employer. However, the employee may exclude only the first \$5,250 of debt forgiveness from income each year. PLR 200339017.

<sup>821</sup> See IRS Fact Sheet FS-2026-10, Q&A-3.

<sup>822</sup> H.R. Rep. No. 1049, 98th Cong., 2d Sess. 6 (1984).

<sup>823</sup> H.R. Rep. No. 1049, 98th Cong., 2d Sess. 6 (1984).

<sup>824</sup> §127(b)(1); Reg. §1.127-2(b). See the Worksheets and IRS Pub. 5993 for sample written plans.

<sup>825</sup> §127(b)(5). Thus, for example, a properly structured loan program will qualify as a §127 plan. See, e.g., PLR 200339017 (law firm program allowing employees to attend law school).

## b. Participation and Discrimination

### (1) Persons Eligible to Be Covered

The educational assistance program must be for the exclusive benefit of the employer's employees and provide educational assistance only to present employees, retired, disabled or laid-off employees or employees on leave, such as an employee in the U.S. Armed Forces.<sup>826</sup> The program also may provide benefits to a sole proprietor or a member of a partnership (including any LLC treated as a partnership for federal income tax purposes under the entity classification rules).<sup>827</sup>

However, the program may not provide educational assistance to an employee's children or spouse.<sup>828</sup> If an employer wishes to provide such assistance, it must be provided either by way of reduced-interest or interest-free loans, by providing scholarships through a separate private foundation created by the employer<sup>829</sup> or as taxable compensation to the employee.<sup>830</sup>

*Comment:* Reg. §1.127-2(h)(1)(ii) defines "employee" to include a present employee on leave, as for example, from the U.S. Armed Forces. If an employee is on leave to attend a university, the tuition of which is being paid by the employer, it is unclear whether such person may be considered an employee who can qualify for benefits under a qualified educational assistance program. From the perspective of implementing the policies behind §127's enactment, however, such an employee should be covered by §127.

### (2) Participation Requirements

Not all employees of the employer must be made eligible to participate in a qualified educational assistance program. However, the program may not discriminate in favor of highly compensated employees (as defined by §414(q)) or the spouses or dependents of such employees who are themselves employees.<sup>831</sup>

The employees who are considered to benefit under the program are the group of employees who are actually eligible for educational assistance under the program, taking into account the eligibility requirements set forth in the written plan, the eligibility requirements reflected in the types of educational assistance under the program and any other conditions that may affect the availability of benefits under the program.<sup>832</sup> For example, if an educational assistance program provides that only employees with five years of service are eligible for the program and a disproportionate number of employees who meet that service requirement are highly compensated, the program

does not qualify.<sup>833</sup> Similarly, if the plan limits the assistance provided under the program to courses in post-graduate study related to the employer's business and only highly compensated employees have undergraduate degrees, the program is discriminatory.<sup>834</sup>

A plan under an educational assistance program may exclude from participation employees who are included in a unit of employees covered by an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers, if the IRS finds that educational assistance benefits were the subject of good faith bargaining.<sup>835</sup> In determining whether such bargaining occurred, it is not material that the employees are not covered by another educational assistance program or that the employer's present program was not considered in the bargaining.<sup>836</sup> Therefore, if an employer has hourly union and salaried nonunion employees, it may exclude the union employees from coverage under its educational assistance program if there was good faith bargaining between the employer and the union, even if the educational assistance benefits never were discussed in the bargaining. Alternatively, the employer may provide separate plans for its union and nonunion employees, with either plan providing better benefits than the other.

In determining whether an educational assistance program discriminates in favor of highly compensated employees, the §127 regulations direct an employer to use the same standards that apply to qualified retirement plans under §410(b)(1)(B), without regard to §401(a)(5).<sup>837</sup> Section 410(b)(1)(B) includes strict numerical tests under which a qualified plan may satisfy the nondiscriminatory classification test by demonstrating that: (1) the classification is reasonable; and (2) its "ratio percentage" is at least 70%.<sup>838</sup> Because the educational assistance classification test is applied to benefit availability rather than benefit utilization, so long as an employer offers its program to a broad spectrum of employees, the program should pass the test even under the numerical formulation of the §410(b) regulations.

All employees of a controlled group of corporations under §414(b), a group of businesses under common control under §414(c) and an affiliated service group under §414(m) are included for purposes of the nondiscriminatory classification test.<sup>839</sup> Further, leased employees are considered employees of the employer for this purpose.<sup>840</sup>

If an educational assistance program discriminates in favor of highly compensated employees, *all* participants must include the benefits received in income.<sup>841</sup> In contrast, if a §129 dependent care assistance program fails to satisfy applicable nondis-

<sup>826</sup> §127(b)(1); Reg. §1.127-2(d), §1.127-2(h)(1). See also Rev. Rul. 96-41 (plans that provide benefits to participants by reason of their employment with the employer will not fail to qualify under §127(b) merely because eligible participants include former employees, regardless of the reason for termination of employment).

<sup>827</sup> §127(c)(2); Reg. §1.127-2(h)(1)(iii).

<sup>828</sup> Reg. §1.127-2(d). The program may benefit a spouse or dependents if they are employees. IRS Fact Sheet FS-2026-10, Q&A-7 (discussing considerations for spouses and dependents of officers, shareholders, self-employed individuals, and highly compensated individuals who are employees).

<sup>829</sup> See 518 T.M., *Exclusion of Scholarships and Other Receipts for Education*, for a further discussion of these benefits.

<sup>830</sup> See IV.A.2. for a discussion of taxable educational benefits.

<sup>831</sup> §127(b)(2); Reg. §1.127-2(e).

<sup>832</sup> Reg. §1.127-2(e)(1).

<sup>833</sup> Reg. §1.127-2(e)(1).

<sup>834</sup> Reg. §1.127-2(e)(1).

<sup>835</sup> §127(b)(2); Reg. §1.127-2(e)(1).

<sup>836</sup> Reg. §1.127-2(e)(1).

<sup>837</sup> Reg. §1.127-2(e)(1).

<sup>838</sup> Reg. §1.410(b)-4. See 351 T.M., *Plan Qualification — Pension and Profit-Sharing Plans*, for a comprehensive discussion of the §410(b) reasonable classification test.

<sup>839</sup> §414(t).

<sup>840</sup> §414(n)(3)(C).

<sup>841</sup> §127(b)(1).

crimination tests, only highly compensated employees are required to include benefits received in income.<sup>842</sup>

### (3) *Discrimination as to Benefits*

An educational assistance program is not considered discriminatory merely because:

- different types of educational assistance available under the program are utilized to a greater degree by highly compensated employees; or
- to receive benefits under the program, an employee must successfully complete the course, attain a particular grade or remain with the employer for a reasonable period of time.<sup>843</sup>

It appears that so long as all employees are eligible to participate in the program and receive benefits thereunder, the program is not considered discriminatory merely because highly compensated employees utilize benefits of the program to a greater extent than other employees. For example, if an engineering firm's program provides for reimbursement of tuition for all engineering courses taken by employees and highly compensated employees take more expensive technical courses while other employees take less expensive drafting courses, the plan is not considered discriminatory. Further, if the program requires the attainment of a minimum grade (e.g., a C+) in the course by the employee before reimbursement can occur and all employees take courses but only highly compensated employees attain this minimum grade, the plan is not considered discriminatory.<sup>844</sup>

*Comment:* Subject to the limitation set forth below, an educational assistance program may provide benefits only to highly compensated employees if: (1) the eligibility requirements of the program do not discriminate in favor of such employees; and (2) only highly compensated employees choose to receive benefits under the program. Therefore, a program may, under certain circumstances, provide benefits only to highly compensated employees.

### (4) *Limitation of Benefits*

An educational assistance program does not qualify for a program year if more than 5% of the amount paid or incurred by the employer for educational assistance benefits during that year (whether or not through the program) are provided to the members of the employer's "limitation class." A program year must be specified in the plan and must be either the taxable year of the employer or the calendar year.<sup>845</sup>

If the employer is a corporation, its "limitation class" consists of those employees, their spouses and dependents who, on any day of the program year, own more than 5% of the total number of outstanding shares of stock of the employer.<sup>846</sup> If the employer is not incorporated, the members of the limitation class include all employees who, on any day of the program year, own more than 5% of the capital or profits of the employer, as well as such employees' spouses and dependents.<sup>847</sup> As a

practical matter, if the owners are the only employees, they cannot receive educational assistance under §127 because of the 5% benefit limitation described above. To calculate the maximum educational assistance for an owner/employee, multiply the total educational assistance provided to other employees by 5.263158%. Round the result down to the nearest cent, but the final amount cannot exceed \$5,250 (as adjusted after 2026).<sup>848</sup> Note that in each case, although the limitation class includes spouses and dependents, such persons are not eligible persons unless they also are employees.<sup>849</sup>

If the employer is a corporation, the attribution rules of §1563(d) and §1563(e) (without regard to §1563(e)(3)(C)) apply in determining an employee's stock ownership.<sup>850</sup> If the employer is not a corporation, an employee's interest in the capital and profits of the employer will be determined under the §414(c) regulations.<sup>851</sup>

*Comment:* Congress clearly focused on utilization rather than availability of educational assistance program benefits in determining whether such programs unduly favor shareholders or owner-employees. Under §127(b)(3) and the regulations thereunder, the percentage of benefits provided to shareholders or owner-employees is measured by comparing the benefits actually paid to them and the benefits actually paid to all other employees. Therefore, an educational assistance program, in operation, must not provide more than 5% of its benefits to members of the limitation class even though the employer's program may provide that the benefits made available to employees within the limitation class will not exceed 5% of the total benefits made available to all employees. Thus, if an employer's educational assistance program made equal benefits available to all employees, and, for example, fewer than 5% of those employees were members of the employer's limitation class, the program would nonetheless fail to qualify if more than 5% of the benefits paid during the program year were paid to those members of the limitation class.

*Comment:* It appears that qualified educational assistance programs may not be adopted by closely held corporations, partnerships (including limited liability companies classified as partnerships for federal income tax purposes), or sole proprietorships, and provide benefits to the owners, partners or members of such entities unless they have a substantial number of employees. Moreover, Congress defined the limitation class to include a child of an employee who is a 5% stockholder or owner of the employer only if that child is a dependent of that employee. Section 127 does not define "dependent"; however, the term is defined in §152(a) to include a child under age 19 (or age 24 if a full-time student) of the taxpayer who has the same principal place of abode as the taxpayer for more than one-half of the taxable year and who has not provided over one-

<sup>847</sup> §127(b)(3); Reg. §1.127-2(f)(2)(ii), §1.127-2(f)(2)(iii).

<sup>848</sup> See IRS Fact Sheet FS-2026-10, Q&A-8.

<sup>849</sup> See IRS Fact Sheet FS-2026-10, Q&A-7.

<sup>850</sup> §127(c)(4)(A); Reg. §1.127-2(f), §1.127-2(h)(4). Section 1563(e)(3)(C) provides that the rules for attribution from estates or trusts do not apply to stock held by an employees' trust qualified under §401(a) as exempt from tax under §501(a).

<sup>851</sup> §127(c)(4)(B); Reg. §1.127-2(f). Section 414(c) sets forth the rules, for purposes of §401, §408(k), §410, §411, §415, and §416, for determining whether one or more trades or businesses (whether or not incorporated) are under common control.

<sup>842</sup> §129(d)(1).

<sup>843</sup> §127(c)(5); Reg. §1.127-2(e)(2)(i), §1.127-2(e)(2)(ii).

<sup>844</sup> See Reg. §1.127-2(e)(2)(ii).

<sup>845</sup> §127(b)(3); Reg. §1.127-2(f)(1).

<sup>846</sup> §127(b)(3); Reg. §1.127-2(f)(2)(i), §1.127-2(f)(2)(iii).

half of his or her own support for the calendar year in which the taxpayer's taxable year begins. Therefore, it appears possible for a taxpayer who owns his or her own business to hire a son or daughter to work for the business, have the child attend night classes that are related to the business, and pay his or her tuition from an educational assistance program. By forgoing the dependency deduction for the child, the taxpayer would be able to deduct the son's or daughter's tuition (up to the annual limitation ceiling) and the son or daughter would not have to include such tuition in his or her income. However, the taxpayer could not furnish over one-half of the child's support for that year. Further, it appears unlikely that the tuition payments would qualify under §127 if the taxpayer's son or daughter took a leave of absence from the parent's employ to attend school full-time.

#### *c. Other Benefits as an Alternative*

An educational assistance program may not provide eligible employees with an alternative of selecting taxable compensation instead of educational assistance under the program.<sup>852</sup>

The regulations make it clear that only the provision of taxable alternative benefits will disqualify an educational assistance program. Under Reg. §1.127-2(b), an educational assistance program may be part of a more comprehensive employer plan providing a choice of nontaxable benefits to employees. Therefore, an educational assistance program may not provide that it will pay an employee either a certain amount of cash or tuition for courses at a university. The IRS will examine the employer's business practices (including the written plan) to determine whether it is providing its employees with a choice of receiving taxable compensation or educational benefits.<sup>853</sup>

An educational assistance program is a nonqualified benefit that may not be offered under a cafeteria plan.<sup>854</sup>

#### *d. Notice to Employees*

An employer must provide all employees eligible to participate in an educational assistance program with reasonable notice of the program's terms and availability.<sup>855</sup> Such notices often are included in employee handbooks. Notice also may be given using electronic means such as e-mail or posting on an employer's internal website.

### *4. Optional Provisions of Program*

In drafting a plan for a qualified educational assistance program, an employer should consider including provisions addressing the following items.

#### *a. When the Education May Be Undertaken*

The plan should specify whether an employee will be allowed to take courses during company time or only on his or her free time. If a plan allows an employee to take educational courses during the work day, it should specify whether that

employee will remain a full-time employee or whether the employee should be considered a part-time employee with a resulting salary reduction.

#### *b. Approval*

The plan should specify whether the courses an employee wishes to take are subject to the approval of the program manager or the employee's supervisor.

#### *c. Successful Completion of Course*

The plan should specify whether an employee will be reimbursed for tuition if the employee does not complete the course or attain a specific grade. If an employee must successfully complete a course, the plan may provide that part or all of the reimbursement will be delayed until the employee submits proof that he or she has successfully completed the course. As an alternative, the plan may provide for continued assistance only if the employee attains a certain grade in the employee's previously taken courses.

#### *d. Double Payment of Benefits*

The plan should specify whether the program will pay assistance to an employee if the employee is already receiving assistance or a scholarship from some other source or whether the employer-provided assistance will be reduced to reflect such outside assistance.

#### *e. Condition Subsequent/Length-of-Service Requirement*

The plan should specify whether an employee must work a certain period of time (i.e., one year) for the employer after the completion of the course before being reimbursed under the program. Such a provision would discourage individuals from using the program solely to obtain education that would enable them to gain employment with another company. Another way of dealing with this type of problem is to require that an employee have worked for the employer for a particular period of time before being eligible to participate in the program. This would help prevent the situation where individuals accept employment with the employer merely to use the educational assistance and then move on to another company. Where such length-of-service rules are included, however, the plan must consider prohibited discrimination, e.g., such as would occur if the highly compensated employees satisfied the length-of-service requirement in numbers disproportionate to the rank-and-file group.

#### *f. Job Relationship Requirements*

The plan should specify whether employees will be reimbursed only for job-related courses. If the employer decides to reimburse the employee for all education, whether or not job-related, the employer must make certain that the plan does not provide assistance for education involving sports, games or hobbies unless such education is related to the employer's business.

#### *g. Education Provider Requirements*

The plan should state whether the benefits provided under the program will only be provided to employees who attend accredited institutions or whether the program will also cover

<sup>852</sup> §127(b)(4); Reg. §1.127-2(c)(1), §1.127-2(c)(2).

<sup>853</sup> Cf. S. Rep. No. 1324, 95th Cong., 2d Sess. 53 (1978), which contained such a requirement for qualified group transportation plans.

<sup>854</sup> §125(f), redesignated as §125(f)(1) by Pub. L. No. 111-148, §1515, applicable to taxable years beginning after December 31, 2013; Prop. Reg. §1.125-1(q)(1)(iii), REG-142695-05, 72 Fed. Reg. 43,938 (Aug. 6, 2007).

<sup>855</sup> §127(b)(6); Reg. §1.127-2(g).

correspondence courses or attendance at unaccredited institutions.

#### *h. Term of Plan*

The plan should state whether the program is permanent or temporary. It should also provide for appropriate procedures to amend the plan.

#### *i. Substantiation*

The plan should state what documentation the employee must present to receive payment or reimbursement (i.e., a tuition bill stamped “paid”).

#### *5. Procedural Requirements*

An employer may, but need not, apply to the IRS for a determination that an educational assistance program qualifies under §127.<sup>856</sup>

Section 6039D requires an annual return to be filed. However, the IRS suspended the filing requirement for §127 plans in 2002.<sup>857</sup>

#### *6. Relationship with Prior Law*

All or part of the amounts received under an educational assistance program not qualified under §127 may still be excluded under §117 or deducted under §162 or §212, as the case may be, if the requirements of those sections are satisfied.<sup>858</sup> Therefore, it appears that if an employer decides to provide educational assistance to its employees for education that is job-related and that does not qualify the employee for another trade or business, the employer need not create a qualified educational assistance program under §127. By not creating a §127 qualified educational assistance program, the employer need not produce a separate written plan, and need not concern itself with the notice, eligibility or discrimination requirements of §127. The continued effectiveness of prior law also has proved to be a significant alternative safe harbor during periods, as discussed below, when §127 has lapsed.<sup>859</sup>

*Comment:* Although any scholarship benefits provided to an employee for such education will not be included in the employee’s income, other noneducational §127 benefit amounts that are merely deductible by the employee do not provide an employee with a complete offset to any required income inclusion because the employee may not itemize deductions or may be subject to one of the various limitations on deduction utilization. Moreover, the employee bears the burden of recordkeeping and risk of audit disallowance in the absence of a §127 plan.

Alternatively, employer-provided educational assistance that meets the standard for deductibility under §162 may be excluded from income under §132, but only as a working condition fringe benefit.<sup>860</sup>

<sup>856</sup> Reg. §1.127-2(a); §601.201. See PLR 200339017, PLR 200245042, PLR 9418010, PLR 8716061, and PLR 8647078 for examples of IRS determinations that an educational assistance program qualified under §127.

<sup>857</sup> See Notice 2002-24, effective April 22, 2002, and applicable to all plan years for which information returns have not been filed. As a result, the IRS modified Form 5500 and removed Schedule F for 2002 and thereafter.

<sup>858</sup> §127(c)(6); Reg. §1.127-1(c).

<sup>859</sup> See Tax Incentives for Education, Hearing Before Committee on Finance, prepared by Joint Committee on Taxation (JCS-5-88) (Mar. 14, 1988), at p. 16.

However, if the employer wants to provide assistance to its employees for education that is not job-related, or for job-related education that qualifies the employees for other employment, and not have the employee recognize taxable income, the employer must create an educational assistance program under §127.

#### *7. Effective Dates*

The original enactment of §127 in 1978 was temporary and expired on December 31, 1983.<sup>861</sup> Congress retroactively reinstated the educational assistance provisions in 1984. A pattern then developed in which budgetary pressures prevented Congress from making the educational assistance provisions permanent, but an unwillingness to let the benefit expire led to repeated short-term extensions, the last of which applied through 2001. In amendments made by 2001 EGTRRA, Congress “permanently” extended the exclusion for employer-provided educational assistance by striking former §127(d), which would have terminated the exclusion for expenses paid for courses beginning after December 31, 2001, subject however to the general sunset rule of EGTRRA.<sup>862</sup> Congress further extended the EGTRRA sunset date to December 31, 2012 in the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010.<sup>863</sup> Under the American Taxpayer Relief Act of 2012, the exclusion for employer-provided educational assistance was made permanent.<sup>864</sup>

Notice 96-68 clarifies that, for purposes of the effective dates in §127(c)(1) and (former) §127(d), a course ordinarily is considered to begin on the first regular day of class for the course, and the first regular day of class for any course that is offered during a regular academic term at an educational institution is considered to be the first day on which regular classes generally begin for courses offered during that term (e.g., a semester), or if the semester consists of more than one session, the session during which the course is offered. Notice 96-68 states that the date on which an individual registers or enrolls in a course does not determine when the course begins for these purposes.

<sup>860</sup> See discussion at II.B.2.a.(4)(e). Section 132(j)(8), however, precludes qualification under any other provision of §132. Such provision would appear to represent a poor, and most likely unadministrable, policy judgment insofar as it may purport to require taxation of benefits not excludible under §127 or as working conditions that would otherwise have been excludible as de minimis fringes. Note that in determining whether an educational benefit qualifies as a working condition fringe under Reg. §1.132-5, it is not sufficient that the tuition if paid by the employee would be deductible under §162. Excludibility under §132 generally is based on all the facts and circumstances. Thus, the IRS generally will not rule on the excludibility of a given benefit as a working condition fringe. See, e.g., PLR 200337004 (employer’s plan qualifies as §127 plan but IRS declines to rule on excludibility of payments exceeding §127 dollar limit by employees under §132(d)).

<sup>861</sup> Pub. L. No. 95-600, §164(a); H.R. Rep. No. 1800, 95th Cong., 2d Sess. 217 (1978).

<sup>862</sup> §127(e) as amended by EGTRRA, Pub. L. No. 107-16, §411(a) effective for expenses related to courses beginning after December 31, 2001.

<sup>863</sup> Pub. L. No. 111-312, §101(a), effective as if included in EGTRRA.

<sup>864</sup> Pub. L. No. 112-240, §101(a)(1), striking EGTRRA §901, as amended.

## B. Dependent Care Assistance Programs — §129

### 1. Background and Purpose

Congress enacted §129 to encourage employers to adopt tax-qualified dependent care assistance programs for the benefit of their employees. The provision was part of a larger package addressing child care in which Congress increased the credit allowed under former §44A for expenses for household and dependent care services, redesignated §44A as §21, and included it in the nonrefundable personal credits group.<sup>865</sup> Congress added §129 because it believed that the preexisting child care credit coupled with the tax-qualified dependent care assistance program would better assist families with children who needed to have both spouses earning income.<sup>866</sup>

### 2. Benefits Provided

#### a. Permissible Benefits

Under §129, an employee may exclude from gross income amounts paid or incurred by the employee's employer for dependent care assistance provided to the employee under a qualified dependent care assistance program, subject to certain limitations. An employee may exclude from income: (1) the value of services provided to the employee; (2) the amount paid directly to the provider of dependent care assistance; or (3) the amount reimbursed to the employee for expenses incurred for dependent care assistance under a dependent care assistance program. The employer's ability to deduct all amounts paid or incurred under a dependent care assistance program seemed to be well settled even before enactment of §129<sup>867</sup> with amounts subject to deduction including the cost of implementation and professional and management fees.<sup>868</sup>

The benefits provided under a dependent care program must be those dependent care assistance services which, if paid for by the employee, would be eligible "employment-related expenses" under §21(b)(2),<sup>869</sup> i.e., expenses incurred to enable the employee or the employee's spouse to remain gainfully employed (or to be in active search of gainful employment) during a period in which there was at least one "qualifying individual" with respect to the employee.

Final regulations under §21 provide guidance as to expenses for household and dependent care services necessary for gainful employment.<sup>870</sup>

### (1) Qualifying Individual

A qualifying individual is: (1) the employee's dependent (who is a qualifying child within the meaning of §152) who has not attained age 13; or (2) the employee's spouse or dependent who is physically or mentally incapable of self-care and who has the same principal place of abode as the employee for more than one-half of the taxable year.<sup>871</sup> An individual is physically or mentally incapable of self-care if, as a result of a physical or mental defect, the individual is incapable of caring for the individual's hygiene or nutritional needs or requires full-time attention of another person for the individual's own safety or the safety of others.<sup>872</sup> Status of an individual as a qualifying individual is determined on a daily basis, and an individual is not a qualifying individual on the day the status terminates.<sup>873</sup>

### (2) Employment-Related Expenses

Expenses are employment-related expenses only if they are for the purpose of enabling the employee to be gainfully employed. The expenses must be for the care of a qualifying individual or household services provided during periods in which the employee is gainfully employed or is in active search of gainful employment. Employment may consist of service within or outside the employee's home and includes self-employment. An expense is not employment-related merely because it is paid or incurred while the employee is gainfully employed; the purpose of the expense must be to enable the employee to be gainfully employed. Work as a volunteer or for a nominal consideration is not gainful employment.<sup>874</sup>

Expenses paid for a period during only part of which the employee is gainfully employed or in active search of gainful employment must be allocated on a daily basis.<sup>875</sup> An employee who is gainfully employed is not required to allocate expenses during short, temporary absences from work, such as for vacation or minor illness, provided that the care-giving arrangement requires the employee to pay for care during the absence. An absence of two consecutive calendar weeks is presumed to be a short, temporary absence. Whether a longer absence is a short,

<sup>871</sup> §21(b)(1), as amended by the Working Families Tax Relief Act of 2004 (2004 WFTRA), Pub. L. No. 108-311, §203(b). Also note that Pub. L. No. 108-311, §201, generally amends the definition of dependent under §152. See REG-137604-07, 82 Fed. Reg. 6370 (Jan. 19, 2017) (proposing changes to §152 regulations to reflect 2004 WFTRA), proposed to apply to taxable years beginning after the date that final regulations are published, but taxpayers may apply in open tax years pending the issuance of the final regulations. Cf. Reg. §1.21-1(b)(1). For taxable years beginning before January 1, 2005, a qualifying individual was: (1) the taxpayer's dependent for whom the taxpayer was entitled to a deduction for a personal exemption under §151(c) and who was under age 13; or (2) the taxpayer's spouse or dependent who was physically or mentally incapable of self-care. Reg. §1.21-1(b)(2). An employer could provide age limit relief for carryovers for its dependent care assistance program, as contained in the Consolidated Appropriates Act, 2021, Pub. L. No. 116-260, Div. EE, §214(d), by amending its §125 cafeteria plan to substitute "under age 14" for "under age 13" for the 2020 and 2021 plan years. See Notice 2021-15.

<sup>872</sup> Reg. §1.21-1(b)(4). The inability of an individual to engage in any substantial gainful activity or to perform the normal household functions of a homemaker or care for minor children by reason of a physical or mental condition does not of itself establish that the individual is physically or mentally incapable of self-care.

<sup>873</sup> Reg. §1.21-1(b)(3).

<sup>874</sup> Reg. §1.21-1(c)(1).

<sup>875</sup> Reg. §1.21-1(c)(2)(i).

<sup>865</sup> Pub. L. No. 97-34, §124(a); Pub. L. No. 98-369, §471(c)(1).

<sup>866</sup> Pub. L. No. 97-34, §124(e)(1). Joint Comm. General Explanation of the Economic Recovery Tax Act of 1981, p. 54 (1981).

<sup>867</sup> Rev. Rul. 73-348 (holding day care expenses deductible). Cf. Reg. §1.162-7 and discussion at I.B.3.

<sup>868</sup> PLR 8310037, citing Rev. Rul. 73-348.

<sup>869</sup> §129(e)(1).

<sup>870</sup> T.D. 9354, 72 Fed. Reg. 45,338 (Aug. 14, 2007) (also removing former Reg. §1.44A-1 through §1.44A-4 previously issued under former §44A). These regulations are effective for taxable years ending after August 14, 2007. Reg. §1.21-1(l). However, taxpayers could apply the IRS's earlier proposed regulations under §21 in taxable years for which the period of limitations on credit or refund under §6511 had not expired as of May 26, 2006. REG-139059-02, 71 Fed. Reg. 29,847 (May 25, 2006). See Prop. Reg. §1.21-1, REG-137604-07, 82 Fed. Reg. 6370 (Jan. 19, 2017), proposed to apply to taxable years beginning after the date that final regulations are published, but taxpayers may apply in open tax years pending the issuance of the final regulations.

temporary absence is determined based on all the facts and circumstances.<sup>876</sup>

A part-time employee generally must allocate expenses for dependent care between days worked and days not worked. However, if a part-time employee is required to pay for dependent care on a periodic basis (such as weekly or monthly) that includes both days worked and days not worked, the employee is not required to allocate the expenses. A day of work is a day on which the employee works at least one hour.<sup>877</sup>

Expenses must be for the care of a qualifying individual, i.e., if the primary function is to assure the individual's well-being and protection. Not all expenses relating to a qualifying individual are provided for the individual's care. Amounts paid for food, lodging, clothing or education are not for the care of a qualifying individual. However, if the care is provided in such a manner that the expenses cover other goods or services that are incidental to and inseparably a part of the care, the full amount is for care.<sup>878</sup>

If an expense is partly for household services or for the care of a qualifying individual and partly for other goods or services, a reasonable allocation must be made. Only so much of the expense that is allocable to the household services or care of a qualifying individual is an employment-related expense. An allocation must be made if a housekeeper or other domestic employee performs household duties and cares for qualifying children and also performs other services for the employee. However, no allocation is required if the expense for the other purpose is minimal or insignificant or if an expense is partly attributable to the care of a qualifying individual and partly to household services.<sup>879</sup>

Expenses for household services may be employment-related expenses if the services are provided in connection with the care of a qualifying individual. The household services must be the performance in and about the taxpayer's home of ordinary and usual services necessary to the maintenance of the household and attributable to the care of the qualifying individual. Services of a housekeeper are household services under the regulations if part of those services is provided to the qualifying individual. However, services provided by chauffeurs, bartenders or gardeners are not household services.<sup>880</sup>

The manner of providing the care need not be the least expensive alternative available to the employee. The cost of a paid caregiver may be an expense for the care of a qualifying individual even if another caregiver is available at no cost.<sup>881</sup>

The regulations provide helpful guidance in determining whether particular kinds of expenses may be employment-related expenses:

(a) *School Expenses.* Expenses for a child in nursery school, pre-school or similar programs for children below the level of kindergarten are for the care of a qualifying individual and may be employment-related expenses. Expenses for a child in kindergarten or a higher grade are not

for the care of a qualifying individual. However, expenses for before or after-school care of a child in kindergarten or a higher grade may be for the care of a qualifying individual. Summer school and tutoring programs are not for the care of a qualifying individual and the costs are not employment-related expenses.<sup>882</sup>

(b) *Camp Expenses.* Expenses for overnight camps are not employment-related expenses,<sup>883</sup> but the cost of a day camp or similar program may be for the care of a qualifying individual and an employment-related expense, without allocation under Reg. §1.21-1(d)(2), even if the day camp specializes in a particular activity.<sup>884</sup>

(c) *Transportation Expenses.* The cost of transportation by a dependent care provider of a qualifying individual to or from a place where care of that qualifying individual is provided may be for the care of the qualifying individual. The cost of transportation not provided by a dependent care provider is not for the care of the qualifying individual.<sup>885</sup>

(d) *Employment Taxes.* FICA and FUTA taxes under §3111 and §3301 and similar state payroll taxes are employment-related expenses if paid in respect of wages that are employment-related expenses.<sup>886</sup>

(e) *Room and Board.* The additional cost of providing room and board for a caregiver over usual household expenditures may be an employment-related expense.<sup>887</sup>

(f) *Indirect Expenses.* Expenses that relate to but are not directly for the care of a qualifying individual, such as application fees, agency fees and deposits, may be for the care of a qualifying individual and may be employment-related expenses if the employee is required to pay the expenses to obtain the related care. However, forfeited deposits and other payments are not for the care of a qualifying individual if care is not provided.<sup>888</sup>

An employee may not exclude from income amounts received under the employer's dependent care assistance program that are used to pay: (1) any dependent of the employee or of the employee's spouse; or (2) the employee's child who is under the age of 19 if such child is a dependent of the employee during the taxable year in which the services are performed.<sup>889</sup> Therefore, an employee may exclude from income amounts paid to him or her under the employer's dependent care assistance program as reimbursement of amounts paid as employment-related expenses to the employee's parents or children over the age of 19, as long as such individuals are not claimed as dependents by the employee.

<sup>882</sup> Reg. §1.21-1(d)(5).

<sup>883</sup> Reg. §1.21-1(d)(6).

<sup>884</sup> Reg. §1.21-1(d)(7)(i). Summer school and tutoring programs are not for the care of a qualifying individual and the costs are not employment-related expenses.

<sup>885</sup> Reg. §1.21-1(d)(8).

<sup>886</sup> Reg. §1.21-1(d)(9).

<sup>887</sup> Reg. §1.21-1(d)(10).

<sup>888</sup> Reg. §1.21-1(d)(11).

<sup>889</sup> §129(c).

<sup>876</sup> Reg. §1.21-1(c)(2)(ii).

<sup>877</sup> Reg. §1.21-1(c)(2)(iii).

<sup>878</sup> Reg. §1.21-1(d)(1).

<sup>879</sup> Reg. §1.21-1(d)(2).

<sup>880</sup> Reg. §1.21-1(d)(3).

<sup>881</sup> Reg. §1.21-1(d)(4).

The employment-related expenses may be incurred for services provided either inside or outside the employee's home. If incurred for services outside the home, the services must be provided for either:

(A) the employee's dependent (who is a qualifying child within the meaning of §152) who has not attained age 13;<sup>890</sup> or

(B) the employee's spouse or dependent who is physically or mentally incapable of self-care, who has the same principal place of abode as the employee for more than one-half of the taxable year,<sup>891</sup> and who regularly spends at least eight hours each day in the employee's household.<sup>892</sup>

A dependent care assistance program may provide or reimburse the expenses of day care services for an employee's dependent if:

- the day care center complies with all applicable laws and regulations of a state or a unit of local government;
- the day care center provides care for more than six individuals (other than individuals who reside at the center); and
- if the center is not operated by the employer, the center receives a fee, payment or grant for providing services for any of the individuals (regardless of whether the facility is operated for profit).<sup>893</sup>

#### b. Limitation on Amount Excludible

##### (1) Dollar Limit

Section 129(a)(2)(A) imposes a \$5,000 cap (\$2,500 for a married person filing separately) for tax years beginning before 2026 (other than 2021) and \$7,500 (\$3,750 if married filing separately) for tax years beginning after 2025 on the exclusion for dependent care assistance.<sup>894</sup> For tax years beginning in 2021 only, the American Rescue Plan Act of 2021 (2021 ARPA) increased the cap to \$10,500 (\$5,250 for a married person filing separately).<sup>895</sup> An employer was allowed to amend a dependent care assistance plan to increase the cap for 2021 so that the amendment was applied retroactively if certain conditions were met.<sup>896</sup>

<sup>890</sup> For taxable years beginning before January 1, 2005, the services must be provided for the employee's dependent for whom the employee is entitled to a deduction for a personal exemption under §151(c) and who is under age 13.

<sup>891</sup> The principal place of abode requirement did not apply for taxable years beginning before January 1, 2005.

<sup>892</sup> Reg. §1.21-1(e)(1). As noted above, services may be performed by a dependent care center if certain conditions are satisfied. See Reg. §1.21-1(e)(2) (ii) for the definition of a dependent care center.

<sup>893</sup> §21(b)(2)(C), §21(b)(2)(D). However, employment-related expenses do not include any amount paid for services outside the employee's household at a camp where the qualifying individual stays overnight. §21(b)(2)(A).

<sup>894</sup> §129(a)(2)(A), as amended by the One Big Beautiful Bill Act (OBB-BA), Pub. L. No. 119-21, §70404(a), effective for taxable years beginning after December 31, 2025.

<sup>895</sup> §129(a)(2)(D), added by 2021 ARPA, Pub. L. No. 117-2, §9632(a) (reference to §129(a)(2)(A)). See Notice 2021-26 (dependent care assistance benefits that would have been excluded from income if used during the taxable year ending 2020 or 2021 remain eligible for the exclusion; examples illustrate possible tax consequences of electing \$10,500 in benefits for a plan year beginning in 2021 but ending 2022).

##### (2) Earned Income Limit

An employee may exclude from income benefits provided to the employee under a dependent care assistance program to the extent of the lower of (1) the employee's "earned income," or (2) the employee's spouse's "earned income" if the employee is married.<sup>897</sup> "Earned income" includes wages, salaries, tips, earnings from self-employment and other employee compensation (such as disability benefits). It excludes all amounts received: (1) under a dependent care assistance program; (2) as a pension or annuity; (3) by a nonresident alien not effectively connected with a U.S. trade or business; (4) as unemployment or workers' compensation;<sup>898</sup> or (5) for services provided by an individual while an inmate at a penal institution.<sup>899</sup> Section 32(c)(2)(A)(i) provides that earned income for purpose of the earned income credit includes only amounts includible in gross income for the taxable year.<sup>900</sup>

*Note:* A taxpayer may elect to treat amounts excluded from gross income under §112 (non-taxable combat pay) as earned income for purposes of the earned income credit, which would also apply for purposes of determining the maximum amount excludible under §129.<sup>901</sup>

If an employee is married, the employee will generally not be able to receive benefits under a dependent care assistance program unless his or her spouse is employed. However, if an employee's spouse is a full-time student at an educational institution or incapable of caring for himself or herself, the spouse will be deemed to have earned income for each month he or she is a full-time student or incapacitated. The amount of deemed earned income is: (1) \$250 a month, if the employee cares for

<sup>896</sup> See 2021 ARPA, Pub. L. No. 117-2, §9632(c). An amendment to a plan increasing the limitation for a tax year beginning in 2021 can apply retroactively if: (i) the amendment is adopted no later than the last day of the plan year in which the amendment is effective; and (ii) the plan is operated consistent with the terms of such amendment during the period beginning on the effective date of the amendment and ending on the date the amendment is adopted.

<sup>897</sup> §129(b)(1).

<sup>898</sup> §129(e)(2), §32(c)(2); Reg. §1.32-2(c)(2). According to §32(c)(2)(B)(i), earned income is computed without regard to any community property laws.

<sup>899</sup> §32(c)(2)(B)(iv). In CCA 200014035, the IRS Chief Counsel's Office advised that: (1) amounts earned by an individual who has been civilly committed to a treatment facility for sex offenders are earned income under §32(c)(2); (2) amounts earned by an individual who is serving a prison sentence at a treatment facility for sex offenders are not earned income under §32(c)(2); and (3) amounts earned by an individual who has been civilly committed to a treatment facility for sex offenders, but is physically located in a prison rather than a separate treatment facility, are earned income under §32(c)(2). See *Skaggs v. Commissioner*, 148 T.C. 367 (2017) (state security hospital to which inmate was transferred is penal institution because inmates continue to undergo punishment for crimes while receiving treatment).

<sup>900</sup> Section 32(c)(2)(A)(i), which restricts earned income to that amount included in gross income, was added by EGTRRA, Pub. L. No. 107-16, §303(b). This amendment was scheduled to sunset for taxable years beginning after December 31, 2012, but was made permanent by the American Taxpayer Relief Act of 2012. Pub. L. No. 112-240, §101(a)(1), striking Pub. L. No. 107-16, §901, as amended by Pub. L. No. 111-312, §101(a)(1).

<sup>901</sup> §32(c)(2)(B)(vi), added by §104(b) of the Working Families Tax Relief Act of 2004, Pub. L. No. 108-311, and amended by §302(a) of the Gulf Opportunity Zone Act of 2005, Pub. L. No. 109-135, and §106(a) of the Tax Relief and Health Care Act of 2006, Pub. L. No. 109-432, and §102(b) of the Heroes Earnings Assistance and Relief Tax Act of 2008, Pub. L. No. 110-245, effective taxable years ending after December 31, 2007.

one qualifying individual; and (2) \$500 a month, if the employee cares for more than one qualifying individual.<sup>902</sup>

*Example:* If an employee has two children and the employee's spouse is a full-time student 10 months out of the year, the employee may exclude from income a maximum of \$5,000 for the year (\$7,500 after 2025) that he or she receives in benefits under the employer's dependent care assistance program. If the employee had no children and his or her spouse was incapacitated the entire year, the employee may receive a maximum of \$3,000 for the year, tax-free, under the employer's dependent care assistance program.

### (3) Identification of Care Provider

For an employee to utilize the dependent care credit under §21 or to exclude child care reimbursements under §129, the employee must supply the IRS with the name, address and taxpayer identification of the person performing the child care services. If the child care provider is a tax-exempt organization, only the name and address must be supplied. The employee does not have to provide such information if he or she exercised due diligence in attempting to provide the required information.<sup>903</sup>

In Notice 89-71, the IRS provides guidance to taxpayers on how to comply with these reporting rules. Generally, the information should be provided on Form 2441 which is filed with the employee's federal income tax return. Notice 89-71 also provides several methods of complying with the due diligence requirement. The employee may provide:

- a completed Form W-10, Dependent Care Provider's Identification and Certification;
- a copy of the care provider's social security card or driver's license (in a state where the license includes the social security number);
- a recently printed letterhead or printed invoice of the care provider that contains the required information;
- a copy of Form W-4 if the care provider is the taxpayer's household employee; or
- a copy of the statement required by §129(d)(7) that contains the required information if the employer is the care provider.

If the employee is unable to provide all the required information because the care provider does not comply with a request for information, the employee should furnish whatever information the employee has on Form 2441 and include a

<sup>902</sup> §129(b)(2), §21(d)(2). The \$250 and \$500 income amounts increased from \$200 and \$400, respectively, effective for taxable years beginning after December 31, 2002. See §21(d)(2), as amended by §418(b) of the 2002 Job Creation and Worker Assistance Act (JCWAA), Pub. L. No. 107-147, effective as if included in EGTRRA, §204. The amendment was scheduled to sunset for taxable years beginning after December 31, 2012, but was made permanent by the American Taxpayer Relief Act of 2012. Pub. L. No. 112-240, §101(a)(1), striking Pub. L. No. 107-16, §901, as amended by Pub. L. No. 111-312, §101(a)(1).

<sup>903</sup> §21(e)(9), §129(e)(9). Note that §21(e)(10) requires the taxpayer identification number of the qualifying individual (see §21(b)(1)) to be included on the return claiming the credit.

statement that he or she requested the information and the care provider did not comply.

Care providers are required to furnish their taxpayer identification numbers to an employee for purposes of IRS reporting. If the care provider fails to provide its taxpayer identification number, a \$50 penalty for each such failure (up to a maximum of \$100,000 per year) may be imposed.<sup>904</sup>

### c. Comparison of §21 Credit and §129 Exclusion

Section 21 provides a nonrefundable credit for a percentage of a specified amount of employment-related child or dependent care expenses. The maximum percentage is 50% for tax years beginning after 2025 and is 35% for tax years beginning before 2026. The specified amount is \$3,000 in the case of one qualifying individual and \$6,000 in the case of two or more qualifying individuals. The 50% credit is reduced (but not below 35%) by one percentage point for each \$2,000 (or fraction thereof) by which the taxpayer's adjusted gross income (AGI) exceeds \$15,000, and further reduced (but not below 20%) by one percentage point for each \$2,000 (\$4,000 in the case of a joint return) or fraction thereof by which the taxpayer's AGI for the taxable year exceeds \$75,000 (\$150,000 in the case of a joint return).<sup>905</sup> In effect, the credit rate is 35% for taxpayers with AGI in excess of \$43,000 up to \$75,000 (20% for taxpayers with AGI in excess of \$75,000) for taxable years beginning after 2025, and the credit rate is 20% for taxpayers with AGI in excess of \$43,000 for taxable years beginning before 2026.<sup>906</sup>

For tax years beginning in 2021 only, the credit is refundable. The credit is up to 50% (the "applicable percentage") of a specified amount of eligible expenses. The specified amount is \$8,000 for one qualifying individual and \$16,000 for more than one. The applicable percentage is reduced by one percentage point for each \$2,000 (or fraction thereof) by which the taxpayer's adjusted gross income exceeds \$125,000.<sup>907</sup> The applicable percentage is not reduced below the "phaseout percentage."<sup>908</sup> The phaseout percentage equals 20%, reduced (but not below zero) by one percentage point for each \$2,000 or fraction thereof by which the taxpayer's adjusted gross income exceeds \$400,000.<sup>909</sup>

Section 129 permits an employee to exclude from income up to \$7,500 per year beginning after 2025 or \$5,000 per year beginning before 2026 (up to \$10,500 in 2021) for amounts provided through employer-sponsored dependent care assis-

<sup>904</sup> §6109(a)(2), §6723; H.R. Rep. No. 247, 101st Cong., 1st Sess. 1385 (1989).

<sup>905</sup> §21(a)(2), as amended by OBBBA, Pub. L. No. 119-21, §70405(a), effective for taxable years beginning after December 31, 2025.

<sup>906</sup> Prior to amendment by EGTRRA, Pub. L. No. 107-16, §204(c), i.e., for taxable years beginning before January 1, 2003, the credit was 30% and the AGI limit for taking the credit was \$10,000. In addition, EGTRRA §204(a)(1) amended §21(c)(1) and §21(c)(2) to increase the employment-related expense dollar limit from \$2,400 to \$3,000 for one qualifying child and from \$4,800 to \$6,000 for two or more qualifying children. The EGTRRA amendment was scheduled to sunset for taxable years beginning after December 31, 2012, but was made permanent by the American Taxpayer Relief Act of 2012. Pub. L. No. 112-240, §101(a)(1), striking Pub. L. No. 107-16, §901, as amended by Pub. L. No. 111-312, §101(a)(1).

<sup>907</sup> §21(g)(3), added by the American Rescue Plan Act of 2021, Pub. L. No. 117-2, §9631(a).

<sup>908</sup> §21(g)(4)(A).

<sup>909</sup> §21(g)(4)(B).

tance programs. Under prior law, an employee could take advantage of both the exclusion under §129 and, for any amounts of child care in excess of the excludible amount, utilizing the credit under §21. However, the ability to combine the income exclusion with the dependent care tax credit was eliminated. Under §21(c), as the dollar amount of expenses eligible for the dependent care credit of an employee is reduced, dollar for dollar, by the amount of expenses excludible from that employee's income under the dependent care exclusion of §129. For example, if an employee with one dependent child excludes \$1,400 from income under a §129 dependent care assistance program, only up to \$1,600 of any additional amounts paid would be eligible for the credit under §21.

*Comparison for tax years other than 2021:*

Dependent care assistance programs provide a major advantage to employees over the §21 dependent care assistance credit. Under §21, an employee whose adjusted gross income is over \$43,000 may only receive a credit for 20% (before 2026) of the employment-related expenses he or she incurs up to a maximum credit of \$600 if the employee's household contains one qualifying individual or \$1,200 if the household contains more than one qualifying individual. However, under a dependent care assistance program, the employee may exclude from income the entire amount of employment-related expenses paid for by the employer up to the lesser of the employee's or the employee's spouse's earned income, or the maximum exclusion (\$5,000 before 2026). Therefore, in many instances, it will be advantageous for an employee to be reimbursed for his or her expenses under a qualified dependent care assistance program, rather than including in income amounts paid the employee by the employer to cover employment-related expenses and then taking a compensating credit.

*Example 1:* An employee and the employee's spouse earn \$175,000 in 2009. The employee incurs \$6,000 of employment-related expenses during the year for the care of the employee's two children for which the employee would receive a credit under §21 of \$1,200 (20% of the maximum allowable \$6,000). The employee and spouse would have taxable income of \$149,000 in 2009 (assuming no itemized deductions and they filed a joint return). Their tax would be \$29,984, which would be reduced to \$28,784 after applying the dependent care assistance credit. Next, the employee's employer has a salary reduction dependent care assistance program that reimburses the employee for dependent care assistance expenses in lieu of paying him or her the maximum allowable \$5,000 of salary. The employee and spouse's taxable income would be \$144,000 on which they would pay tax of \$28,584. The employee would therefore save \$200 in taxes by receiving benefits under the employer's dependent care assistance program.

In certain instances, however, it is to the employee's advantage to receive taxable compensation and take the credit under §21.

*Example 2:* A single employee with one child earns \$20,000 in 2009. The employee incurs \$2,000 in employ-

ment-related expenses to take care of the child. If the employer had a dependent care assistance program, the employee would be better off receiving \$2,000 as taxable compensation instead of electing to reduce his or her salary by \$2,000 under the employer's dependent care assistance program. If the employee reduced his or her salary by \$2,000 under the program, taxable income would be \$2,350 (assuming no other income, itemized deductions or credits) and the employee would have to pay a tax of \$235. If the employee took the \$2,000 as taxable income, the employee would have taxable income of \$4,350 which would subject him or her to a tax of \$435. However, the employee would receive a \$500 credit for the \$2,000 of employment-related expenses incurred in 2009 (32% of \$2,000), reducing the tax liability to \$0. Therefore, the employee would save a total of \$235 in taxes by including the \$2,000 in income and taking a compensating credit for that amount. Consequently, it appears that lower-income employees with employment-related expenses, particularly those whose marginal tax rate is in (or below) the 15% tax bracket, may not benefit from dependent care assistance programs, depending on the year in which they incur the employment-related expenses.

*Comparison for the 2021 tax year:*

For 2021, because the amount of expenses used to determine the §21 credit is increased to \$8,000, and the applicable percentage is increased to 50% (i.e., \$4,000 max credit where there is one qualifying individual), taxpayers may find that recognizing income and taking the credit is more beneficial than electing to reduce salary under a qualified dependent care assistance program. However, legislative changes for 2021 include a full phase-out of the §21 credit for taxpayers making \$440,000 or more. This phase-out does not exist in other years. The annual §129 limit for 2021 generally is increased to \$10,500 (up from \$5,000), and there are no income limits in effect. A taxpayer with \$450,000, therefore, would be better off participating in a dependent care assistance program than taking a §21 credit.

*3. Requirements Under §129*

*a. Written Plan*

A dependent care assistance program must be evidenced by a separate written plan that may not be part of any other employee benefit plan (such as a pension or profit-sharing plan).<sup>910</sup> A dependent care assistance plan need not be funded through a separate trust.<sup>911</sup> Under the plan the employer may either reimburse the employee for the expenses of dependent care assistance he or she incurs, pay the provider of the dependent care assistance directly or supply the dependent care assistance directly to the employee.

<sup>910</sup> §129(d)(1). See the Worksheets for a sample plan.

<sup>911</sup> §129(d)(5).

### b. Manner of Offering Plan

A dependent care assistance plan may be offered to employees on a stand-alone basis or may be offered to employees as an option under a §125 cafeteria plan.<sup>912</sup> If provided under a cafeteria plan, certain additional special rules apply:<sup>913</sup>

- any amounts elected as dependent care assistance benefits may be paid only as benefits under such plan;
- dependent care services must be incurred during the period of coverage under the cafeteria plan;
- participants must be precluded from purchasing coverage only for periods in which they expect to incur dependent care services; and
- contributions under a dependent care assistance plan are excludible under §129 only if the plan meets all requirements of §125 and §129.<sup>914</sup>

### c. Participation and Discrimination

A dependent care assistance program must be for the exclusive benefit of the employer's employees, and benefits may be provided under the program to a sole proprietor or a member of a partnership (including a limited liability company treated as a partnership for federal income tax purposes under the entity classification rules).<sup>915</sup>

A dependent care assistance program must satisfy certain statutory requirements as to participation and discrimination. However, if a program fails the §129(d) nondiscrimination rules, only highly compensated employees must include their benefits in gross income.<sup>916</sup> Under prior law, if a dependent care assistance program failed the various nondiscrimination and other related tests, all employees would be taxed on these benefits.

All employees of a controlled group of corporations under §414(b), a group of businesses under common control under §414(c) and an affiliated service group under §414(m) are included for purposes of the §129 nondiscrimination tests.<sup>917</sup> Further, leased employees are considered employees of the employer for this purpose.<sup>918</sup>

#### (1) Eligibility Test

A dependent care assistance program must benefit employees who qualify under a classification set up by the employer that does not discriminate in favor of highly compensated employees (as defined in §414(q)) or their dependents.<sup>919</sup>

Employees who have not reached age 21 and completed one year of service may be disregarded in applying the §129(d)

<sup>912</sup> §125(f), as amended by Pub. L. No. 111-148, §1515, applicable to taxable years beginning after December 31, 2013; Prop. Reg. §1.125-1(a)(3)(F), §1.125-5(i), REG-142695-05, 72 Fed. Reg. 43,938 (Aug. 6, 2007).

<sup>913</sup> See generally Prop. Reg. §1.125-1, §1.125-2, §1.125-5–§1.125-7, REG-142695-05, 72 Fed. Reg. 43,938 (Aug. 6, 2007); Reg. §1.125-3, §1.125-4.

<sup>914</sup> Prop. Reg. §1.125-5(i), §1.125-6(a)(4), REG-142695-05, 72 Fed. Reg. 43,938 (Aug. 6, 2007); see discussion in 397 T.M., *Cafeteria Plans*.

<sup>915</sup> §129(d)(1), §129(e)(3).

<sup>916</sup> §129(d)(1).

<sup>917</sup> §414(t).

<sup>918</sup> §414(n)(3)(C).

<sup>919</sup> §129(d)(3).

(3) nondiscriminatory classification test.<sup>920</sup> In addition, for purposes of this test, employees who are not included in a dependent care assistance program, but who are covered by a collective bargaining agreement may be excluded (if dependent care benefits were the subject of good faith bargaining in arriving at the collective bargaining agreement).<sup>921</sup> A dependent care assistance program is not considered discriminatory merely because it is utilized to a greater degree by one class of employees than by another class.<sup>922</sup> Therefore, if the percentage of highly paid employees utilizing the benefits of the program is larger than the percentage of low-paid employees utilizing the program, the program will not necessarily be considered discriminatory.

#### (2) Discrimination as to Benefits

Section 129(d)(2) requires that a dependent care assistance program not discriminate as to contributions or benefits in favor of highly compensated employees (as defined in §414(q)) or their dependents. As with the eligibility test, a dependent care plan will not necessarily be considered discriminatory if highly compensated employees utilize dependent care benefits to a greater degree than non-highly compensated employees. However, the average benefits test effectively imposes a utilization test as to benefits provided under a plan.<sup>923</sup>

#### (3) Average Benefits Test

The average benefits test of §129(d)(8) requires that the average benefits provided to nonhighly compensated employees (NHCEs) be at least 55% of the average benefits provided to highly compensated employees (HCEs). To perform the test, the benefit provided to each nonexcludible NHCE is added and divided by the total number of nonexcludible NHCEs. This procedure is repeated with respect to the group of HCEs.

An employer may disregard employees earning less than \$25,000 per year in testing whether a salary reduction dependent care plan meets the 55% test. Congress recognized in this provision that lower income employees are more likely to utilize the child care credit under §21 rather than reducing salary under a §129 plan. For this purpose, compensation is defined under §414(q)(4). Alternatively, an employer may determine compensation on any other basis that does not discriminate in favor of HCEs.<sup>924</sup>

*Example:* An employer sponsors a salary reduction dependent care plan in which employees can elect to defer up to the statutory ceiling (\$5,000 before 2026 and \$7,000 after 2025) to pay for dependent care expenses on a pre-tax basis. The employer has 5,000 employees in 2024, 4,100 of whom can be disregarded because they have compensation less than \$25,000. Each HCE who participates elects to defer \$4,000 and each NHCE who participates elects to defer \$3,000. The number of employees participating in the plan and the benefits elected are as follows:

<sup>920</sup> §129(d)(9)(A).

<sup>921</sup> §129(d)(9)(B).

<sup>922</sup> §129(e)(6). However, see discussion of average benefits test and concentration test in III.B.3.c.(3) and III.B.3.c.(4).

<sup>923</sup> 1986 Act Bluebook, fn. 12, at p. 810.

<sup>924</sup> §129(d)(8)(B).

	HCEs	NHCEs
Total nonexcludible employees:	100	800
Participants in dependent care plan:	90	550
Total contributions:	\$360,000	\$1,650,000

The average benefit for the nonexcludible NHCEs is:

$$\frac{\$1,650,000}{800} = \$2,063$$

The average benefit for the nonexcludible HCEs is:

$$\frac{\$360,000}{100} = \$3,600$$

Because \$2,063 is 57.3% (or at least 55%) of \$3,600, the plan passes the test.

The average benefits test may be applied on a separate line of business basis.<sup>925</sup> Until the IRS issues guidance, an employer may determine it is operating a separate line of business by applying the §414(r) rules on a reasonable basis.<sup>926</sup> For a further discussion of the separate line of business rules, see VI.

#### (4) Concentration Test

No more than 25% of the amounts paid or incurred by an employer under a dependent care assistance program may be provided to or for the benefit of any of the following groups:

- if the employer is a corporation, all employees who each own more than 5% of the employer's outstanding stock, including stock owned by the employee's spouse and dependents; and
- if the employer is not a corporation, all individuals who own more than 5% of the capital or profits interest in the employer, including such ownership by the spouse and dependents of each individual.<sup>927</sup>

In determining stock ownership, the attribution rules of §1563(d) and §1563(e) apply without regard to §1563(e)(3)(C).<sup>928</sup>

If an employer is not incorporated, an individual's interest in the employer will presumably be determined under the regulations promulgated under §414(c).<sup>929</sup>

*Comment:* An employer must make certain that its dependent care assistance program makes available no more than 25% of its benefits to shareholder or owner-employees and does not actually pay or provide to shareholder or owner-em-

<sup>925</sup> §414(r).

<sup>926</sup> Debt Limit Extension Act, Pub. L. No. 101-140, §204(b)(1). This rule remains in effect following issuance of the regulations under §414(r). See discussion at VI.F.1.

<sup>927</sup> §129(d)(4).

<sup>928</sup> §129(e)(5)(A). For a discussion of §1563(e)(3)(C), see III.A.3.b.(4).

<sup>929</sup> §129(e)(5)(B).

ployees during the program year more than 25% of the benefits paid or provided during the year. Therefore, closely held corporations, partnerships (including LLCs classified as partnerships for federal income tax purposes) or sole proprietorships will not be able to adopt these programs solely to benefit their shareholders or owners.

#### d. Statement of Expenses

The employer must furnish to participants on or before January 31 a written statement showing the amounts paid or expenses incurred by the employer in providing dependent care assistance to the participant during the previous calendar year.<sup>930</sup>

Section 6051(a)(9) requires that amounts incurred for dependent care assistance under §129 plans be reported to the IRS on Form W-2. Notice 89-111<sup>931</sup> provides guidance with respect to the manner of reporting and the valuation of on-site day care. An employer satisfies both §129(d)(7) and §6051(a)(9) by reporting dependent care assistance on Form W-2. For cash reimbursement arrangements, the amount reported is the total amount of cash reimbursements provided by the employer to the employee for dependent care assistance furnished during the calendar year. If the plan permits reimbursement after the end of the year for assistance received during the year, the employer may report a reasonable estimate of the total amount of dependent care assistance on Form W-2. In the case of a salary reduction plan, the amount of elective deferrals for dependent care assistance, plus any employer matching contributions, is deemed to be a reasonable estimate.

If the employer maintains an on-site child care facility, the amount that may be excluded with respect to any dependent is based on the individual's utilization and the value of services provided.<sup>932</sup> In the case of in-kind dependent care assistance, the amount reported is the fair market value of the program. Fair market value means the employer's reasonable estimate of the amount the employee would pay for comparable dependent care in an arm's-length transaction.

For purposes of reporting the value of in-kind dependent care assistance, an employer is permitted to use the safe harbor valuation method provided in Notice 89-111<sup>933</sup> of 125% of reasonably estimated direct costs. For this purpose, direct costs are food, expendable materials and supplies, transportation, staff training, special or additional insurance directly attributable to the day care facility, periodic consulting or management fees

<sup>930</sup> §129(d)(7).

<sup>931</sup> Notice 2005-61 amplified Notice 89-111 to clarify that when an employer amends a cafeteria plan to provide for the grace period allowed under Notice 2005-42 for dependent care assistance, the employer may continue to rely on Notice 89-111 and report salary reduction amounts elected by an employee for a calendar year in Box 10 on Form W-2. Notice 2005-42 extended the year-end deadline for using balances in flexible spending accounts beyond the calendar year by a 2½-month grace period for qualified dependent care assistance. Because of the Covid-19 pandemic, the Consolidated Appropriations Act, 2021, Pub. L. No. 116-260, Div. EE, §214, also provided a special carryover rule and an extended grace period for contributions to dependent care assistance programs. The IRS provided additional guidance in Notice 2021-26 and Notice 2021-15. For a detailed discussion of these special rules see 397 T.M., *Cafeteria Plans*.

<sup>932</sup> §129(e)(8).

<sup>933</sup> The safe harbor rule contained in Notice 89-111 was extended to post-1989 years in Notice 90-66.

directly related to the operation of the day care facility and the cost of labor for personnel whose services relating to the facility are performed primarily on the premises of the day care facility. The result of 125% of direct costs is divided by the total number of dependents the facility is permitted to care for and divided further by the number of days the facility is open. The result is the deemed daily cost per dependent at the facility. This result is then multiplied by the number of days that each dependent of the employee made use of the facility in order to determine the deemed fair market value of the in-kind dependent care assistance provided by the employer to the employee during the year.

#### e. Notice to Employees

The employer must give reasonable notification of the availability and terms of a dependent care assistance program to all eligible employees.<sup>934</sup> Under the repealed §89 qualification rules, the required notification had to include a description of the dependent care credit and the circumstances under which the credit was more advantageous than the exclusion.<sup>935</sup> Following the repeal of §89, it is unclear whether employers should provide this information, but absent some reason making the provision of this information impracticable, it would seem prudent for employers to provide such notice.

#### 4. Procedural Requirements

An employer who adopts a dependent care assistance program need not apply to the IRS for prior approval of the plan.

Annual reporting requirements were imposed on employers maintaining §129 plans starting with plan years beginning in 1989.<sup>936</sup> However, in Notice 90-24, the IRS deferred the reporting requirement under §6039D until further guidance is issued.

Before providing any benefits under a dependent care assistance program to an employee, the employer should obtain a signed written statement or electronic acknowledgment from the employee containing the following information:

- the nature of the services or the expenses that the employee seeks to have paid under the program;
- the employee's marital status and if the employee is married, what the employee's spouse's salary is or if the spouse is not employed, whether the spouse is: (1) incapacitated; or (2) a full-time student attending an accredited institution (and the number of months the spouse will attend such institution);
- the age and relationship of all the employee's dependents and whether or not such dependents live with the employee; and
- a description of any day care center to which an employee may send his or her child including the identity of the operator and number of children regularly cared for.

*Comment:* All this information must be collected to determine the maximum amount the employer can pay to the employee under its dependent care assistance plan that can be ex-

cluded from income. If an employer pays an amount in excess of the maximum amount the employee can exclude, it will be liable for all employment taxes on such amounts that it may have failed to withhold from the payment to the employee.<sup>937</sup> If the employer offers the dependent care assistance under a cafeteria plan, all expenses must be substantiated by information from a third party independent of the employee and the employee's spouse and dependents.<sup>938</sup>

#### C. Employee Achievement Awards

Under prior law, the U.S. Supreme Court ruled that an employer ordinarily did not possess the detached and disinterested generosity necessary to make gifts to employees. Thus, it ruled that most such benefits provided to an employee were taxable income.<sup>939</sup> However, within certain limitations of then-existing §74 and §274, employers were permitted to provide gifts with a value under \$25 as part of an employer incentive or award program, which were not includible in an employee's income.

Congress amended the I.R.C. to remove the uncertainty that existed with respect to the proper tax treatment of employee awards and to provide express rules with respect to such awards. Congress added §102(c) to provide that §102(a), providing that gross income does not include the value of property acquired by gift, shall not exclude from income any amount transferred by an employer to or for the benefit of an employee. Congress also added §74(c), which provides that gross income does not include the value of an employee achievement award to the extent that the employer is permitted a deduction under §274(j) with respect to the award.<sup>940</sup>

Congress further added a cross-reference to the de minimis incidental fringe benefit exclusion to both §74(c) and §102(c). The legislative history and proposed regulations under §274(j) clarify that the de minimis fringe benefit exclusion<sup>941</sup> applies only to employee awards of low value but may include traditional awards, such as a gold watch, upon retirement after lengthy service for an employer.<sup>942</sup>

Section 274(j) sets limits on the amount of an employer's deduction for an employee achievement award. An employee achievement award is an item of tangible personal property

<sup>937</sup> Cf. §7501.

<sup>938</sup> Prop. Reg. §1.125-6(b)(3), REG-142695-05, 72 Fed. Reg. 43,938 (Aug. 6, 2007). Situation 6 in CCA 202317020 addressed a dependent care assistance program under a cafeteria plan that allows employees to submit a form on which they attest to dependent care expenses for the year before they receive the care and requires them to notify the employer of dependent care situation changes. The Chief Counsel's Office advised that the dependent care assistance claims for payment or reimbursement are not substantiated, because they are claimed in advance without additional verification; because claim reimbursements or payments are not limited to expenses that have been incurred or substantiated, the plan does not satisfy the §129 and §125 requirements; and the failure to comply with the cafeteria plan substantiation requirements results in a failure to operate in accordance with the written plan or a failure to operate in accordance with §125. See also Prop. Reg. §1.125-6(g) for rules on using debit cards to pay or reimburse dependent care assistance benefits. For further discussion, see 397 T.M., *Cafeteria Plans*.

<sup>939</sup> *Duberstein v. Commissioner*, 363 U.S. 278 (1960); but see Rev. Rul. 53-131.

<sup>940</sup> In the case of a tax-exempt employer, the amount excludible is based on the deduction that would be allowed if the employer were subject to tax. §74(c)(3).

<sup>941</sup> §132(e)(1); see also discussion at II.B.2.d.(4)(f).

<sup>942</sup> 1986 Conf. Rep. at II-18; Prop. Reg. §1.274-8(d)(2).

<sup>934</sup> §129(d)(6).

<sup>935</sup> 1986 Act Bluebook p. 812.

<sup>936</sup> §6039D.

transferred to an employee for length of service or safety achievement, awarded as part of a meaningful presentation, and is not the payment of disguised compensation.<sup>943</sup> Note that an award for productivity, or for any other purpose not specified in §274(j), is not deductible by the employer or excludible by the employee under §74(c).<sup>944</sup> As under the de minimis fringe benefit rules, a gift of cash does not constitute a deductible employee achievement award. Also excluded are vacations, meals, lodging, theater or sporting event tickets, and stocks, bonds and other securities.<sup>945</sup> Congress codified this IRS position for amounts paid or incurred after 2017 by defining tangible personal property for purposes of §274(j). Tangible personal property is defined to exclude cash and cash equivalents, and vacations, meals, tickets to the theater or sporting events, and securities.<sup>946</sup>

The amount that the employer may deduct (and that an employee may exclude from income under §74(c)) depends on whether the award is a qualified plan award or a nonqualified plan award. A qualified plan award is one that is awarded under a written plan or program that does not discriminate (in form or in operation), in favor of highly compensated employees (as defined in §414(q)) as to eligibility or benefits.<sup>947</sup> A nonqualified plan award is one that is not a qualified plan award.

An employer may deduct an award to an employee of up to \$400 under a nonqualified plan and up to \$1,600 under a qualified plan.<sup>948</sup> These two limitations are coordinated so that an employer may not deduct more than \$1,600 with respect to any one employee. A further restriction is that no award is considered a qualified plan award to the extent that the average cost of all employee achievement awards awarded during the year under a qualified plan exceeds \$400. An award costing \$50 or less is disregarded for this purpose.<sup>949</sup>

Section 274(j) further places limits on the class of employees who are eligible to receive employee achievement awards. A length of service award may be given only to an employee who has completed at least five years of service and may not be awarded to an employee who has received a length of service achievement award in that year or any of the prior four years.<sup>950</sup>

Safety achievement awards may be awarded to no more than 10% of the employer's eligible employees. "Eligible employees" include full-time employees with at least one year of service, and do not include a manager, administrator, clerical employee or other professional employee.<sup>951</sup>

The limits on safety awards and length of service awards do not apply to awards that qualify as de minimis fringe benefits. For example, a pin or similar item with a value of \$15 awarded to an employee on joining a business, on completing six months' employment or on completing a probationary em-

ployment period would qualify as a de minimis fringe benefit under §132(e)(1).<sup>952</sup>

If the cost of the employee achievement award does not exceed the amount allowed as a deduction to the employer under §274(j), then the employee may exclude the fair market value of the award from income.<sup>953</sup> If the cost to the employer of an employee achievement award exceeds the amount allowable as a deduction to the employer, the employee must include in income an amount that is the greater of (1) the excess of such cost over the amount allowable as a deduction (up to the fair market value of the award) or (2) the excess of the fair market value of the award over the amount allowed as a deduction to the employer.<sup>954</sup> However, where the cost of an award to the employer is so disproportionate to the fair market value of the award that there is a significant likelihood that the award was given as disguised compensation, no amount of the award is excludible from income as an employee achievement award.<sup>955</sup>

#### D. Employer Contributions to Trump Accounts — §128

Congress added §128 in 2025 to provide a fringe benefit exclusion for employer contributions to the Trump account of an employee or the employee's dependent.<sup>956</sup> A Trump account is a type of individual retirement account that is available for taxable years beginning after December 31, 2025, and that is established exclusively for the benefit of qualifying individuals under the age of 18.<sup>957</sup> Employers may begin contributing to Trump accounts for taxable years beginning after December 31, 2025, but no earlier than July 4, 2026,<sup>958</sup> enabling them to incorporate Trump account funding into 2026 open enrollment cycles.

Amounts an employer deposits into a Trump account for an employee or the employee's dependent are excluded from the employee's gross income when the payments are made under a separate written plan called a Trump account contribution program.<sup>959</sup> When an employer makes the contribution, the employer must affirmatively indicate to the Trump account trustee that the contribution is a §128 employer contribution that is excludible from the employee's gross income.<sup>960</sup>

Employer contributions to the Trump account contribution program count towards the annual contribution limit of \$5,000 per year (indexed for inflation after 2027).<sup>961</sup> If an employer chooses to provide a Trump account contribution program, the program must meet nondiscrimination, eligibility, benefit, and administrative requirements comparable to those imposed on dependent care assistance programs under §129(d).<sup>962</sup>

<sup>943</sup> §274(j)(3)(A); Prop. Reg. §1.274-8(c)(1).

<sup>944</sup> 1986 Act Bluebook fn. 14 at p. 35.

<sup>945</sup> Prop. Reg. §1.274-8(c)(2).

<sup>946</sup> §274(j)(3)(A)(ii), added by Pub. L. No. 115-97, §13310, applicable to amounts paid or incurred after December 31, 2017.

<sup>947</sup> §274(j)(3)(B); Prop. Reg. §1.274-8(c)(5).

<sup>948</sup> §274(j)(2); Prop. Reg. §1.274-8(b).

<sup>949</sup> §274(j)(3)(B)(ii); Prop. Reg. §1.274-8(c)(5)(ii).

<sup>950</sup> §274(j)(4)(B); Prop. Reg. §1.274-8(d)(2).

<sup>951</sup> §274(j)(4)(C); Prop. Reg. §1.274-8(d)(3).

<sup>952</sup> 1986 Act Bluebook at p. 37.

<sup>953</sup> §74(c)(1); Prop. Reg. §1.74-2(a).

<sup>954</sup> §74(c)(2); Prop. Reg. §1.74-2(b).

<sup>955</sup> Prop. Reg. §1.74-2(a)(2).

<sup>956</sup> §128, added by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70204(b)(1), effective for taxable years beginning after December 31, 2025.

<sup>957</sup> See §530A. For discussion of Trump accounts, see 367 T.M., IRAs.

<sup>958</sup> §530A(b)(1)(C).

<sup>959</sup> §128(a).

<sup>960</sup> Notice 2025-68, Q&A I-2.

<sup>961</sup> §530A(c)(2)(A), §530A(c)(2)(C).

<sup>962</sup> §128(c). The program must meet requirements similar to §129(d)(2), §129(d)(3), §129(d)(6), §129(d)(7), and §129(d)(8), which are discussed at III.B.3., above. The Treasury and the Department of Labor anticipate issuing

The employee income exclusion is capped at \$2,500 (indexed for inflation after 2027)<sup>963</sup> and any employer funding above that threshold is taxable to the employee. The \$2,500 limit “with respect to any employee” is available each calendar year. Also, this is the total amount available per employee. Thus, if an employee has multiple qualifying dependents each with a Trump account, the employer may contribute in the aggregate only up to this annual limit for all of the Trump accounts of that employee’s dependents.<sup>964</sup>

Employer contributions may be deductible to the employer as ordinary and necessary business expenses under §162(a), consistent with the treatment of other qualified fringe benefits.<sup>965</sup> For plan design purposes, the benefit option can be integrated into an employer’s overall benefits package, allowing employers to offer Trump account funding on a voluntary, nondiscriminatory basis similar to 401(k) matching or education assistance tuition benefits.<sup>966</sup> A Trump account contribution program may not be offered through salary reduction under a §125 cafeteria plan if the contribution is made to the Trump account of an employee, but this option is available if the contribution is made to the Trump account of the employee’s dependent.<sup>967</sup>

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guidance on how to structure the employer contributions so that they are not subject to the ERISA coverage framework. Notice 2025-68 n.3.

<sup>963</sup> §128(b)(1). For taxable years beginning after 2027, the \$2,500 limit is indexed for inflation using the §1(f)(3) cost-of-living adjustment formula, rounded down to the nearest \$100. §128(b)(2)(A), §128(b)(2)(B).

<sup>964</sup> Notice 2025-68, Q&A I-1.

<sup>965</sup> §162(a).

<sup>966</sup> See §125(f).

<sup>967</sup> Notice 2025-68, Q&A I-3.

### E. Benefits Discussed in Other Portfolios

A complete discussion of all benefits exempt from tax pursuant to statute is beyond the scope of this portfolio. However, discussions of the following I.R.C. sections, which exempt specific benefits that may be provided by an employer from an employee’s gross income, may be found in the following portfolios:

- Section 79 — relating to life insurance coverage provided by employers — 386 T.M., *Insurance-Related Compensation*.
- Section 104, §105, and §106 — relating to amounts contributed by employers to, and amounts received under, accident and health plans — 330 T.M., *Tax and ERISA Implications of Employer-Provided Medical and Disability Benefits*, and 395 T.M., *VEBAs and Other Welfare Benefit Funding*.
- Section 117 — relating to employer-provided scholarships and fellowship grants — 518 T.M., *Exclusion of Scholarships and Other Receipts for Education*.
- Section 119 and §274 — relating to meals or lodging furnished for the convenience of the employer — 519 T.M., *Travel, Transportation, Entertainment, Meal, and Gift Expenses*.
- Section 125 — relating to cafeteria plans — 397 T.M., *Cafeteria Plans*.

## IV. Taxable Benefits

### A. Benefits Subject to Current Tax

#### 1. Vacations and Holidays

Vacations and holidays or special days off, such as birthdays, are taxed to employees to the extent they receive salary or compensation and/or benefits as though they were working on those days,<sup>968</sup> and the cost to the employer of such payments or benefits is deductible.

Likewise, when an employer provides or pays the expenses for an employee's vacation, such payment constitutes compensation to the employee regardless of whether it is provided as a reward for extraordinary performance or for other motivational reasons.<sup>969</sup> This rule does not, however, extend to business trips that incidentally happen to be pleasurable or even exotic.<sup>970</sup>

Employer-provided paid sick leave benefits are generally treated as wages paid to the employee and costs incurred by the employer for income tax purposes. Though federal law does not require employers to provide sick leave to employees — except in the case of a public health emergency,<sup>971</sup> and for federal contractors — several states and localities impose such requirements on employers. For further discussion of tax treatment of employer-provided paid sick leave, see the *Payroll Administration Guide, Sick Pay — Tax*.

#### 2. Tuition Payment and Tuition Reduction Plans

A popular form of benefit is a tuition payment plan. Such plans are most frequently established to benefit key employees by payment of tuition and other educational or college costs for such employees' children or other family members. Such plans are not ordinarily related to the employee's performance of services for the employer's business and, in the IRS's view, generally result in income to the employee.<sup>972</sup>

The tax status of these plans has been the subject of considerable litigation<sup>973</sup> in which the IRS has maintained that an employer's payment of college tuition costs for an employee's children constitutes a deferred compensation plan within the meaning of §404(a)(5), which requires deferral of the employer's deductions until the benefits are paid out to the children of employee participants.<sup>974</sup>

If such plans are structured as welfare benefit plans, an employer may deduct its contribution to the plan in the year in which made under §162,<sup>975</sup> subject to the limitations imposed by §419 on welfare benefit funds.<sup>976</sup> In determining whether a plan is a welfare benefit plan or a deferred compensation plan, a court will examine such factors as whether the benefits are based on employees' salaries or length of service, the class of eligible employees, whether plan benefits are a substitute for increased compensation and the method of plan administration.<sup>977</sup> If benefits are provided to a broad classification of employees, are not linked to employee compensation or length of service, the plan is administered by an independent trustee and the funds will not revert to the employer upon plan termination, a court may find the arrangement to be a welfare benefit plan and permit current deduction of contributions.

Tuition reduction plans are widely offered by colleges to faculty members. These plans characteristically provide that faculty and their family members may attend that institution, and occasionally an institution offering a reciprocal privilege, tuition-free or at a greatly reduced rate of tuition. Although the IRS experienced some success in treating such plans as taxable compensation<sup>978</sup> and the Second Discussion Draft of the incidental fringe benefit regulations would have similarly treated these arrangements as taxable,<sup>979</sup> Congress specifically provided in the 1984 Act that gross income does not include a qualified tuition reduction.<sup>980</sup> A qualified tuition reduction is a reduction in tuition that is provided by an educational institution for undergraduate education at that or another institution. The tuition reduction may be provided to an employee and to his or her spouse or dependents. The reduction is excludible from the income of highly compensated employees (as defined in §414(q)) only if the plan does not discriminate in favor of such employees.<sup>981</sup> See 518 T.M., *Exclusion of Scholarships and Other Receipts for Education*, and 373 T.M., *Employee Benefits for Tax-Exempt Organizations*, for a further discussion of tuition reduction plans.

For a discussion of educational assistance benefits provided by employers (other than educational institutions) to employees, see II.B.2.a.(4)(e) and III.A.

<sup>975</sup> Reg. §1.162-10(a); *Joel A. Schneider, M.D., S.C. v. Commissioner*, T.C. Memo 1992-24.

<sup>976</sup> 1984 Act Bluebook at p. 774–775. For a discussion of the welfare benefit fund limitations, see V.B.

<sup>977</sup> *Greensboro Pathology Associates, P.A. v. United States*, 698 F.2d 1196 (Fed. Cir. 1982).

<sup>978</sup> *Knapp v. Commissioner*, 90 T.C. 430 (1988), *aff'd*, 867 F.2d 749 (2d Cir. 1989).

<sup>979</sup> Second Discussion Draft, §1.61-17(d), Ex. (2).

<sup>980</sup> §117(d). See FSA 200231016 (tuition reduction provided by an educational institution employer for graduate-level education is not excludible from an employee's gross income as a working condition fringe benefit under §132(a)(3) because it is excluded from gross income under §117(d) and §132(l) predates the application of §132 to exclude tuition reduction amounts from gross income other than as a de minimis fringe benefit); PLR 201006033 (scholarship awards under employer-related grant program to benefit dependent children of employees are excludible from recipients' gross incomes subject to limitations under §117).

<sup>981</sup> See, e.g., PLR 9239044 (tuition reduction programs found to be nondiscriminatory and, therefore, the benefits were excludible from income).

<sup>968</sup> Reg. §31.3121(a)-1; Rev. Rul. 76-286, Rev. Rul. 65-194.

<sup>969</sup> *Rudolph v. United States*, 370 U.S. 169 (1962); *Patterson v. Thomas*, 289 F.2d 108 (5th Cir. 1961); *Campbell Sash Works, Inc. v. United States*, 217 F. Supp. 74 (N.D. Ohio 1963); Lubick Statement at Task Force Hearings p. 22. See also Rev. Rul. 57-130.

<sup>970</sup> *United States v. Gotcher*, 401 F.2d 118 (5th Cir. 1968); *Sanitary Farms Dairy, Inc. v. Commissioner*, 25 T.C. 463 (1955), *acq.*, 1956-2 C.B. 8; *McDonnell v. Commissioner*, T.C. Memo 1967-18.

<sup>971</sup> See Emergency Paid Sick Leave Act, Pub. L. No. 116-127, Div. E, §5101–§5111 (federally-mandated paid sick leave issued in response to 2020 Coronavirus (Covid-19) pandemic).

<sup>972</sup> *Armantrout v. Commissioner*, 570 F.2d 210 (7th Cir. 1978); *Wheeler v. United States*, 768 F.2d 1333 (Fed. Cir. 1985); Rev. Rul. 75-448.

<sup>973</sup> See, e.g., *Greensboro Pathology Associates, P.A. v. United States*, 698 F.2d 1196 (Fed. Cir. 1982).

<sup>974</sup> *Grant-Jacoby, Inc. v. Commissioner*, 73 T.C. 700 (1980); *Citrus Orthopedic Medical Group v. Commissioner*, 72 T.C. 461 (1979).

### 3. Financial Counseling

The provision of financial counseling by an employer to employees is treated as taxable compensation.<sup>982</sup> Such expenses are deductible to the employee to the extent permissible under §212, subject to limits on itemized deductions.<sup>983</sup> This treatment presumably also applies to other financial or investment services an employer might provide its employees.<sup>984</sup> However, qualified retirement planning services, which may include financial counseling, may be provided as an excludible fringe benefit under §132(m). See II.B.2.g.

### 4. Interest-Free or Low-Interest Loans

Interest-free and low-interest employer loans have been a matter of long-standing concern to the IRS. In *Dean v. Commissioner*,<sup>985</sup> the IRS argued unsuccessfully that an executive employee should be charged with income in connection with an interest-free loan from his employer. The Tax Court rejected that view, in part, on the ground that the employee, under the law as then in effect, would have been allowed an interest deduction equivalent to the value of any constructive interest included in income as compensation. That decision established what eventually became a well-settled rule that such loans generally were not includible in employee income irrespective of whether they were low-interest<sup>986</sup> or interest-free.<sup>987</sup>

<sup>982</sup> Rev. Rul. 73-13.

<sup>983</sup> The deductibility of these expenses is subject to the 2% floor on miscellaneous itemized deductions and the §68 phase-out on itemized deductions. Note that no miscellaneous itemized deductions are allowed for taxable years beginning after 2017 and no overall limitation on itemized deductions applies for taxable years beginning after 2017 and before 2026. §67(h), added by TCJA, Pub. L. No. 115-97, §11045 (added as §67(g) to suspend miscellaneous itemized deductions through 2025), effective for taxable years beginning after December 31, 2017, and redesignated and amended by the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70110(a) and §70110(b)(2) (permanently disallowing miscellaneous itemized deductions), effective for taxable years beginning after December 31, 2025; §68(f), added by TCJA, Pub. L. No. 115-97, §11046, and amended by OBBBA, Pub. L. No. 119-21, §70111(a) (removing §68(f)). For taxable years beginning after 2025, allowable itemized deductions are reduced by 2/37 of the lesser of (i) the aggregate amount of itemized deductions or (ii) taxable income exceeding the §1(j) threshold for the 37% tax bracket. This calculation replaces the pre-2018 so-called Pease formula under which the total amount of itemized deductions, with specified exceptions, was limited for certain higher-income taxpayers. §68(a), as amended by the OBBBA, Pub. L. No. 119-21, §70111(a).

<sup>984</sup> See discussion at II.B.2.a.(4)(l), and PLR 9442003 and TAM 8547003 as to tax preparation services furnished by an employer. In PLR 199929043, the IRS ruled that financial counseling services provided to a survivor of a deceased employee or to a survivor of a terminally ill employee may be not excluded from income under §132(a)(3). Thus, the fair market value of the services provided to a survivor of a deceased employee is includible in the recipient's gross income under §61, and in the case of a terminally ill employee, the fair market value of the services provided to a survivor is includible in the employee's gross income under Reg. §1.61-21(a)(4). The IRS further reasoned that, in accordance with §132(d), for such working condition fringes to be excluded from income, they must be made in connection with the employee's performance of services for the employer.

<sup>985</sup> 35 T.C. 1083 (1961), *nonacq.*, 1973-2 C.B. 4.

<sup>986</sup> *Greenspun v. Commissioner*, 670 F.2d 123 (9th Cir. 1982).

<sup>987</sup> See, e.g., *Beaton v. Commissioner*, 664 F.2d 315 (1st Cir. 1981), *aff'g per curiam* T.C. Memo 1980-413; *Suttle v. Commissioner*, 625 F.2d 1127 (4th Cir. 1980), *aff'g* T.C. Memo 1978-393; *Proctor v. Commissioner*, T.C. Memo 1981-436. *Cf. Crown v. Commissioner*, 67 T.C. 1060 (1977) (reviewed opinion), *aff'd*, 585 F.2d 234 (7th Cir. 1978); *Johnson v. United States*, 254 F. Supp. 73 (1966) (reaching the same conclusion for gift tax purposes).

Having been unsuccessful in its attempts to overturn this rule in litigation,<sup>988</sup> the IRS obtained legislative relief. Section 7872 mandates income inclusion for interest-free and below-market loans. The rules recharacterize interest-free and below-market rate loans as “arm’s-length” transactions with the parties treated as if the lender made a loan to the borrower in exchange for a note requiring the payment of interest at the “Applicable Federal Rate” and the borrower paid interest in the amount of the “forgone” interest. This treatment applies for all purposes of the I.R.C., and thus the lender treats the forgone interest as income, and a borrower who itemizes may deduct the imputed interest to the extent otherwise allowable, subject to the limitations on such deductibility. A \$10,000 de minimis exception applies for any day the aggregate outstanding loans do not exceed that amount.

*Comment:* Broadly based employer-loan programs can be developed to utilize the de minimis exception to provide employees with financing related to corporate purposes at favorable rates. For example, an employer could make reduced interest rate financing available to employees required to relocate to reduce the burden of unreimbursed relocation expenses or assist with a down payment on a new residence. Employers can also use the provisions to help employees obtain high-cost equipment such as computers that may be required or useful in their work.

In any event, it remains clear that cancellation of an employer loan is compensation to the employee.<sup>989</sup>

See 181 T.M., *Time Value of Money — Holders of Debt Instruments*, and 182 T.M., *Time Value of Money — Issuers of Debt Instruments*, for a further discussion of the treatment of below-market loans.

### 5. Gifts and Awards

To the extent that a gift or an award by an employer to an employee does not qualify for an exclusion from income either under §74(c) as an employee achievement award or under §132(e)(1) as a de minimis fringe benefit, the fair market value of the gift or award is includible in income and subject to employment tax withholding.<sup>990</sup>

### 6. Unrelated Employer Facility Benefits

In recent years, employers occasionally have found it beneficial to provide convenience services or facilities such as garages or day care centers to ease employees' personal burdens in coming to work each day. The Second Discussion Draft of the incidental fringe benefit regulations proposed a formal rule of inclusion in employee income of the value of benefits of employer facilities deemed insufficiently related to the employer's business. However, the draft did not articulate a standard for applying such a rule. One example treated the value of employer-run automobile service center discounts as includible in gross income, stressing that automobile repairs were not the employer's business,<sup>991</sup> and the same result would be reached

<sup>988</sup> See, e.g., *Baker v. Commissioner*, 677 F.2d 11 (2d Cir. 1982).

<sup>989</sup> Rev. Rul. 69-465.

<sup>990</sup> See discussion at II.B.2.d.(4)(f); I.B.2.a.; and III.C. See *Yarborough Oldsmobile Cadillac Inc. v. Commissioner*, T.C. Memo 1995-538.

<sup>991</sup> Second Discussion Draft, §1.61-19(c), *Ex.* (4).

under the regulations.<sup>992</sup> The First Discussion Draft of the incidental fringe benefit regulations attempted to reach the same result with respect to day care centers only to be overtaken by statutory developments.<sup>993</sup> Thus, an employer should approach the provision of any unrelated convenience facilities (other than those specifically sanctioned in §132 or another section of the I.R.C., e.g., on-premises day care, athletic facilities and eating facilities) with substantial caution.

### 7. Commuting

Despite certain very early authority to the contrary,<sup>994</sup> the IRS has historically and generally successfully maintained that commuting is a personal expense that is not deductible by employees and that when commuting expenses are assumed or paid by the employer, the payment constitutes income to the employee.<sup>995</sup>

The application of this rule to travel to temporary job sites has been highly controversial. The IRS exacerbated the uncertainty with the publication of Rev. Rul. 76-453 in which it attempted to reverse a rule, in effect from the beginning of the 1954 Code pursuant to Rev. Rul. 190, that expenses of commuting to a temporary work site outside an employee's regular work area were deductible. The IRS then attempted to quell the controversy by issuing Rev. Rul. 90-23, which held that travel between an employee's residence and a temporary work location constituted a deductible business expense under §162(a). Accordingly, if such expenses are paid or reimbursed by an employer, they are excludible from an employee's income if paid pursuant to an accountable plan under §62(c). A temporary work location is a location at which the employee performs services on an irregular or short-term basis (i.e., generally a matter of days or weeks).

However, issues of interpretation remained, and, in Rev. Rul. 94-47, the IRS again attempted to clarify its position in response to *Walker v. Commissioner*.<sup>996</sup> In *Walker*, the Tax Court applied Rev. Rul. 90-23 to a taxpayer whose recurring work at home was sufficient, in the court's view, to make the residence a regular place of business but did not qualify as a principal place of business under §280A(c)(1)(A). In *Walker*, the court permitted the taxpayer to deduct daily transportation expenses incurred in going between his residence and numerous temporary work sites.

In Rev. Rul. 94-47, the IRS stated that it would not follow the Tax Court's decision in *Walker* because Rev. Rul. 90-23 only provides a deduction for daily transportation expenses incurred in going between a taxpayer's residence and a temporary place of business where the taxpayer also has a regular place of business that is not located at the taxpayer's residence.

<sup>992</sup> Reg. §1.132-2(a)(1).

<sup>993</sup> First Discussion Draft, §1.61-16(f), Ex. (19). See discussion of employer dependent care assistance programs at III.B. Note the Discussion Draft position was contrary to Rev. Rul. 73-348.

<sup>994</sup> *Donaldson v. Commissioner*, 18 B.T.A. 230 (1929), acq., IX-1 C.B. 15 (1930) (no income from commuting because no additional cost to employer).

<sup>995</sup> §262(a); Reg. §1.162-2(e); Reg. §1.262-1(b)(5). The IRS is not always successful, however. See, e.g., *Pollei v. Commissioner*, 877 F.2d 838 (10th Cir. 1989), rev'g 87 T.C. 869 (1986), in which the court held that two police captains were entitled to deduct the expenses of traveling between their residences and police headquarters in unmarked police cars.

<sup>996</sup> 101 T.C. 537 (1993).

According to Rev. Rul. 94-47, the IRS will recognize the following three exceptions to the general rule that daily transportation expenses incurred in going between the taxpayer's residence and a work location are nondeductible commuting expenses:

- A taxpayer may deduct daily transportation expenses incurred in going between the taxpayer's residence and a temporary work location outside the metropolitan area where the taxpayer lives and normally works. Unless one of the other two exceptions applies, however, daily transportation expenses incurred in going between the taxpayer's residence and a temporary work location within that metropolitan area are nondeductible commuting expenses.
- If a taxpayer has one or more regular work locations away from his or her residence, the taxpayer may deduct daily transportation expenses incurred going between the taxpayer's residence and a temporary work location in the same trade or business, regardless of the distance.
- If the taxpayer's residence is the taxpayer's principal place of business within the meaning of §280A(c)(1)(A), the taxpayer may deduct daily transportation expenses incurred in going between the residence and another work location, in the same trade or business, regardless of whether the other location is regular or temporary and regardless of the distance.

In Rev. Rul. 90-23, the IRS defined a "temporary" place of business as "any location at which the taxpayer performs services on an irregular or short-term (i.e., generally a matter of days or weeks) basis." In Rev. Rul. 99-7, the IRS redefined "temporary work location" as used in the context of commuting expenses. For the purposes of commuting expenses, the IRS replaced the "irregular or short-term basis" standard with a 1-year standard. The IRS ruled that if employment at a work location is realistically expected to last (and does in fact last) for one year or less, the employment is temporary in the absence of facts and circumstances indicating otherwise. If employment at a work location is realistically expected to last for more than one year or there is no realistic expectation that the employment will last for one year or less, the employment is not temporary, regardless of whether it actually exceeds one year. If employment at a work location initially is realistically expected to last for one year or less, but at some later date the realistic expectation changes so that the employment is expected to exceed one year, that employment will be treated as temporary until the date the realistic expectation changes.

In CCA 200018052, the IRS Chief Counsel's Office provided guidance under eight factual scenarios on the standard of whether employment at a work location is realistically expected to last for one year or less.

In CCA 200025052, the IRS Chief Counsel's Office provided guidance on the application of Rev. Rul. 99-7 regarding the deductibility of daily transportation expenses. The Chief Counsel clarified that Rev. Rul. 99-7 addresses only "daily" transportation expenses — those incurred by an employee going from the residence to a work location and back to the residence within a day — and that the tax treatment of overnight travel expenses is governed by Rev. Rul. 93-86, and involves an analysis of the employee's "tax home."

Rev. Rul. 99-7 focuses on residence-to-business trips, the Chief Counsel observed and, therefore, does not deal with business-to-business trips. However, Rev. Rul. 99-7 restates the general rule that costs associated with going between one business location and another business location are deductible business expenses, although this general rule does not apply where one of the business locations is the employee's residence. When one of the business locations is the employee's residence,  *Holding 3* of Rev. Rul. 99-7 applies, requiring that an in-home office meet the "principal place of business" criteria set forth in §280A(c)(1)(A) and that the trip be to a work location in the same trade or business as that of the in-home office. Meeting the requirements of §280A(c)(1)(A) is a factual inquiry, but an employee's in-home office expenses are not deductible under §280A(c)(1)(A) unless the office: (1) is the employee's principal place of business; (2) is used regularly and exclusively; and (3) is for the convenience of the employer. If an in-home office does not meet these requirements, trips between the residence and other work locations continue to be nondeductible commuting expenses unless the temporary work location rules in Rev. Rul. 99-7 apply.

The Chief Counsel observed that the nature of an employee's duties with respect to an assignment is irrelevant to the taxability issue; the focus in Rev. Rul. 99-7 is on the taxpayer's physical presence performing services at a particular location. An employee's job classification also is irrelevant in determining whether the employee is performing services at a location for a temporary period.

The Chief Counsel clarified the rule regarding non-overnight assignments to work locations outside the metropolitan area where the employee normally works, explaining that if an employee has at least one regular work location away from the employee's residence, it makes no difference whether an assignment at a temporary location is inside or outside this metropolitan area. If the employee works a series of temporary jobs and has no regular work location, transportation expenses incurred only for temporary work locations outside the metropolitan area are considered business expenses.

Further, the Chief Counsel noted that no guidance has been issued regarding infrequent trips to a work location that is expected to extend over a year, such as quarterly trips to a manager's meeting, but observed that both Rev. Rul. 99-7 and Rev. Rul. 90-23 treat trips to regular work locations as nondeductible commuting expenses.

The Chief Counsel also clarified whether a break in service at a particular location will "restart the clock" in determining whether employment following the break is temporary or whether the periods of employment may be aggregated in applying the 1-year limitation. The Chief Counsel noted that this is a factual inquiry but reasoned that a short break of two to three weeks is inconsequential, while a break of more than one year will "restart the clock."<sup>997</sup>

In CCA 200026025, the Chief Counsel further clarified its position on the "break in service" rules. A break of three weeks or less is not significant and will not "stop the clock" in applying the 1-year limitation. With respect to employers administering transportation expense reimbursements under an account-

able plan, a break of at least seven months may be treated as significant, thereby treating the two work segments separated by a 7-month break as separate periods of employment for applying the 1-year limitations. Presumably a facts and circumstances analysis would be applied to a break in service of more than three weeks but less than seven months.

In CCA 200026025, the Chief Counsel also provided an objective test to be used in determining whether infrequent or sporadic trips to the same location over a period of more than one year may be deductible business expenses. For employers administering transportation expense reimbursements under an accountable plan, if there is an initial realistic expectation that an employee will perform services at a work location for a period exceeding one year, but for no more than 35 workdays during each of the calendar years within that period, then employment at that location may be considered temporary for a calendar year in which the employee actually works no more than 35 workdays at that location. However, if employment at a work location initially may be treated as temporary, but at some point this expectation changes, then the assignment at that location will not be considered temporary for at least the remainder of that calendar year.

The exceptions include: (1) de minimis use of a company vehicle for commuting provided as a "working condition" benefit, limited to once a month;<sup>998</sup> (2) qualifying use of a demonstrator automobile by a full-time automobile salesman;<sup>999</sup> (3) employer-provided transportation for commuting under unusual circumstances when it is unsafe for the employee to use other available means of transportation;<sup>1000</sup> (4) employer-provided transportation in a commuter highway vehicle;<sup>1001</sup> (5) employer-provided transit passes;<sup>1002</sup> and (6) qualified bicycle commuting reimbursements (in 2009 through 2017).<sup>1003</sup>

#### 8. Excess Moving Expense Reimbursements

It is a prevalent practice for employers to reimburse employees for moving expenses that fall outside the §217 statutory limits (but which are still related to, or incurred on account of, the move), particularly since the narrowing of such definition by the 1993 RRA.<sup>1004</sup> Included among such costs are the costs of house-hunting visits, temporary living expenses, the loss realized by an employee on the sale of a personal residence, extra compensation related to the higher interest payments an employee may be required to pay in purchasing a new residence, allowances for redecorating expenses, fees for initiation into new clubs, etc. To the extent these items are paid for by an employer, they cannot be excludible from income as a qualified

<sup>998</sup> Reg. §1.132-6(e)(2).

<sup>999</sup> Reg. §1.132-5(o)(5)(ii).

<sup>1000</sup> Reg. §1.132-6(d)(2)(iii); see also discussion at II.B.2.d.(4)(c).

<sup>1001</sup> §132(f)(1)(A). See discussion at II.B.2.e.(5)(a).

<sup>1002</sup> §132(f)(1)(B). See discussion at II.B.2.e.(5)(b) and II.B.2.d.(4)(d).

<sup>1003</sup> See former §132(f)(1)(D), amended by Pub. L. No. 110-343, Div. B, §211, and repealed by OBBBA, Pub. L. No. 119-21, §70112(a)(1), effective for taxable years beginning after December 31, 2025; §132(f)(8), added by TC-JA, Pub. L. No. 115-97, §11047 (suspending the qualified bicycle commuting reimbursement exclusion for taxable years beginning after December 31, 2017, and before January 1, 2026), and repealed by Pub. L. No. 119-21, §70112(a)(5), effective for taxable years beginning after December 31, 2025. See discussion at II.B.2.e.(5)(d).

<sup>1004</sup> See discussion at II.B.2.f.

<sup>997</sup> See also CCA 200018052, Scenario 7.

moving expense reimbursement under §132(g) and generally are includible in the employee's income.<sup>1005</sup>

Contracting with a relocation management firm also has become a common way for employers to deal with relocation. The taxability of such services may depend on the particular benefits provided. Reg. §1.82-1(a)(2) and §1.82-1(a)(3) provide that moving expenses are considered income to an employee even if received in the form of services provided indirectly by a third-party.

Accordingly, the IRS has ruled that expenses paid by an employer in connection with securing the services of a relocation firm to assist its employees in making employer-required moves are includible in the employee's income to the extent the payments relieve the employee of direct home selling costs.<sup>1006</sup> The employee may exclude such payments from income as a qualified moving expense reimbursement to the extent permitted by statute.

If the employee's home is purchased by the relocation firm, the employer is deemed to have purchased the home, which is treated as a capital asset. Amounts paid by an employer to the relocation firm for such items as mortgage payments, brokers' commissions, title examinations and transfer taxes are nondeductible capital expenditures that must be added to the basis of the home<sup>1007</sup> but the employee does not realize income to the extent payment of an item such as a real estate commission is avoided altogether through the sale to the employer.<sup>1008</sup> The employer must recognize capital gain upon the subsequent sale of the home and any losses incurred are deductible only to the extent of capital gains.<sup>1009</sup>

However, the IRS National Office has advised that the amounts paid or incurred by a relocation management firm in connection with its ownership or sale of a residence after it has been purchased from an employee are not included in the gross income of the employee as compensation for services. The amounts paid or incurred by the relocation firm in connection with selling the house, for repairs, incentives to purchasers, broker commissions, legal costs, title expenses, closing costs, and losses were costs which then benefited only such firm, because it had assumed all responsibilities of ownership of the residence. Such amounts were not reimbursements of the employee's moving expenses under Reg. §1.82-1(a)(2) and

§1.82-1(a)(3), because the amounts paid or incurred were solely on the relocation firm's behalf and not on behalf of the employer or the employee.<sup>1010</sup>

In *Amdahl Corp. v. Commissioner*,<sup>1011</sup> the Tax Court held that the employer's payments made to relocation service companies (RSCs) to assist in the disposition of the homes of its employees who relocate in connection with their employment were deductible. The taxpayer (T) deducted payments to the RSCs as ordinary and necessary business expenses, including the losses from sales of residences to third parties. The IRS disallowed a deduction for payments to the RSCs against ordinary income and treated the payments as a capital loss, arguing that T acquired equitable ownership of the residences and that, in T's possession, the residences were capital assets.

In *Amdahl*, the Tax Court determined that T did not acquire beneficial ownership of the employees' residences and that the contractual terms defining the relationship between T and the RSCs coupled with T's reimbursement of the RSC's expenses did not provide a sufficient basis to find that the RSC was an agent of T for the purpose of acquiring real property. The court also noted that relocating employees did not have a present, legally enforceable right to compel the RSC to purchase the residence. Title passed to the RSC only if a third-party did not purchase the residence within one year. Thus, the court concluded that T's actions with respect to the residences were inconsistent with those of an owner. Payments on the mortgages or for other expenses relating to property ownership were for the benefit of relocating employees and not for T to acquire an equity interest in the residences. The most significant factors — relocating employees' retention of legal title, the intent of the parties, the executory nature of the contracts of sales, and the employees' receiving any profits from the sale to third parties — demonstrated that relocating employees retained the benefits and burdens of ownership.

*Comment:* Although the Tax Court did not address the tax treatment of employees, the logical application of *Amdahl* is that expenses paid by the employer to the RSC would be taxable income to the employees.

In Rev. Rul. 2005-74, the IRS analyzed three different situations to determine whether, for federal income tax purposes, a sale of a home facilitated by a relocation management company involves two sales (a first sale from the employee to the employer and a second sale from the employer to a third-party buyer) or only one sale from the employee to the third-party buyer.

The IRS noted that a sale occurs for federal income tax purposes upon the transfer of the "benefits and burdens" of ownership. This is a question of fact determined from the intention of the parties as evidenced by their written agreements read in light of the facts and circumstances. Courts consider the following factors in determining whether the benefits and burdens of ownership are transferred: (1) whether legal title passes; (2) how the parties treat the transaction; (3) whether an equity was acquired in the property; (4) whether the contract creates a present obligation of the seller to execute a deed and a present

<sup>1005</sup> §82; Reg. §1.82-1(a)(1). See *Ritter v. United States*, 393 F.2d 823 (Ct. Cl. 1968). This treatment does not, however, extend to amounts that are not in fact paid, e.g., a real estate commission avoided by a direct sale of a house to an employee. Rev. Rul. 72-339; PLR 8134089. For taxable years beginning after December 31, 2017, the qualified moving expense reimbursement exclusion is suspended except for certain active duty military moves and, for taxable years beginning after December 31, 2025, certain intelligence community assignment relocations. §132(g)(2), added by Pub. L. No. 115-97, §11048, and amended by OBBBA, Pub. L. No. 119-21, §70113(c) and §70113(d). For a discussion of qualified moving expense reimbursements, see I.B.2.f. Section 217(k), added by Pub. L. No. 115-97, §11049, and amended by Pub. L. No. 119-21, §70113(a) and §70113(b), suspends the moving expense deduction for taxable years beginning after 2017, except for qualifying active duty military and intelligence community moves.

<sup>1006</sup> Reg. §1.82-1(a).

<sup>1007</sup> TAM 9036003; see also Rev. Rul. 82-204, reaching the same result as to an employer that purchased homes directly from employees who were relocated.

<sup>1008</sup> PLR 9552040.

<sup>1009</sup> §1211(a); *Azar Nut Co. v. Commissioner*, 94 T.C. 455 (1990), *aff'd*, 931 F.2d 314 (5th Cir. 1991).

<sup>1010</sup> TAM 9447002; PLR 9620026. *Cf.* Rev. Rul. 72-339. Note however that any gain on the employee's sale of the house to the management company still would be taxable to the employee.

<sup>1011</sup> 108 T.C. 507 (1997).

obligation of the purchaser to make payments; (5) whether the right of possession is vested in the purchaser; (6) which party pays the property taxes; (7) which party bears the risk of loss or damage to the property; and (8) which party receives the profits from the operation and sale of the property.<sup>1012</sup> Although the passage of legal title is a significant factor, it is not determinative.<sup>1013</sup>

In *Situation 1*, Employer X enters into a contract with Y, a relocation management program, to provide relocation assistance, including a home purchase program, to employees of X whom X is relocating to new job sites. Y agrees to act as X's agent in purchasing at fair market value the home of relocating employees and then selling those homes to third-party buyers. X is liable for all costs incurred by Y in purchasing and selling the homes. X is liable for losses incurred upon sale of the home and is also entitled to gains in excess of the cost of purchasing the home.

A, an employee of X who is being relocated, chooses to participate in Y's relocation program. Y and A enter into a contract under which Y will purchase the home from A at the fair market value. The fair market value of A's home to be purchased is determined by the average of two independent appraisals. At the closing, Y pays to A the value of the equity in the home (the appraised fair market value less mortgages, liens or encumbrances that are assumed), plus property tax proration and other customary allocations. Y also pays the settlement costs that are typically imposed on a buyer under local law. A vacates the home and Y becomes unconditionally obligated to pay all maintenance, taxes, insurance, expenses, risks, losses and costs associated with the home. At the closing, A, as grantor, transfers the home to Y by executing a deed to the property on which the name of the grantee is left blank (a "blank deed"). Y has the option of inserting its own name as grantee and recording the deed, or inserting the name of a third-party buyer of the home from Y at the time Y closes the sale of the home to the third-party buyer. Y does not insert its name and does not record the deed. Y manages and maintains the property while listing the home for sale through a real estate broker that locates B, a third-party buyer. Y sells the home to B. Y inserts B's name in the deed and conveys legal title to the home to B. Pursuant to the contract between X and Y, X pays Y's fee and reimburses Y for any costs incurred and any loss on the sale of the home to B.

Based on the facts outlined in *Situation 1*, the IRS ruled that pursuant to a "benefits and burdens" analysis, there are two separate sales of the home. The first sale is from A to X, because Y is acting as X's agent. A sale occurs for federal income tax purposes even though the execution of a blank deed is not sufficient to convey legal title under local law. The second sale is from X to B, the third-party buyer.

In *Situation 1*, any gain on the sale of the home from A to X is capital gain under §1001 and §61(a)(3), and no amount constitutes taxable compensation to A.

In *Situation 2*, the facts are the same as in *Situation 1*, except that the home purchase program in X's contract with Y

gives an "amended value option" to employees that are being relocated. In addition to receiving the appraised value offer from Y, an employee who exercises the amended value option may list the home with a real estate broker to market the home to other potential buyers. If the employee exercises the amended value option, the employee must select the broker from a list of qualified brokers maintained by Y. Any listing agreement entered into by the employee must include an "exclusion clause" that provides that no commission is earned by or due to the broker unless a sale of the home to a third-party buyer closes, and that a sale of the home to Y terminates the listing agreement without any commission being earned or due.

If a potential third-party buyer makes an offer, the real estate broker refers the offer to Y. If Y determines that the offer is bona fide and exceeds Y's earlier offer based on the appraisals, Y amends the contract of sale to match the third-party buyer's offer. If the employee accepts the amended offer by signing the contract of sale, Y then enters into a new listing agreement with a real estate broker, customarily the broker previously selected by the employee, to market the home to a third-party buyer, who may or may not be the same potential buyer who made the previous offer. The employee does not sign any contract with a third-party buyer, nor does the employee accept any down payment, deposit or earnest money from a third-party buyer.

Y remits to X any proceeds received on the sale of the home to a third-party buyer in excess of the purchase price paid to the employee for the home. In no event does X or Y transfer any part of the excess amount to the employee.

C is an employee of X whom X is relocating to another job site. In addition to receiving an appraised value offer from Y of \$500x, C exercises the amended value option and lists the home with a qualified real estate broker. As a result of this listing, C obtains an offer for \$520x from a third-party buyer, D, and forwards the offer to Y. Y determines that the \$520x offer is bona fide and amends its proposed contract of sale to match D's offer. C accepts Y's offer by signing the contract of sale at the amended price of \$520x.

Y subsequently pays to C the value of the equity in the home based on the purchase price of \$520x. Pursuant to the exclusion clause, C's listing agreement with the real estate broker is terminated without any commission being earned or due. Y takes possession of the home and, pursuant to the contract of sale, becomes unconditionally obligated for all maintenance, taxes, insurance, expenses, risks, losses and costs associated with the home. C, as grantor, transfers the home to Y by executing a blank deed to the property. Y leaves the name of the grantee blank and does not record this deed.

Y enters into a new listing agreement with the real estate broker and thereafter Y enters into a separate sales agreement with D for \$520x. The sales agreement is made in Y's name. C does not sign any contract with D. Y's sale of the home to D closes. At closing, D pays \$520x to Y, Y inserts D's name on the deed as grantee, and the deed is recorded in D's name.

The IRS ruled in *Situation 2* that in applying a benefits and burdens analysis, the fact that C exercises the amended value option does not alter the conclusion that there are two separate sales of the home. For the reasons discussed with respect to the sale of the home from A to X in *Situation 1*, the benefits and burdens of ownership also transfer from C to X in the sale of the home in *Situation 2*. Further, the sale of C's home

<sup>1012</sup> *Grodt and McKay Realty, Inc. v. Commissioner*, 77 T.C. 1221, 1237-38 (1981).

<sup>1013</sup> *Yelencsics v. Commissioner*, 74 T.C. 1513, 1527 (1980).

to X is not contingent in any respect on X's sale of the home to D or any other third-party buyer. X's agent, Y, is identified as the seller in the sales agreement with D, and under no circumstances is C entitled to any part of the gain realized if the consideration received by X on the sale of the home to D exceeds the consideration paid to C by X on the purchase of the home.

Thus, in *Situation 2*, C sells the home to X for \$520x. Any gain on the sale of the home is realized by C under §1001 and §61(a)(3), and none of this amount constitutes taxable compensation to C under §61(a)(1). X separately sells the home to D for \$520x.

In *Situation 3*, the facts are the same as in *Situation 2*, except that X instead enters into a contract with Z, a relocation management company, to provide relocation assistance to employees whom X is relocating to new job sites. Under the home purchase program in X's contract with Z, employees may select an "amended value option" that has different terms and conditions than the amended value option offered by Y as described in *Situation 2*. Specifically, Z, acting as X's agent, is not required to offer a higher, amended value for an employee's home, based on an offer from a prospective third-party buyer located by the employee, unless and until Z enters into a sales contract with that third-party buyer. In addition, the employee retains the right to approve or reject any offer or counter-offer made in the course of negotiations between Z and the third-party buyer. Finally, the proceeds representing the higher amended value are distributed to the employee, and not to X or Z, only if and when the sale to the third-party buyer closes.

E, an employee of X, receives an appraised value offer from A of \$500x for E's home. E exercises Z's amended value option and locates a prospective purchaser, F, who offers \$510x for E's home. E informs Z of F's offer of \$510x. Z, with E's approval, agrees that Z will accept F's offer and sell the home to F for \$510x once Z purchases the home from E. Z subsequently enters into a contract to purchase the home from E for \$510x. Z closes on the purchase of the home from E for \$510x and receives a blank deed signed by E, as grantor. At the closing of the sale of the home to F, Z inserts F's name on the deed as grantee, and the deed is recorded in F's name. Z pays to E the value of the equity in the home based on the \$510x sales price.

The IRS ruled that applying the benefits and burdens analysis to the transaction in *Situation 3* yielded a different result than in *Situations 1* and *2*. In *Situation 3*, the amended value option offered under the contract between X and Z differs significantly from the option described in *Situation 2*. The sale of E's home to Z, acting for X, at the higher amended price is contingent on Z entering into a contract at that price with F, the third-party buyer located by E. In addition, E retains the right to approve any offer or counter-offer in any negotiations between Z and F. Therefore, although X, through its agent Z, is burdened with some costs in connection with the transaction, E effectively retains the right to negotiate the final contract and obtain the benefit of a higher price for the property.

Thus, in *Situation 3*, the transaction is, for federal tax purposes, one sale of the home from E to F for \$510x, facilitated by X through its agent Z. Any gain on the sale of the home is realized by E under §1001 and §61(a)(3). Any expenses paid by X, directly or through its agent Z, with respect to the home, including maintenance costs, taxes, insurance, losses and other

costs associated with the home would be considered paid on behalf of E by virtue of E's employment with X. Consequently, any such amounts paid by X constitute taxable compensation to E under §61(a)(1).

The IRS additionally stated in Rev. Rul. 2005-74 that it will follow the *Amdahl* opinion in circumstances involving relocation service programs that are substantially similar to the programs described in that opinion, and in other circumstance, such as those described in *Situation 3*, which indicate that the benefits and burdens of ownership of an employee's home are not transferred to the employer. Consistent with the holdings in *Situation 1* and *Situation 2*, the use of a blank deed will not, by itself, cause a program to be treated as substantially similar to the programs described in *Amdahl*.

#### 9. Housing Assistance Benefits

As a result of legislation permitting employers and unions to bargain over contributions to jointly administered trusts set up to provide housing assistance to employees, more employers, whether or not they participate in the collective bargaining process, may consider providing payments to employees to assist them in obtaining affordable housing, i.e., down payments, closing costs, initial rental expenditures or financing assistance. Pub. L. No. 101-273 amended §302 of the Labor-Management Relations (Taft-Hartley) Act of 1947 (LMRA),<sup>1014</sup> and exempts jointly administered housing trusts set up by management and labor from LMRA §302, which prohibits employers from making payments to employees for purposes other than as specified in LMRA §302(c).

Pub. L. No. 101-273 does not address the federal tax status of such housing trusts, which must therefore be analyzed under existing law. Direct grants or other payments to employees constitute taxable compensation under §61 in the year in which the payment is received. A loan of \$10,000 or less at no interest or a below-market interest rate should not result in taxable compensation under §7872. However, loans in excess of \$10,000 provided interest-free or at an interest rate below the applicable federal rate (AFR) will result in imputed income to the employee under §7872.<sup>1015</sup>

If an employer provides direct payments to employees from general assets, such payments should be deductible (to the extent they are reasonable) as compensation under §162. If an employer provides below-market loans in excess of \$10,000, the employer would receive deemed interest income and be entitled to an offsetting compensation deduction.

A trust established by an employer to provide housing assistance benefits should constitute a welfare benefit fund under §419 and as such, the trust would be subject to the limitations on employer contributions to such funds. In general, an employer may deduct contributions to a welfare benefit fund only to the extent of the fund's qualified cost for the year, defined as the benefits actually provided to employees during the year plus administrative expenses. Any amounts not deductible

<sup>1014</sup> 29 USC §186(c)(7).

<sup>1015</sup> See discussion at IV.A.4., 181 T.M., *Time Value of Money — Holders of Debt Instruments*, and 182 T.M., *Time Value of Money — Issuers of Debt Instruments*.

in a year are carried over and may be deducted in a subsequent year.<sup>1016</sup>

It is unclear whether housing assistance benefits may be provided through a voluntary employees' beneficiary association (VEBA) that is tax-exempt under §501(c)(9). A VEBA may provide life, sick, accident or other benefits. "Other benefits" include benefits similar to life, sick or accident benefits and that are intended to either safeguard or improve an employee's or a family member's health or to protect against a contingency that interrupts or impairs an employee's earning power.<sup>1017</sup> The regulations further provide that, except to the extent otherwise provided, "other benefits" also include any benefit provided in the manner permitted by LMRA §302(c)(5) *et seq.*<sup>1018</sup>

Assuming that housing assistance may be provided under a VEBA, the advantages of establishing a VEBA (primarily to obtain the exemption from tax for trust income) should be balanced against the disadvantages (a VEBA is subject to the §419 welfare benefit fund limitations and the unrelated business income tax under §511).<sup>1019</sup>

#### 10. Leave Sharing Programs

An employer may implement a program to facilitate the desire of employees who wish to donate a portion of their paid leave time to another employee who is faced with a catastrophic illness of the employee or a family member, or who is affected by a major disaster such as a flood or hurricane. The IRS has issued guidance on two types of leave sharing programs.

In Rev. Rul. 90-29, the IRS ruled on the tax consequences of a leave sharing plan for medical emergencies. In this program, employees were allowed to donate unused leave time to an employer-sponsored leave bank. An employee who experienced a "medical emergency" was allowed to apply for additional paid time off from the leave bank after the employee had exhausted his or her own leave time. A "medical emergency" was defined in the program as a medical condition of the employee or a family member that would require the prolonged absence of the employee from duty and would result in a substantial loss of income because the employee will have used his or her allotted paid time off. Any additional paid leave that would be approved is paid to the leave recipient at his or her normal rate of compensation. The program contained limits on the amount of leave time that could be deposited in the leave bank and rules as to the manner in which the deposited leave would be granted to eligible leave recipients.

In a leave sharing program for medical emergencies, the amount paid to the leave recipient is included in gross income and is considered "wages" subject to FICA, FUTA and income tax withholding. In a departure from the application of the "assignment of income" doctrine, the employee who donated the leave time to the leave bank does not realize any income on the

donated leave time and incurs no income or loss on the deposit of the leave or its use by the recipient.<sup>1020</sup>

The IRS has also ruled on a leave sharing plan that is available to victims of a major disaster. For this purpose, a "major disaster" is a major disaster as declared by the President under §401 of the Robert T. Stafford Disaster Relief and Emergency Assistance Act.<sup>1021</sup> A major disaster leave sharing plan is a written plan meeting each of the following requirements:

- The plan allows a leave donor to deposit accrued leave in an employer-sponsored leave bank for use by other employees who have been adversely affected by a major disaster. For purposes of the plan, an employee is considered to be adversely affected by a major disaster if the disaster has caused severe hardship to the employee or a family member of the employee that requires the employee to be absent from work.
- The plan does not allow a leave donor to deposit leave for transfer to a specific leave recipient.
- The amount of leave that may be donated by a leave donor in any year generally does not exceed the maximum amount of leave that an employee normally accrues during the year.
- A leave recipient may receive paid leave (at his or her normal rate of compensation) from leave deposited in the leave bank. Each leave recipient must use this leave for purposes related to the major disaster.
- The plan adopts a reasonable limit, based on the severity of the disaster, on the period of time after the major disaster occurs during which a leave donor may deposit the leave in the leave bank, and a leave recipient must use the leave received from the leave bank.
- A leave recipient may not convert leave received under the plan into cash in lieu of using the leave. However, a leave recipient may use leave received under the plan to eliminate a negative leave balance that arose from leave that was advanced to the leave recipient because of the effects of the major disaster. A leave recipient also may substitute leave received under the plan for leave without pay used because of the major disaster.
- The employer must make a reasonable determination, based on need, as to how much leave each approved leave recipient may receive under the leave-sharing plan.
- Leave deposited on account of one major disaster may be used only for employees affected by that major disaster. Except for an amount so small as to make accounting for it unreasonable or administratively impracticable, any leave deposited under a major disaster leave-sharing plan that is not used by leave recipients by the end of the period, must be returned within a reasonable period of time to the leave donors (or, at the employer's option, to those leave donors who are still employed by the employer) so that the donor will be able to use the leave. The amount of leave returned to each leave donor must be in the same proportion as the

<sup>1016</sup> See V.B. for a further discussion of welfare benefit fund limitations.

<sup>1017</sup> Reg. §1.501(c)(9)-3(d).

<sup>1018</sup> Reg. §1.501(c)(9)-3(e).

<sup>1019</sup> See 395 T.M., *VEBAs and Other Welfare Benefit Funding Arrangements*, for a further discussion of VEBAs. For a further discussion of the tax and ERISA implications of housing assistance benefits in light of enactment of Pub. L. No. 101-273, see Fuchs, *The Newest Employee Benefit: Housing Assistance*, 18 Tax Mgmt. Comp. Plan. J. 187 (Aug. 1990).

<sup>1020</sup> Rev. Rul. 90-29.

<sup>1021</sup> 42 U.S.C. §5170.

amount of leave donated by the leave donor bears to the total amount of leave donated on account of that major disaster.

A leave donor who deposits leave in an employer-sponsored leave bank under a major disaster leave-sharing plan will not realize income, compensation or wages with respect to the deposited leave, provided that the leave recipient includes the leave as “wages” for purposes of FICA, FUTA and income tax withholding. A leave donor may not claim an expense, charitable contribution or loss deduction on account of the deposit of the leave or its use by a leave recipient.<sup>1022</sup>

Any other type of leave sharing or leave donation program will likely not relieve the leave donor from being taxed on the donated leave under the assignment of income doctrine. For example, in PLR 200626036, the IRS ruled that employees who transferred vacation or other accrued leave to the survivor of a deceased correctional guard or highway patrol officer who died while in service but not in the line of duty were required to include such donated leave in income. Such donated leave time was also “wages” subject to FICA tax, FUTA tax and income tax withholding. Thus, any employer-sponsored leave sharing program should be carefully structured to qualify either as a medical emergency leave sharing program or as a major disaster leave sharing program.

### 11. Employer-Provided Cell Phones

Employers often provide employees with cellular telephones or other similar telecommunications equipment. Employees typically engage in some personal use of the item. According to the IRS, if the employer acquires and pays the costs of using the cell phone, the employee receives a fringe benefit. To the extent that the employee uses the cell phone for business, the fair market value of that usage qualifies as a working condition fringe excludible from the employee’s gross income. However, the fair market value of the employee’s personal use of the cell phone is includible in the employee’s gross income.<sup>1023</sup>

For tax years beginning before 2010, to the extent that an employee used the cell phone for business purposes, the cell phone expense was a deductible business expense for the employer as long as the substantiation requirements of §274(d) were met.<sup>1024</sup> However, in addition to substantiating the amount of the cell phone expense, the use of the property, the business purpose of the expense, and the business relationship of the employer and the cell phone users, the employer had to substantiate: (1) the amount of each separate expenditure, such as the cost of acquisition, and the amount of each business use based on the appropriate measure (i.e., time) and the amount of total use of the cell phone for the taxable period; (2) the date of the expenditure or use; and (3) the business purpose for the cell phone’s expenditure or use.<sup>1025</sup> For tax years beginning after

2009, the cost of cell phones may be deducted or depreciated without the employer having to meet the substantiation requirements for listed property.

If an employer provides an employee with a cell phone (or other similar telecommunications equipment) primarily for noncompensatory business reasons, the IRS treats the employee’s business use of the employer-provided cell phone as a non-taxable working condition fringe benefit under §132(d).<sup>1026</sup> Solely for purposes of determining whether the working condition fringe benefit under §132(d) applies, the substantiation requirements that the employee would have to meet in order for a deduction under §162 to be allowable are deemed satisfied. In addition, the IRS treats the value of any personal use of a cell phone provided by the employer primarily for noncompensatory business purposes as excludible from the employee’s income as a de minimis fringe benefit under §132(e).

The IRS considers an employer to have provided an employee with a cell phone primarily for noncompensatory business purposes if there are substantial reasons relating 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 provided to promote the morale or good will of an employee, to attract a prospective employee, or as a means of furnishing additional compensation to an employee is not provided primarily for noncompensatory business purposes.

*Comment:* Although the IRS’s guidance for cell phones under Notice 2011-72 is favorable, there are several follow-up items for employers to consider. First, employers should document the business reasons noted above behind providing cell phones in their policies on issuing employer-provided cell phones. Second, although Notice 2011-72 does not address the treatment of cash reimbursements received by employees for the business use of the employee’s personal cell phone, this issue is addressed in the Internal Revenue Manual (IRM), which provides that in cases in which employers have substantial business reasons for requiring employees’ use of personal cell phones in connection with the employer’s business, examiners should analyze reimbursements of employees’ cell phone expenses in a manner similar to the approach described in Notice 2011-72.<sup>1027</sup> Thus, in addition to requiring a substantial business purpose, the employee must maintain the type of cell phone coverage that is reasonably related to the needs of the employer’s business, and the reimbursement must be reasonably calculated so as not to exceed expenses the employee actually incurred in maintaining the cell phone.<sup>1028</sup> Although

<sup>1022</sup> Notice 2006-59; Leave Sharing Plans Frequently Asked Questions, Q&A-2-3. IRS guidance clarifies that employers may set up leave sharing plans in response to major disasters, including the COVID-19 pandemic. See Leave Sharing Plans Frequently Asked Questions, Q&A-1.

<sup>1023</sup> Notice 2009-46.

<sup>1024</sup> §274(d)(3), redesignated by Pub. L. No. 115-97, §13304(a)(2)(A) (formerly §274(d)(4)); former §280F(d)(4)(A)(v), repealed by Pub. L. No. 111-240, §2043, effective for taxable years beginning after December 31, 2009.

<sup>1025</sup> Reg. §1.274-5T(a), §1.274-5T(b)(6), §1.274-5T(e)(2); Notice 2009-46.

<sup>1026</sup> Notice 2011-72. In conjunction with the Notice, the IRS released SBSE-04-0911-083, providing audit guidance to examiners regarding employers that reimburse their employees for the business use of an employee’s personal cell phone.

<sup>1027</sup> IRM 4.23.5.15.3.2(1) (11-22-17).

<sup>1028</sup> IRM 4.23.5.15.3.2(2) (11-22-17).

reasonable reimbursements for business calls on personal mobile phones should be nontaxable, the reimbursement of unusual or excessive expenses or reimbursements provided as a substitute for wages remains taxable. Because the guidance continues to allow examiners to base their decisions on a facts-and-circumstances analysis, employers should consider establishing (or modifying) a written reimbursement policy that incorporates the above guidance. Notice 2011-72 and the guidance do not clearly address all employer issues and concerns, for example, the definition of “similar telecommunications equipment.” The IRM, however, provides that tablet devices are considered “similar telecommunications equipment.”<sup>1029</sup> No distinction is made for tablets that include cell phone service and those that do not.

### 12. Tax Preparation Services

Generally, employer-provided tax preparation services are includible in the employees’ gross income. Section 212(3) provides an individual deduction (temporarily suspended for 2018 through 2025) for all ordinary and necessary expenses paid or incurred in connection with the determination, collection, or refund of any tax. Because tax services are deductible under §212, and not under §162 or §167, they are not working condition fringe benefits under §132(d).

In CCA 201810007, the Chief Counsel’s Office advised that tax preparation services provided by an employer to employees working in foreign countries was includible in the employees’ gross income. There, the employer was a large multinational American company that employed many U.S. citizens and residents of other countries around the world. The employer maintained a “tax equalization” policy in order to facilitate transfers of its employees from country to country. Tax equalization is a process that is intended to result in employees paying the same amount of income tax as the employee would have paid had the employee not been stationed away from the country of citizenship on an international assignment. Because of the complexities in determining the equalization, the employer engaged a CPA firm to (1) prepare foreign, United States, and state tax returns, (2) compute and pay the equalization settlements, (3) respond to inquiries from taxing authorities as necessary, (4) coordinate the assignment program, and (5) provide advice and instruction to the employer’s payroll department regarding how to report and tax appropriately. The IRS explained that the value of the employer-provided tax preparation services with regard to the foreign and domestic tax returns was includible in the employees’ income because it was direct and personal benefit to the employees, and §132(d) does not exclude it as a working condition fringe. The value of the equalization and other services, however, was not includible in the employees’ income.

The IRS position relied on Reg. §1.61-21(b)(2) in determining that the value of the services rendered is the fair market value. The IRS noted that, due to the unique nature of the services, the amount paid by the employer is indicative of the fair market value. Therefore, the fair market value of the tax preparation services is includible in the employees’ income. Additionally, the value of the tax preparation services is considered

<sup>1029</sup> IRM 4.23.5.15.3.1(6) (11-22-17).

wages for FICA and federal income tax withholding purposes because the value of tax return preparation provided in-kind by an employer to an employee is not excludible under §132(d).<sup>1030</sup>

This is in contrast to PLR 9442033 in which the IRS ruled that the value of the services of an electronic filer in formatting and/or transmitting an employee’s return is excludible by the employee as a de minimis fringe benefit under §132(a)(4) because the value of such services is so small as to make accounting for them unreasonable or impracticable.

### 13. Student Loan Repayment Assistance

Generally, employer-provided student loan repayments are includible in an employee’s gross income unless they are made on a qualified education loan incurred by the employee for the employee’s education. Section 127 provides an exclusion for employer-provided qualified educational assistance,<sup>1031</sup> but that exclusion did not extend to loan repayments made before March 28, 2020.

In PLR 201833012, however, Abbott Industries received confirmation from the IRS that their student loan repayment plan would allow for employer contributions to be excluded from employees’ income. Under the program, employees who pay a minimum of 2% of their pay towards student loan debt would earn an employer nonelective contribution of 5% of their pay to their §401(k) plans. Under the contingent benefit rule,<sup>1032</sup> an employer may not base its decision to contribute to an employee’s §401(k) on the amount or percentage of an employee’s own contributions to his or her account, except in the case of matching contributions. The IRS ruled that the employer could pay into the employees’ §401(k) retirement accounts while the employees pay off their student loan debt, even if the employees are not contributing to their own accounts. Thus, the IRS concluded that Abbott’s student loan repayment program did not violate the contingent benefit rule.

Under the informal PLR, the employer was able to take a deduction for the contributions to employees’ §401(k) accounts, and the contributions were not included in the employees’ income. Thus, under this PLR, an employer could effectively subsidize an employee’s student loan payments, receive a deduction, and the employee would not recognize income at the time the employer made a loan repayment contribution.

*Comment:* The IRS indicated that formal guidance regarding student loan repayment programs is in the works; thus, it will not consider further letter rulings during the course of the guidance project. Meanwhile, recognizing that some employees may be too overwhelmed with student debt to save for retirement, Congress provided a way for employers to help with less risk of violating the qualified plan requirements. For plan years beginning after December 31, 2023, a defined contribution plan may be amended to provide employees who are otherwise eligible for matching contributions with employer contributions

<sup>1030</sup> See also FSA 200137039 (tax return preparation services provided by an employer to expatriate employees are wages for FICA and FUTA purposes).

<sup>1031</sup> See III.A.

<sup>1032</sup> §401(k)(4)(A). For further discussion of the contingent benefit rule, see 358 T.M., *Section 401(k) Cash or Deferred Arrangements*.

that are matching contributions based on the qualified student loan payments made by the employee.<sup>1033</sup>

## **B. Benefits Subject to Deferred Tax**

### *1. Retirement and Similar Benefits*

As discussed previously,<sup>1034</sup> pursuant to §402, an employee need not include in income amounts contributed to a tax-qualified pension, profit-sharing or stock bonus or stock ownership plan on the employee's behalf until such amounts have actually been distributed. A discussion of the requirements of these plans and the taxation of benefits distributed from them is beyond the scope of this portfolio. However, a complete discussion of such deferred compensation plans and the taxation of benefits provided by them may be found in the following portfolios:

- 350 T.M., *Plan Selection — Pension and Profit-Sharing Plans*;
- 351 T.M., *Plan Qualification — Pension and Profit-Sharing Plans*;
- 352 T.M., *Specialized Qualified Plans — Cash Balance, Target, Age-Weighted and Hybrids*;
- 354 T.M., *ESOPs*;
- 356 T.M., *Nondiscrimination Testing and Permitted Disparity in Qualified Retirement Plans*;
- 360 T.M., *Qualified Plans — IRS Determination Letter Procedures*;
- 370 T.M., *Distributions from Qualified Plans — Taxation and Qualification*; and
- 371 T.M., *Employee Plans — Deductions, Contributions, and Funding*.

Under §421(a), an employee will not recognize income on the exercise of a qualified incentive or restricted stock option or an option issued pursuant to an employee stock purchase plan until the stock received on such exercise is sold.<sup>1035</sup>

For a further discussion of when an employee must include in income the value of stock or other property transferred to him or her in return for services under §83, see 384 T.M., *Restricted Property — Section 83*.

Finally, a discussion of nonqualified deferred compensation plans may be found in 385 T.M., *Deferred Compensation Arrangements*.

### *2. Supplemental Unemployment Benefit Plans*

#### *a. Background and Purpose*

Supplemental Unemployment Benefit (SUB) plans are plans designed to provide income to laid-off workers to supplement the state unemployment benefits that they may receive.

They are generally created pursuant to a collective bargaining agreement between an employer and the employees' bargaining agent. SUB plans have historically been most prevalent in the durable goods manufacturing industry, which includes automobile, steel and machinery manufacturers, and in the apparel and rubber industries.<sup>1036</sup>

A SUB plan may be funded either with employer or employee contributions or a combination of the two. Contributions may be made to a trust forming part of the plan and are usually computed on a specified rate per hour for each hour paid to hourly employees or as a certain percentage of the earnings of salaried employees. The funds held in a trust are invested and the income earned is accumulated tax-free if the trust qualifies as a voluntary employee beneficiary association under §501(c)(9) or a supplemental unemployment benefit trust under §501(c)(17).

The employer generally will receive a deduction for a contribution made to a trust in the year the payment is made; an employee does not receive a deduction for contributions made to a trust.<sup>1037</sup> An employee generally will include in income the amount of benefits received under a SUB plan in the year in which he or she receives such benefits.<sup>1038</sup>

The plan or trust will pay an employee either a lump sum or periodic payments to supplement the state unemployment benefits the employee receives if he or she is laid off either temporarily or permanently. However, the employee has no vested interest in amounts the employer pays into the trust. If the employee leaves the employ of the employer voluntarily or is discharged for cause, the employee will not receive any benefits from the plan or trust.

A SUB plan, therefore, provides an employer with the advantage of creating a trust for the benefit of its employees in case the economic climate changes where the employer may deduct contributions to the trust in the year made, and have the trust earn income on the amounts contributed free of tax. Such a plan provides employees with the security of knowing that a fund is available in case they are laid off, and that they will not have to include amounts contributed to the fund on their behalf in income until they receive such funds.

A SUB plan is not, however, required to be funded through a trust. Because payments from a properly structured SUB plan are exempt from FICA and FUTA tax (see V.A.2.d.), an employer may establish an unfunded SUB plan that provides for budgeted periodic payments and achieves employment tax savings.

#### *b. Supplemental Unemployment Benefit Trusts*

A trust created under a SUB plan is exempt from tax if it is either a voluntary employee benefit association described in §501(c)(9)<sup>1039</sup> or a supplemental unemployment benefit trust as described in §501(c)(17). Before the Tax Reform Act of 1969, trusts exempt from tax under §501(c)(9) could not derive more than 15% of their income from investments. Congress there-

<sup>1033</sup> See §401(m)(4) and §401(m)(13), as amended and added, respectively, by SECURE 2.0 Act of 2022, Pub. L. No. 117-328, Div. T, §110, effective for contributions made for plan years beginning after December 31, 2023. See also Notice 2024-63, Q&A-A-2.

<sup>1034</sup> See I.B.2.

<sup>1035</sup> For further discussion of these statutory stock options, see 381 T.M., *Statutory Stock Options*.

<sup>1036</sup> See, e.g., *Major Collective Bargaining Agreements — Supplemental Unemployment Benefit Plans and Wage Employment Guarantees*, Bureau of Labor Standards Bulletin No. 1425-3 (1965).

<sup>1037</sup> See discussion at IV.B.2.d.

<sup>1038</sup> See discussion at IV.B.2.e.

<sup>1039</sup> §501(c)(17)(E); Rev. Rul. 58-442.

fore enacted §501(c)(17) in 1969 to provide that a trust created primarily to provide supplemental unemployment benefits would be exempt from tax even if it derived more than 15% of its income from investments.<sup>1040</sup> However, the Tax Reform Act of 1969 also amended §501(c)(9) to eliminate that limitation on investment income.<sup>1041</sup> Therefore, few differences exist today between trusts forming part of a SUB plan that are exempt from tax under either §501(c)(9) or §501(c)(17).

*Note:* Trusts created under §501(c)(9) are discussed in 395 T.M., *VEBAs and Other Welfare Benefit Funding Arrangements*. Generally, these trusts are created to provide life, sick and accident benefits to an employer's employees. Therefore, the detailed analysis below will focus only on the requirements of §501(c)(17).

### c. Requirements of §501(c)(17)

#### (1) General Requirements

For a trust to be exempt from tax under §501(c)(17):

- the trust must be a valid, existing trust under local law and must be evidenced by an executed written document;<sup>1042</sup>
- the trust must be part of a plan maintained by an employer, its employees or both to provide supplemental unemployment compensation benefits;<sup>1043</sup>
- the corpus or income of the trust may not be used for, or diverted to, any purpose other than providing supplemental unemployment compensation benefits;<sup>1044</sup>
- the trust must be part of a plan whose eligibility conditions and benefits do not discriminate in favor of highly compensated employees within the meaning of §414(q);<sup>1045</sup> and
- the trust must be part of a plan which requires that benefits are determined under objective standards.<sup>1046</sup>

#### (2) Requirement of Plan

A §501(c)(17) trust must be part of a SUB plan that is a permanent plan as opposed to a temporary program.<sup>1047</sup> Thus, although an employer may reserve the right to change or terminate the plan, the abandonment of the plan without a good business reason within a few years after its creation could be evidence that the plan was not created to provide supplemental unemployment benefits.<sup>1048</sup> Therefore, an employer will not be able to create a SUB plan and trust for a few years in order to receive the tax-free benefits associated with such plans and trusts and then abandon the plan.

Whether or not a particular plan constitutes a permanent arrangement will be determined on all the facts and circum-

stances.<sup>1049</sup> However, merely because a collective bargaining agreement provides that a plan may be modified at the termination of such agreement, or that particular provisions of the plan are subject to renegotiation during the duration of such agreement, does not necessarily imply that a plan is not a permanent plan.<sup>1050</sup> Further, the fact that a plan or collective bargaining agreement provides that all of the plan's assets, after the satisfaction of all liabilities, may be returned to the employer does not necessarily imply that the plan is not a permanent arrangement.<sup>1051</sup> Therefore, an employer should feel free to negotiate with its employees' representatives the right to modify a SUB plan if, for example, economic conditions change.

#### (3) Permissible Benefits

For a trust to be exempt from tax under §501(c)(17), its income and corpus must be used solely to provide "supplemental unemployment compensation benefits."<sup>1052</sup> These benefits must be:

- benefits paid to an employee because of his or her involuntary separation from the employment of the employer (whether or not such separation is temporary);<sup>1053</sup> or
- sick and accident benefits subordinate to the benefits described above.<sup>1054</sup>

An employee is only entitled to benefits under a trust created under a SUB plan if the separation results from a reduction in force, the discontinuance of a plant or operation or other similar conditions such as separation resulting from cyclical, seasonal or technological causes.<sup>1055</sup> An employee may not receive benefits under a SUB plan if he or she is involuntarily separated from service for disciplinary reasons or because of the employee's age.<sup>1056</sup> Also, such benefits may not qualify if they are, in effect, payments for past services.<sup>1057</sup>

The separation from service need not be permanent and the employee may receive benefits under a SUB plan even if it is believed that he or she will be reemployed by the employer.<sup>1058</sup> Therefore, a SUB plan may pay the expenses of an employee to relocate to another plant of the employer if the employee is laid off from the plant where he or she is presently working,<sup>1059</sup> or compensate an employee for lost income if the employee's working hours are reduced.<sup>1060</sup> However, a trust created under a SUB plan will lose its exemption if it pays benefits to all union employees, including those whose wages are not reduced because of a loss of hours.<sup>1061</sup>

<sup>1049</sup> Reg. §1.501(c)(17)-2(d). *E.g.*, PLR 200939032 (plan in existence for a considerable period of time that was discontinued only because contributors were being undercut by competitors who could negotiate less costly labor contracts satisfied permanency requirements of Reg. §1.501(c)(17)-2(d)).

<sup>1050</sup> Reg. §1.501(c)(17)-2(d).

<sup>1051</sup> Reg. §1.501(c)(17)-2(d).

<sup>1052</sup> §501(c)(17)(A)(i); Reg. §1.501(c)(17)-1(a)(4).

<sup>1053</sup> §501(c)(17)(D)(i); Reg. §1.501(c)(17)-1(b)(1)(i).

<sup>1054</sup> §501(c)(17)(D)(ii); Reg. §1.501(c)(17)-1(b)(1)(ii).

<sup>1055</sup> Reg. §1.501(c)(17)-1(b)(3), §1.501(c)(17)-1(b)(4).

<sup>1056</sup> Reg. §1.501(c)(17)-1(b)(4).

<sup>1057</sup> *NYSA-ILA Container Royalty Fund v. Commissioner*, 847 F.2d 50 (2d Cir. 1988).

<sup>1058</sup> Reg. §1.501(c)(17)-1(b)(3).

<sup>1059</sup> Rev. Rul. 70-188.

<sup>1060</sup> Rev. Rul. 70-184.

<sup>1061</sup> Rev. Rul. 77-43.

<sup>1040</sup> S. Rep. No. 1518, 86th Cong., 2d Sess. 1 (1960).

<sup>1041</sup> Pub. L. No. 91-72, §121(b)(5)(A).

<sup>1042</sup> Reg. §1.501(c)(17)-1(a)(2).

<sup>1043</sup> Reg. §1.501(c)(17)-1(a)(3).

<sup>1044</sup> §501(c)(17)(A)(i); Reg. §1.501(c)(17)-1(a)(4).

<sup>1045</sup> §501(c)(17)(A)(ii), §501(c)(17)(A)(iii); Reg. §1.501(c)(17)-1(a)(5).

<sup>1046</sup> Reg. §1.501(c)(17)-1(a)(6).

<sup>1047</sup> Reg. §1.501(c)(17)-2(d).

<sup>1048</sup> Reg. §1.501(c)(17)-2(d).

The separation from service must be involuntary.<sup>1062</sup> An employee will not be deemed to have separated voluntarily merely because the relevant collective bargaining agreement provides that the employee will be separated if a certain condition occurs.<sup>1063</sup> For example, if the employee's collective bargaining agreement provides that he or she may be laid off if the employer automates the plant where the employee works, the employee may receive benefits under a SUB plan if he or she is in fact separated because of automation.<sup>1064</sup>

Sick and accident benefits may be provided under a §501(c)(17) trust to an employee otherwise receiving benefits from the trust.<sup>1065</sup> Such benefits may compensate the employee for his own illness or personal injury or for the illness or personal injury of the employee's spouse or dependents.<sup>1066</sup> Such benefits must be subordinate to the separation benefits provided to the employee under the trust<sup>1067</sup> and need not be provided to all employees covered by the plan and trust as long as the plan does not discriminate in favor of highly compensated employees with respect to such benefits.<sup>1068</sup>

A plan that provides sick and accident benefits and that is financed solely by employer contributions must specify what portion of the employer contributions will be used to fund such benefits.<sup>1069</sup> If the plan is financed in whole or in part by employee contributions, the plan must specify what portion, if any, of employee contributions are allocated to the cost of funding such benefits and must allocate the cost of funding such benefits between employer and employee contributions.<sup>1070</sup>

Benefits paid by a SUB trust may be paid in a lump sum or in installments.<sup>1071</sup> Payments may be made in cash, services, or property.<sup>1072</sup> Therefore, a SUB plan may furnish separated employees with medical care at an established clinic, food, job training and schooling, and job counseling.<sup>1073</sup> Benefits may be paid to an employee even if the employee has found other employment,<sup>1074</sup> and an employee may instruct the trustee of the SUB trust paying the supplemental unemployment compensation benefits to withhold union dues from his or her salary.<sup>1075</sup>

Benefits must be determined under objective criteria. A plan may provide similarly situated employees with benefits that vary in kind and amount, but benefits may not be determined in the trustee's discretion.<sup>1076</sup>

<sup>1062</sup> §501(c)(17)(D)(i); Reg. §1.501(c)(17)-1(b)(1)(i). Cf. TAM 9328001, where the National Office advised that payments from railroad companies' separation programs constituted compensation under §3231(e). The National Office concluded that the programs were not supplemental unemployment benefit plans under Rev. Rul. 56-249 and Rev. Rul. 77-347 because the payments were generally made to employees who voluntarily separated from service and were not tied to the receipt of state unemployment benefits.

<sup>1063</sup> Reg. §1.501(c)(17)-1(b)(3).

<sup>1064</sup> Reg. §1.501(c)(17)-1(b)(3).

<sup>1065</sup> §501(c)(17)(D)(ii); Reg. §1.501(c)(17)-1(b)(1)(ii).

<sup>1066</sup> Reg. §1.501(c)(17)-1(b)(5).

<sup>1067</sup> Reg. §1.501(c)(17)-1(b)(5).

<sup>1068</sup> Reg. §1.501(c)(17)-2(b).

<sup>1069</sup> Reg. §1.501(c)(17)-2(i).

<sup>1070</sup> Reg. §1.501(c)(17)-2(i).

<sup>1071</sup> Reg. §1.501(c)(17)-2(a).

<sup>1072</sup> Reg. §1.501(c)(17)-2(a).

<sup>1073</sup> Reg. §1.501(c)(17)-2(a).

<sup>1074</sup> Reg. §1.501(c)(17)-2(a). See PLR 9525054.

<sup>1075</sup> Rev. Rul. 73-307.

<sup>1076</sup> Reg. §1.501(c)(17)-1(a)(6).

#### (4) Persons Eligible

Only common-law employees of the employer are entitled to receive separation benefits from a trust created under a SUB plan.<sup>1077</sup> Self-employed individuals, such as sole proprietors, service partners in a partnership or service members of a limited liability company, may not receive benefits from a SUB plan. However, if the individual were classified as an "employee" under the state or federal unemployment compensation law covering employment, he or she may be eligible to receive benefits under a SUB plan.<sup>1078</sup>

#### (5) Discrimination as to Eligibility and Benefits

A §501(c)(17) trust must be part of a SUB plan that does not discriminate as to eligibility and benefits in favor of highly compensated employees.<sup>1079</sup> The plan will not be discriminatory as to eligibility and benefits if it covers and pays benefits to a classification of employees that would be described in §410(b)(1)(B) (before its amendment by the 1986 TRA) if the SUB plan were a qualified retirement plan.<sup>1080</sup> However, the trust may be part of a plan that provides benefits bearing a uniform relationship to compensation, just as pension and profit-sharing plans do.<sup>1081</sup> Therefore, higher-paid employees may receive greater benefits under a SUB plan than lower-paid employees as long as the benefits paid to higher-paid employees do not bear a larger ratio to their compensation than the benefits paid to lower paid employees bear to their compensation.<sup>1082</sup>

Similar to an integrated pension or profit-sharing plan, a SUB plan may provide that the benefits provided may be reduced by the entire or partial amount of any sick, accident or unemployment compensation benefits received under state or federal law.<sup>1083</sup> This may occur even if as a result higher-paid employees receive a greater percentage of their salary than lower-paid employees.

*Example:* Employee B, who earns \$1,000 a week, and Employee C, who earns \$1,200 a week, are laid off at the same time and each begin to receive \$300 a week in state unemployment compensation benefits. If the employees' employer maintained a SUB plan that pays its employees, who are separated involuntarily, 50% of their salary less any state unemployment benefits they receive, B would receive \$200 a week and C would receive \$300 a week under the plan. The plan is not discriminatory in this instance even though B is receiving 20% of salary under the plan while C is receiving 25% of salary.

A SUB plan will not be considered discriminatory merely because it provides benefits only to those employees who are not eligible to receive sick, accident or unemployment benefits under state or federal law.<sup>1084</sup> However, the benefits provided under the plan must not exceed the benefits an employee would

<sup>1077</sup> Reg. §1.501(c)(17)-1(b)(2).

<sup>1078</sup> Reg. §1.501(c)(17)-1(b)(2).

<sup>1079</sup> §501(c)(17)(A)(ii); §501(c)(17)(A)(iii); Reg. §1.501(c)(17)-1(a)(5).

<sup>1080</sup> Reg. §1.501(c)(17)-1(a)(5).

<sup>1081</sup> §501(c)(17)(A)(iii); Reg. §1.501(c)(17)-1(a)(5).

<sup>1082</sup> Reg. §1.501(c)(17)-1(a)(5).

<sup>1083</sup> §501(c)(17)(B)(i); Reg. §1.501(c)(17)-2(c)(2). See, e.g., PLR 9525054.

<sup>1084</sup> §501(c)(17)(B)(ii); Reg. §1.501(c)(17)-2(c)(3).

receive under the plan if he or she were eligible for benefits under state or federal law.<sup>1085</sup> Therefore, if the plan only provides benefits to employees who are not eligible to receive unemployment benefits under state or federal law and such benefits exceed the benefits provided under the state or federal law, the plan will be discriminatory if the plan benefits highly compensated employees.

*Example:* Employer X maintains a SUB plan that will pay benefits to laid off employees only after they have exhausted their benefits under their state unemployment compensation plan. X's plan provides that it will pay such employees 100% of the benefits such employees received under the state plan for 50 weeks and 50% of such benefits thereafter. The plan will not be considered discriminatory even if only highly compensated employees receive benefits thereunder. However, if the plan provided that employees would receive 150% of the benefits they received under their state plan, X's plan would be discriminatory if it favors highly compensated employees.

A SUB plan will not be considered discriminatory merely because it provides benefits only to employees who are not eligible to receive benefits under another qualified SUB plan funded solely by employer contributions.<sup>1086</sup> Therefore, if an employer maintains a SUB plan only for hourly paid employees, the employer may maintain a separate plan for salaried employees.<sup>1087</sup> However, the benefits provided to lower-paid hourly employees must be the same benefits they would be entitled to if both plans were combined.<sup>1088</sup> For example, if the hourly plan provided that each employee would be entitled to receive 50% of their wages while members of the salaried plan would be entitled to receive 60% of their salary, the salaried plan would be considered discriminatory. The employer may also create a SUB plan for salaried employees if the hourly paid employees are entitled to supplemental unemployment benefits under a voluntary employee's beneficiary association exempt from tax under §501(c)(9) and the benefits provided to the salaried employees are equivalent to the unemployment benefits provided to hourly employees under the voluntary employee's beneficiary association.<sup>1089</sup>

*Note:* Several trusts providing supplemental unemployment benefits may be designated as constituting part of one plan that is intended to satisfy the requirements of §501(c)(17).<sup>1090</sup> In such case, all the trusts taken as a whole must meet the requirements of that section.<sup>1091</sup> If the combination of the trusts does not satisfy §501(c)(17) as one plan, the separate trusts that satisfy §501(c)(17) may qualify for exemption under that section.<sup>1092</sup> Therefore, if an employer adopts a separate trust for salaried and nonsalaried employees under one SUB plan, even if the salaried trust fails to meet the discrimination re-

quirements of §501(c)(17), the trust for hourly employees may be qualified under §501(c)(17).

A SUB plan will satisfy the nondiscrimination requirements described above for any plan year if on at least one day in each quarter of the taxable year of the plan's trust, the plan satisfies the requirements.<sup>1093</sup>

*Comment:* Unlike tax-qualified retirement plans, there are no minimum age and service requirements under the Code regarding eligibility to participate in a SUB plan. Therefore, an employer may condition participation in a SUB plan on any reasonable age and service requirements, as long as the requirements do not result in the plan failing to meet the nondiscrimination requirements.

#### (6) Investments of Trustee

Contributions to a trust forming part of a SUB plan may be used by the trustee to purchase any investments permitted by the trust agreement to the extent allowed by local law.<sup>1094</sup> Therefore, the trustee of a SUB plan trust may invest in low-income-producing investments that serve social purposes which do not accrue for the benefit of related parties and are not contrary to the employees' interests,<sup>1095</sup> although any such investments would seem likely to diminish the utility of the plan by reducing the amount of earnings available for benefits.

However, the trust will lose its tax-exempt status if the trust makes an investment that is considered a "prohibited transaction" under §503.<sup>1096</sup> A prohibited transaction includes any of the transactions set forth below between the trust and the employer creating the trust, a person owning more than 50% of the voting power or total value of outstanding shares of the employer or any member of the employer's family (as defined in §267(c)(4)) or any corporation controlled by the employer creating the trust. The transactions that are prohibited between the trust and the above parties are:

- lending any part of the trust's income or corpus, without the receipt of adequate security and a reasonable rate of interest;
- paying any compensation in excess of a reasonable allowance for salaries or other compensation for personal services actually rendered;
- making any part of its services available on a preferential basis;
- making any substantial purchase of securities or any other property for more than adequate consideration;
- selling any substantial part of its securities or other property for less than an adequate consideration; or
- engaging in any other transaction that results in a substantial diversion of its income or corpus.<sup>1097</sup>

However, pursuant to §503(e), the trustee may cause a SUB plan trust to invest in any obligation (i.e., bond, debenture,

<sup>1085</sup> Reg. §1.501(c)(17)-2(c)(3).

<sup>1086</sup> §501(c)(17)(B)(iii); Reg. §1.501(c)(17)-2(c)(4).

<sup>1087</sup> Reg. §1.501(c)(17)-2(c)(4).

<sup>1088</sup> Reg. §1.501(c)(17)-2(c)(4).

<sup>1089</sup> Reg. §1.501(c)(17)-2(c)(4).

<sup>1090</sup> Reg. §1.501(c)(17)-2(f).

<sup>1091</sup> Reg. §1.501(c)(17)-2(f).

<sup>1092</sup> Reg. §1.501(c)(17)-2(f).

<sup>1093</sup> §501(c)(17)(C); Reg. §1.501(c)(17)-2(e).

<sup>1094</sup> Reg. §1.501(c)(17)-2(h).

<sup>1095</sup> Rev. Rul. 70-536.

<sup>1096</sup> §503(a)(1), as amended by Pub. L. No. 113-295, Div. A, §221(a)(63); Reg. §1.501(c)(17)-2(h).

<sup>1097</sup> §503(b).

note, certificate, or other evidence of indebtedness) of the employer creating the trust if the obligations are acquired:

- on an established securities market at market price;
- from an underwriter at a price not in excess of the public offering price for the obligations and at which a substantial portion of the same issue is acquired by persons independent of the employer;
- directly from the employer, at a price not less favorable to the trust than the price paid currently for a substantial portion of the same issue by persons independent of the employer; or<sup>1098</sup>
- Under a diversification rule, the trust may not own more than 25% of any one issue, and at least 50% of the issue must be held by persons independent of the employer.<sup>1099</sup> Also, not more than 25% of the assets of the trust may be invested in obligations of the employer.<sup>1100</sup>

Even if the acquisition of employer obligations satisfies §503(e), the trust may still be engaged in a prohibited transaction if such acquisition results in a substantial diversion of the trust income or corpus to the employer.<sup>1101</sup> Therefore, if the employer's obligations bear interest at a rate below market, the trustee may still be engaged in a prohibited transaction even if it meets the literal requirements of §503(e).<sup>1102</sup>

If the trustee of a SUB plan trust engages in a prohibited transaction, the trust will lose its exemption beginning in the taxable year following the year in which it is notified of that fact by the IRS.<sup>1103</sup> However, if the trust entered into the prohibited transaction with the purpose of diverting a substantial part of the corpus or income of the trust to the employer, the revocation of exemption may be retroactive.<sup>1104</sup> See discussion below at V.C.

If the trustee receives a notice from the IRS that the trust has engaged in a prohibited transaction, the trust may again file for exemption in the year following the taxable year of the trust in which it received the notice.<sup>1105</sup> If the IRS is satisfied that the trustee will not knowingly cause the trust to engage in a subsequent prohibited transaction, the IRS will grant exemption to the trust in the year following the year the application is made.<sup>1106</sup>

## (7) Procedural Requirements

### (a) Application

The application for exemption must be submitted on Form 1024 together with Schedule J and must be filed within 15 months (27 months with automatic extension) after the date the trust is formed. If the application is filed within this period and if the trust meets the requirements of §501(c)(17), the determination letter will recognize the exemption of the trust as of

<sup>1098</sup> §503(e)(1)(A), §501(e)(1)(C).

<sup>1099</sup> §503(e)(2)(A), §503(e)(2)(B).

<sup>1100</sup> §503(e)(3).

<sup>1101</sup> Reg. §1.503(e)-1(a)(3).

<sup>1102</sup> Reg. §1.503(e)-1(a)(2).

<sup>1103</sup> §503(a)(2).

<sup>1104</sup> §503(a)(2); Reg. §1.503(a)-1(c)(5).

<sup>1105</sup> §503(c); Reg. §1.503(c)-1(a).

<sup>1106</sup> Reg. §1.503(c)-1(b).

the date of its formation if its purposes and activities during the period before the date of the determination letter were consistent with the requirements of §501(c)(17).<sup>1107</sup> If the application is filed after the submission period, the trust is exempt only for the period after the application is filed.<sup>1108</sup> A completed Form 1024 must be submitted electronically using Pay.gov.<sup>1109</sup>

*Note:* For a further description of the application procedures for receiving a determination that a trust is exempt under §501(c)(17), see 452 T.M., *Tax-Exempt Organizations — Reporting, Disclosure, and Other Procedural Aspects* (Estates, Gifts and Trusts Series).

If the trustee of a SUB plan trust receives notice that it has engaged in a prohibited transaction under §503, the trustee may reapply for exemption as described above.<sup>1110</sup> The reapplication must be made on Form 1024 together with Schedule J. In addition, a trustee of the trust must attach a written declaration to Form 1024, under the penalties of perjury, that the trust will not knowingly again engage in a prohibited transaction under §503.<sup>1111</sup>

### (b) Maintenance

The trustee of a SUB plan trust must file Form 990 with the Internal Revenue Service Center covering the trust's situs for each of the trust's taxable years.<sup>1112</sup> If the trust realizes any unrelated business taxable income (as defined in §512), the trust must also file Form 990-T.<sup>1113</sup>

## (8) Multiemployer Plans

A trust qualified under §501(c)(17) may be a trust forming part of a plan of several employers or of the employees of several employers.<sup>1114</sup>

### d. Deductions by Employers

A SUB is a welfare benefit fund under §419, and as such is subject to the deduction limitations imposed by §419 and §419A discussed at V.B.

### e. Tax Consequences to Employees

Separation benefits paid directly to an employee by the employer or through a SUB plan's tax-exempt trust are includi-

<sup>1107</sup> Reg. §601.201(n)(3); see IRS Pub. 5727 (SUB trust technical guide TG 17). An automatic extension is available if Form 1024 is submitted within 12 months from the end of the 15-month period in accordance with the Instructions for Form 1024. In addition, this time period is postponed for individuals qualifying under §7508 for qualifying individuals serving in the U.S. Armed Forces in a combat zone or contingency operation and may be postponed under §7508A in the event of a federally declared disaster, terroristic or military action, or a significant fire for which assistance is provided after November 15, 2021. Rev. Proc. 2018-58, §10.3 (effective for acts that may be performed or disasters which occur on or after November 20, 2018), *superseding* Rev. Proc. 2007-56, §10.2. For further discussion of plan-related postponements due to disaster situations, see 370 T.M., *Distributions from Qualified Plans — Taxation and Qualification*. For a discussion of §7508 and §7508A, 627 T.M., *Limitations Periods, Interest on Underpayments and Overpayments, and Mitigation*.

<sup>1108</sup> Reg. §1.505(c)-1T, Q&A-6 and -7.

<sup>1109</sup> See Rev. Proc. 2026-5, §4.02(3); Instructions to Form 1024. The electronic submission requirement took effect on January 3, 2022.

<sup>1110</sup> §503(c); Reg. §1.503(c)-1(a).

<sup>1111</sup> Reg. §1.503(c)-1(a).

<sup>1112</sup> §6033(a); Reg. §1.6033-2(a)(2)(i).

<sup>1113</sup> Reg. §1.501(c)(17)-2(h).

<sup>1114</sup> Reg. §1.501(c)(17)-2(g).

ble in the employee's gross income in the year received.<sup>1115</sup> However, amounts contributed by an employer to a trust containing an individual account for each employee in which the employee is fully vested in the amount placed in this account are includible in the employees' income in the year in which the benefits are contributed.<sup>1116</sup>

If the SUB plan is funded in whole or in part with employee contributions, the amount of separation benefits includible in the employee's income is determined according to a rule that treats employee contributions as being returned first so that the taxable amount is the amount by which the distribution and any prior distribution of such separation payments exceed the employee's total contributions to the fund.<sup>1117</sup> The employee will not receive any deduction for amounts contributed to a

SUB plan, even if the plan is maintained by such employee's union.<sup>1118</sup>

*Comment:* Because the employee effectively recovers his or her own contributions first, it is important for the employer (and the employee) to maintain detailed records of the contributions by each employee and to provide such information to each employee receiving benefits during a particular year to avoid double taxation of those amounts.

Any benefit received from a SUB plan providing for payment of sick and accident benefits must be included in the employee's gross income unless specifically excluded under §104, §105, or §213.<sup>1119</sup>

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<sup>1115</sup> Rev. Rul. 56-249.

<sup>1116</sup> Rev. Rul. 57-37.

<sup>1117</sup> Reg. §1.501(c)(17)-3(a)(1); Rev. Rul. 57-383.

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<sup>1118</sup> Rev. Rul. 57-383, Rev. Rul. 67-38.

<sup>1119</sup> Reg. §1.501(c)(17)-3(a)(2).

## V. Miscellaneous Considerations

### A. Withholding and Employment Taxes

#### 1. Section 132 Incidental Fringe Benefits

All fringe benefits that are not expressly exempted from income are not only treated as income but are also uniformly subject to income tax withholding pursuant to §3401(a) and to the taxes under the Federal Insurance Contributions Act (FICA) and the Federal Unemployment Tax Act (FUTA).<sup>1120</sup> This results from statutory changes made by the 1984 Act,<sup>1121</sup> which eliminated a patchwork of inclusion and exclusion rules and the substantial confusion that had existed previously as a result.

##### a. Background

There had been considerable authority under prior law for the proposition that even if certain fringe benefits were required to be treated as additional employee income, such characterization was not conclusive of whether such payments were also “wages” within the meaning of the then applicable withholding requirements of §3401(a) and the similar definitions for FICA and FUTA. When compensation-oriented factors, such as an employee’s grade, responsibility and length of service, were not primarily involved in determining the timing or amount of a benefit, such benefit might have been viewed to constitute taxable income but not “wages.” Examples were excess moving reimbursements costs<sup>1122</sup> and gifts, awards and “prize points.”<sup>1123</sup> Moreover, many incidental fringe benefits, particularly those now characterized as working conditions or de minimis fringes, were not subject to withholding because they were not treated as income.

The IRS had long regarded withholding as the key to effective enforcement of fringe benefit taxation. As a result, even before the 1984 Act, there had been continuing IRS pressure to expand withholding requirements administratively.<sup>1124</sup> For example, in Rev. Proc. 80-53, the IRS proposed to require employers to withhold in all cases except where specific benefits were exempted. However, the IRS’s attempt to administratively require full withholding for such benefits met considerable opposition, which was quelled only by the 1984 Act changes.

Also, the question of parallel construction of the term “wages” for purposes of the income tax withholding, FICA and FUTA provisions had been the subject of litigation. The

Supreme Court ultimately upheld parallel construction of these provisions notwithstanding minor language differences.<sup>1125</sup>

#### b. General Rules for Collection

Congress was aware that there could be significant practical difficulties in implementing the changes in the 1984 Act, which required withholding and employment tax payments with respect to all fringe benefits treated as taxable income. The particular problem is that, unlike cash compensation payments, noncash fringe benefits afford no immediate source of funds from which an employer can withhold the required amounts. Accordingly, Congress provided for the issuance by Treasury of legislative regulations to implement the withholding rules.<sup>1126</sup>

Treasury responded with highly pragmatic rules issued as part of the now largely withdrawn first temporary regulations (the “Withholding Reg.”),<sup>1127</sup> which rules the IRS subsequently announced would be interpreted under even more liberalized guidelines set forth in Announcement 85-113.<sup>1128</sup> Overall, Treasury and the IRS have demonstrated considerable sensitivity to employer difficulties in implementing withholding on noncash compensation.

##### (1) Deemed Payment Date Election

As provided in the Withholding Reg., an employer may elect to deem most noncash benefits to have been paid as of any date on or after the benefit is provided so long as that date is within the same calendar quarter.<sup>1129</sup> Announcement 85-113 expanded the period in which the benefit may be deemed to have been provided from the calendar quarter to the full calendar year.<sup>1130</sup> Employers do not have to make the same election for all employees and may withhold more frequently for some employees than for others. The purpose of this rule is to allow time for employers to internally collect information with respect to the amount of benefits (for example, the amount of an employee’s taxable use of employer-provided vehicles) provided during reporting periods that are convenient for the employer to maintain (weekly, biweekly, monthly, quarterly, etc.). Employers may deem the benefit to have been provided in two or more parts.<sup>1131</sup> Thus, an employer can spread the financial impact of withholding with respect to large benefits over a sufficient period to permit collection of the appropriate amounts without undue employee hardship.

<sup>1120</sup> §3121 (FICA), §3306 (FUTA), §3401 (income tax withholding). See, e.g., *American Airlines Inc. v. United States*, 204 F.3d 1103 (Fed. Cir. 2000), *aff’d in part and rev’d and rem’d in part* 40 Fed. Cl. 712 (1998).

<sup>1121</sup> Pub. L. No. 98-369, §531(d)(1), (3) and (4) amending §3121(a), §3306(b), and §3401(a) to each apply to “all remuneration (including benefits).”

<sup>1122</sup> PLR 7739007.

<sup>1123</sup> Rev. Rul. 70-331 (involving “prize points” awarded by a distributor to its salesmen which were redeemable for merchandise); Rev. Rul. 59-58. See generally discussion in *Central Illinois Public Service Co. v. United States*, 435 U.S. 21 (1978).

<sup>1124</sup> Treasury Summary and Explanation, First Discussion Draft at p. 12.

<sup>1125</sup> *Rowan Cos. v. United States*, 452 U.S. 247 (1981).

<sup>1126</sup> 1984 Act, §531(d)(5), adding §3501(b); Senate Report at p. 1170; 1984 Bluebook at p. 865.

<sup>1127</sup> T.D. 8004, 50 Fed. Reg. 836 (Jan. 7, 1985) at ¶4 through ¶8.

<sup>1128</sup> IRS News Release IR-85-70 (July 19, 1985).

<sup>1129</sup> Reg. §31.3501(a)-1T, Q&A-1.

<sup>1130</sup> Announcement 85-113, §1.

<sup>1131</sup> Announcement 85-113, §1.

*Example:* B, a key sales employee of Corporation R, receives a taxable benefit worth \$5,000 in January as a result of receiving the use of an apartment in Florida for that month in recognition of outstanding sales performance. Collection of withholding on that amount out of B's regular compensation could cause a financial hardship to B. Thus, R deems the \$5,000 amount paid in installments for purposes of withholding tax obligations, and B may be treated as receiving \$1,000 per month at the end of each of R's following five monthly pay cycles, February through June.

The withholding deposits by the employer must track the employer's elections with respect to when a benefit is deemed to have been paid and must therefore be made no later than the time for filing the appropriate employment tax forms for such periods. However, to the extent any amounts are in fact withheld by the employer earlier than that date, such withheld amounts are subject to and must be paid under the general deposit rules.<sup>1132</sup> This has the effect of ensuring that the liberal deferral of the date a benefit is deemed to be provided cannot be used to generate an employer "float" of funds withheld from employees.<sup>1133</sup>

Actual cash collections from the employee are not required to precisely correspond to the deemed payouts or employer payments of the withholding. Thus, in the example above, if R had a bi-weekly pay cycle, it could withhold cash from the first biweekly payment to B in each month from February through June. Any excessive delay in employee withholding may cause the nonwithheld amounts to be treated as additional compensation, apparently sanctioning, but not quantifying, permissible nonexcessive delay.<sup>1134</sup> It is not clear, however, whether the IRS intended to modify this approach or whether final regulations will permit such discretion, because Announcement 85-113 states that "In general, an employer must withhold the applicable ... [taxes] on the date or dates it elects to treat the benefits as paid."<sup>1135</sup> (Emphasis added).

*Comment:* Employers can avoid any difficulties arising under the possibility of more restrictive Announcement 85-113 language by simply designating a later date or dates as the dates of the deemed payments.

Employers also are allowed the flexibility to treat includible fringe benefit income as either regular or supplemental

wages. This allows withholding to be made at either the regular rate applicable to each employee's income or at the special flat withholding rate<sup>1136</sup> applicable to bonuses and other extraordinary payments.<sup>1137</sup>

It is not necessary for employers utilizing the deemed payment date election to make a formal election or filing with the IRS; actual treatment of benefits consistently with the rules establishes entitlement to utilize this method.<sup>1138</sup> Such use appears to require proper utilization of either the Estimation Option or Special Accounting Rule discussed below. The deemed payment date election may be utilized on a benefit-by-benefit basis; however, this method may not be used for any transfer of real property or personal property of a type held for investment.<sup>1139</sup> Thus, it could not be used to defer the date on which corporate stock is considered received by an employee, leaving the rules under §83 applicable to such transfers.

The deemed payment date election, even with the liberalizing modifications of Announcement 85-113, poses year-end difficulties in collecting information necessary to properly withhold by the end of the year (the latest date that may be elected) on the value of benefits made available late in the calendar year. An employer faced with this difficulty has two options discussed below.

<sup>1136</sup> See Reg. §31.3402(g)-1 (T.D. 9276, 71 Fed. Reg. 42,049 (July 25, 2006)), effective for wages paid after January 1, 2007. For payments made after December 31, 2004, an employer electing to determine the amount to be deducted and withheld from any supplemental wage payment under \$1 million must use a rate not less than 28% (or the corresponding rate in effect under §1 [22% under §1(j) after 2017, and 25% under §1(i)(2) for taxable years after 2012 and before 2018]). Reg. §31.3402(g)-1(a)(7)(iii)(F). See the One Big Beautiful Bill Act (OBBBA), Pub. L. No. 119-21, §70101, which made the reduced tax rates permanent. See also Pub. L. No. 115-97, §11001(a), which reduced tax rates for taxable years beginning after December 31, 2017 and before January 1, 2026, and the American Jobs Creation Act of 2004 (AJCA), Pub. L. No. 108-357, §904(a) and §904(c), which repealed §13273 of the 1993 Revenue Reconciliation Act, Pub. L. No. 103-66, as amended by Pub. L. No. 107-16. For rates for prior years, see Reg. §31.3402(g)-1(a)(7)(iii)(A) through §31.3402(g)-1(a)(7)(iii)(E).

Supplemental wages exceeding \$1 million are subject to a flat withholding rate equal to the maximum tax rate in effect under §1 [currently 37%]. Reg. §31.3402(g)-1(a)(2); Pub. L. No. 108-357, §904(b)(1). See §1(j), added by Pub. L. No. 115-97, §11001(a) (lowering the maximum rate to 37% for taxable years beginning after December 31, 2017, and before January 1, 2026), and by Pub. L. No. 119-21, §70101 (making permanent the lower rate), effective for taxable years beginning after December 31, 2025. See also Pub. L. No. 112-240, §101(b)(1) (raising the maximum rate to 39.6%), Pub. L. No. 115-97, §11002(c)(2).

<sup>1137</sup> Reg. §31.3501(a)-1T, Q&A-10.

<sup>1138</sup> Announcement 85-113, §1.

<sup>1139</sup> See discussion under special rules at V.A.1.c.(2).

<sup>1132</sup> Reg. §31.3501(a)-1T, Q&A-1.

<sup>1133</sup> Reg. §31.3501(a)-1T, Q&A-1.

<sup>1134</sup> Reg. §31.3501(a)-1T, Q&A-1.

<sup>1135</sup> Announcement 85-113, §2.

## (2) Estimation Option

For purposes of meeting the timely deposit requirement, an employer may make a “reasonable estimate” of the benefits provided as of the applicable date. This procedure is to be followed “even if the employer does not know which employee is the recipient of the benefit on the date the deposit is due,” citing the example of an airline which might know the amount of discounted taxable flight benefits provided in total (from passenger flight statistics) but not the identity of the guest or an individual employee provided the taxable fringe benefit of free travel.<sup>1140</sup>

Employers using the estimation option are liable for failure to deposit penalties with respect to any underestimating and may claim a refund or credit for any overpayment. Employers who withhold less than the required amount may recover those amounts before April 1 of the following year.

Under all circumstances, employers using the estimation option must determine the actual value of benefits provided during a year to each employee by January 31 of the following year and that amount must be included on each employee’s Form W-2 for the year.<sup>1141</sup>

An advantage of the estimation option method is that employers adopting that approach may elect to use the deemed payment date election for some employees and not for others.<sup>1142</sup> Thus, for example, the method might be applied only to executives provided employer automobiles.

## (3) Special Accounting Rule

Announcement 85-113 provides an alternative rule of administrative convenience that permits an employer to treat the value of fringe benefits actually provided during the last two months of a calendar year (or any shorter period) as paid during the subsequent calendar year.<sup>1143</sup> This rule does not apply to further defer withholding with respect to benefits provided earlier in the year but treated as wholly or partly provided during the last two calendar months under the deemed payment date election.

If an employer is using the special accounting rule provided in Announcement 85-113, benefits that are deemed provided in a subsequent calendar year pursuant to that rule are considered as provided in that subsequent calendar year for purposes of the special valuation rules of Reg. §1.61-21. Thus, if a particular special valuation rule is in effect for a calendar year, it applies to benefits deemed provided during that calendar year under the special accounting rule.<sup>1144</sup>

The rule may be applied flexibly with different periods applicable to different benefits. Thus, for example, because of differing information collection constraints, an employer could include in an employee’s January income the value of use of an automobile during all of December and the value of meals in an employer-provided eating facility made available during the last two-week pay period in December. However, special conformity rules require that if an employer uses the special ac-

counting rule for a particular fringe benefit, the rule must be used for all employees receiving that benefit and such employees must also use the rule for income inclusion purposes.<sup>1145</sup>

### c. Special Rules

#### (1) Discount Purchases

A special rule treats income realized in connection with discount purchases of property or services (to the extent not excludible under §132) as a benefit provided at the time ownership of the property is transferred or the service is rendered.<sup>1146</sup> For this purpose the date of the employee’s payment is immaterial.

#### (2) Investment Property and Real Estate

Special anti-abuse limitations preclude the application of either the general fringe benefit reporting rule or the special 2-month accounting rule to investment property (tangible or intangible) or to real estate. The withholding regulations cite stock transferred to an employee for services as an example, and hold that such property is not entitled to the special fringe benefit reporting rules because such stock is treated as having been paid to the employee on the date of transfer (absent an election under §83(b)).<sup>1147</sup>

#### (3) Demonstration Automobiles

If an employer reports the value of personal use of a demonstration automobile on a monthly basis under the “partial exclusion” method provided in Rev. Proc. 2001-56, the employer may not utilize the annual reporting and withholding method provided in Announcement 85-113.<sup>1148</sup>

#### (4) Qualified Transportation Fringe Benefits

Qualified transportation fringe benefits exceeding the applicable statutory monthly limits are included in the employee’s wages for income and employment tax purposes. Noncash benefits in excess of the limits may be reported on a periodic basis under the guidelines of Announcement 85-113.<sup>1149</sup> Cash benefits in excess of the limits are treated as paid for employment tax purposes when actually or constructively paid.<sup>1150</sup>

### 2. Other Statutory Fringe Benefits

#### a. Educational Assistance Programs

Amounts provided to employees under a §127 qualified educational assistance program are not subject to income tax withholding, FICA or FUTA taxes.<sup>1151</sup> However, if benefits are provided in excess of the allowable amount under §127, such excess amounts would be subject to withholding, FICA and FUTA taxes.<sup>1152</sup>

<sup>1140</sup> Announcement 85-113, §2.

<sup>1141</sup> Announcement 85-113, §5.

<sup>1142</sup> Announcement 85-113, §1.

<sup>1143</sup> Announcement 85-113, §5(a).

<sup>1144</sup> Reg. §1.61-21(c)(7).

<sup>1145</sup> Announcement 85-113, §5(b).

<sup>1146</sup> Reg. §31.3501(a)-1T, Q&A-9.

<sup>1147</sup> Reg. §31.3501(a)-1T, Q&A-2; Announcement 85-113, §1 and §5.

<sup>1148</sup> Rev. Proc. 2001-56, §5, Q&A-37.

<sup>1149</sup> Notice 94-3, Q&A-12(a); Reg. §1.132-9(b), Q&A-22(c).

<sup>1150</sup> Reg. §1.132-9(b), Q&A-22(b).

<sup>1151</sup> §3121(a)(18), §3306(b)(13), §3401(a)(18).

<sup>1152</sup> See discussion at III.A.2.c.

### b. Dependent Care Assistance Programs

Amounts provided to employees under a §129 qualified dependent care assistance program are not subject to income tax withholding, FICA or FUTA taxes.<sup>1153</sup> However, if benefits are provided in excess of the allowable amount under §129, such excess amounts would be subject to withholding, FICA and FUTA taxes.<sup>1154</sup>

### c. Employee Achievement Awards

Amounts excluded from income under §74(c) as a qualified or nonqualified plan achievement award are not subject to income tax withholding, FICA or FUTA taxes.<sup>1155</sup> However, if an employer provides awards or gifts in excess of the allowable amount under §74(c), such excess amount would be subject to withholding, FICA, and FUTA taxes.<sup>1156</sup>

### d. Supplemental Unemployment Benefit Plans

Payments from a §501(c)(17) SUB plan are subject to income tax withholding to the extent they exceed any employee contributions.<sup>1157</sup> The IRS has addressed the status of such payments as “wages” for purposes of FICA and FUTA taxes in a series of revenue rulings.

In Rev. Rul. 56-249,<sup>1158</sup> the IRS held that benefits paid to individuals by the trustees of a SUB trust are not wages for purposes of FICA or FUTA. The ruling summarizes the following eight features of the plan: (1) benefits are paid only to unemployed former employees who are laid off by the employer; (2) eligibility for benefits depends upon meeting prescribed conditions after terminating employment with the employer; (3) benefits are paid by trustees of independent trusts; (4) the amount of weekly benefits payable is based upon state unemployment benefits, other compensation allowable under state laws and the amount of straight-time weekly pay; (5) the duration of the benefits is affected by the fund level and the employee’s seniority; (6) the right to benefits does not accrue until a prescribed period after termination of employment; (7) the benefits are not attributable to the rendering of particular services; and (8) no employee has any right, title or interest in the fund until such employee is qualified and eligible to receive benefits.

Subsequent revenue rulings broadened the scope of Rev. Rul. 56-249. For example, in Rev. Rul. 60-330, the IRS concluded that the fact that benefits were not paid from a trust did not change the result of Rev. Rul. 56-249.

In Rev. Rul. 77-347, the IRS held for the first time that benefits paid from a SUB plan did not have to be linked to state unemployment benefits in order for the benefits to be excluded from the definition of wages. However, in Rev. Rul. 90-72,<sup>1159</sup> the IRS revoked the part of Rev. Rul. 77-347 that permitted an exclusion from the definition of wages for payments that are not linked to state unemployment compensation, reasoning that

the position taken in Rev. Rul. 77-347 was inconsistent with the underlying premise for the exclusion. The IRS further ruled in Rev. Rul. 90-72 that benefits provided in the form of lump-sum payments are not linked to state unemployment compensation for this purpose and are not excludible from wages as SUB pay.<sup>1160</sup>

Rev. Rul. 90-72 is consistent with the 1984 Act changes broadening the application of withholding taxes and eliminating the distinction between “wages” and “taxable income.”<sup>1161</sup> However, because it overruled a long-standing IRS position, the IRS made it prospective in application — applying to benefits paid on or after January 1, 1991. For plans maintained pursuant to a collective bargaining agreement, the revenue ruling applies to all benefits paid after the later of January 1, 1991, or the date on which the collective bargaining agreement expires.

In PLR 9523023, the IRS concluded that SUB pay paid to former employees who are not eligible for state unemployment compensation benefits solely because they are receiving too high a pension benefit from the employer is not designed to supplement the receipt of state unemployment benefits because it disqualifies the recipient from receiving state unemployment benefits. Accordingly, the IRS ruled that such benefits are wages for FICA, FUTA and income tax withholding purposes.

In PLR 200322012 and PLR 9734035, the IRS considered SUB pay that is contingent on the receipt of state unemploy-

<sup>1160</sup> In TAM 9322001, the National Office advised that separation payments made by a railroad industry company were not supplemental unemployment benefits under Rev. Rul. 77-347 and were not excludible from the §3231(e) definition of compensation because the payments at issue made the recipients ineligible to receive railroad retirement benefits. As a result, the National Office concluded, classifying the payments as SUB pay would be inconsistent with the theory underlying Rev. Rul. 56-249 and Rev. Rul. 77-347, i.e., that the exclusion was intended to apply only to payments that supplemented governmental benefits and not to ones that disqualify the recipient from eligibility to receive such benefits. Compare PLR 9338017 and PLR 9338022, in which the IRS concluded that a company’s plan intended to supplement state unemployment benefits of certain former employees is a SUB pay plan because it continues to resemble the plan in Rev. Rul. 56-249, as modified by Rev. Rul. 90-72, in all material respects. Thus, it ruled that contributions to the SUB plans are not wages for purposes of FICA, FUTA or income tax withholding. The IRS also applied the FICA and FUTA exclusion to laid-off employees who receive regular benefits but are ineligible for state unemployment compensation, because they: (1) have insufficient wage credits; (2) have exhausted their state unemployment benefits; or (3) have not met the waiting period requirement for state unemployment benefits but are otherwise eligible for the state benefits. The IRS further ruled in both letters that separation payments (payments to employees involuntarily separated from service and payments to disabled employees who would otherwise receive a disability benefit from the company’s qualified pension plan except for insufficient credited service) are wages for FICA and FUTA purposes because they are paid in a single sum rather than periodically for the duration of unemployment. The IRS ruled in both letters that automatic short week benefits, paid to participants who otherwise qualify for regular benefits but whose period of unemployment during the affected calendar week was less than 40 hours, are not wages for FICA and FUTA purposes if they are paid to employees who otherwise qualify for excludible regular benefits. See PLR 200709056. But see CCA 201639015 (short week benefits paid from SUB trust to employees with less than specified number of hours, without regard to whether employees applied for state unemployment benefits, are not excluded from wages for FICA purposes). In PLR 201201003, the IRS ruled employer insurance premium payments made on their behalf were not wages subject to FICA or FUTA taxes because the plan was a SUB plan similar in all material respects to the plan described in Rev. Rul. 56-249, as modified by Rev. Rul. 90-72, i.e., it was designed to supplement state unemployment benefits and the benefits were linked to the receipt of state unemployment compensation.

<sup>1161</sup> See discussion at V.A.1.a.

<sup>1153</sup> §3121(a)(18), §3306(b)(13), §3401(a)(18).

<sup>1154</sup> See discussion at III.B.2.b.

<sup>1155</sup> §3121(a)(20), §3306(b)(16), §3401(a)(19).

<sup>1156</sup> See discussion at III.C.

<sup>1157</sup> §3402(o)(1)(A).

<sup>1158</sup> As modified by Rev. Rul. 90-72. See also CCA 201020018 (discussing effect of Rev. Rul. 90-72 on Rev. Rul. 56-249).

<sup>1159</sup> Amplifying Rev. Rul. 65-251 and revoking in part Rev. Rul. 77-347.

ment compensation but for the fact that: (1) the employee is receiving other compensation in an amount that disqualifies the employee from receiving state benefits; (2) the employee refused an offer of work that the employee had the right to refuse under the collective bargaining agreement; or (3) the employee is granted a waiver of the requirement for receipt of state benefits when the benefits have been denied because the employee has refused to accept a minimum wage job, and ruled in each case that such payments are wages for purposes of FICA and FUTA taxes.

Several cases have held that SUB benefits that are attributable to employer contributions and are, in effect, payments for past services are wages for purposes of FICA and FUTA tax withholding.<sup>1162</sup> Courts have also addressed the issue of whether SUB benefits are subject to FICA and FUTA tax. Taxability depends on whether such benefits are characterized as wages or SUB payments.<sup>1163</sup>

<sup>1162</sup> *Sheet Metal Workers Local 141 Supplemental Unemployment Benefit Trust Fund v. United States*, 64 F.3d 245 (6th Cir. 1995); *NYSA-ILA Container Royalty Fund v. Commissioner*, 847 F.2d 50 (2d Cir. 1988).

<sup>1163</sup> See *CSX Corp. v. United States*, 518 F.3d 1328 (Fed. Cir. 2008), *aff'g in part, rev'g in part and rem'g* 52 Fed. Cl. 208 (2002), 58 Fed. Cl. 341 (2003), and 71 Fed. Cl. 630 (2006). In that case, the U.S. Court of Appeals for the Federal Circuit concluded that whether SUB payments are subject to FICA (or Railroad Retirement Tax Act) and FUTA tax does not automatically follow from whether they are subject to income tax withholding under §3402(o). Rather, the nature of the payment, and not whether the employee's action was voluntary or involuntary, is the deciding factor. The court held that all payments to various groups of employees who received benefits in connection with the employer's reduction in force were wages for FICA purposes. Employees who were placed in layoff status received benefits that represented a fixed percentage of their average monthly compensation, and the duration of the payments was governed by each employee's length of service with the employer. As such, the payments were similar to the payments at issue in *Abrahamsen v. United States*, 228 F.3d 1360 (Fed. Cir. 2000), which were held to be wages. The trial court's ruling that those payments were not wages because they qualified as SUB payments under §3402(o) was reversed. Separation payments made to non-management employees, whether on layoff status or otherwise, who chose to sever their relationship with the employer constituted wages because those payments were dismissal or severance payments of the sort that have consistently been treated as wages for FICA purposes. Payments to management employees who were separated from employment, either voluntarily or involuntarily, also were wages for FICA, as those payments also constituted dismissal or severance payments that were similar in character to the dismissal payments that were held to be wages in *Abrahamsen*. Finally, payments made to employees whose full-time positions were eliminated but who continued to be employed by the company were wages and were subject to employment taxation. However, in *United States v. Quality Stores, Inc.*, 424 B.R. 237 (W.D. Mich. 2010), a federal district court disagreed with the Federal Circuit's reasoning in *CSX* and held that severance payments fall within the §3402(o) (2) exception to "wages" for supplemental unemployment compensation benefits and are not subject to FICA. The Sixth Circuit subsequently affirmed the case, holding that severance payments to employees terminated due to downsizing and subsequent closing of operations by their employer fall within the §3402(o) exception to wages for supplemental unemployment compensation benefits and are not taxable for purposes of FICA taxation. The court reasoned that the severance payments at issue were properly viewed as wage-replacement social benefits, not taxable remuneration for the employees' services or wages. The court concluded that the severance payments were made because of the employees' involuntary separation from employment, which resulted directly from a reduction in force or the discontinuance of a plant or operation. *United States v. Quality Stores, Inc.*, 693 F.3d 605 (6th Cir. 2012). On appeal, the Supreme Court reversed the Sixth Circuit, relying primarily on statutory construction grounds to conclude that FICA's broad definition of wages included the severance payments at issue. The Court noted that as a matter of plain meaning, severance payments made to terminated employees are remuneration for employment. The Court also highlighted the fact that §3121(a) provides an exhaustive list of exclusions from the definition of wages for FICA tax purposes and that the specificity of these exemptions reinforces the broad nature of

### e. Vehicle Fringe Benefits

Any "vehicle fringe benefit" must be treated as wages from which income taxes are required to be deducted and withheld.<sup>1164</sup> A "vehicle fringe benefit" is any fringe benefit that consists of providing a highway motor vehicle for the use of the employee and constitutes "wages" under §3401.<sup>1165</sup>

An employer may elect not to deduct and withhold income taxes from a vehicle fringe benefit. The employer must, however, withhold applicable FICA taxes from such benefit. This exception applies if the employer notifies the employee of the election not to withhold and timely reports the amount of includible income on the employee's Form W-2.<sup>1166</sup> Notice must be provided by the later of January 31 of the year for which the election is to apply or within 30 days after the date the employer first provides a vehicle to the employee. The notice must be provided in a manner reasonably expected to come to the attention of all affected employees, such as by providing the notice directly to the employee or by posting the notice in a workroom. An employer may change its election not to withhold at any time by notifying its employees as described in the preceding sentence.<sup>1167</sup>

### 3. Penalties for Failure to Withhold

The I.R.C. includes a number of civil penalties that apply to employers who fail to withhold and pay over the proper amount due from an employee's wages. A detailed discussion of these penalty provisions is beyond the scope of this portfolio. The penalties that are most likely to apply to an employer's failure to withhold employment taxes are briefly summarized below.

See 634 T.M., *Civil Tax Penalties*, for a detailed discussion of civil tax penalties.

#### a. Failure to Pay Assessed Deficiency — §6651(a)(3)

If an employer fails to pay a deficiency in the amount of employment taxes owing within 21 calendar days from the date of notice and demand therefor (10 business days if the amount for which such notice and demand is made equals or exceeds \$100,000), a penalty equal to 0.5% on the amount of the deficiency is assessed for each month during which the deficiency remains unpaid. The penalty may not exceed a total of 25% of the amount subject to the penalty. The penalty will not apply if the employer demonstrates that the failure to timely pay the deficiency is due to reasonable cause and not to willful neglect. A delay is deemed to be due to reasonable cause if the employer

FICA's definition of wages. The Court found the taxpayer's argument that, because §3402(a) subjects SUB payments to federal income tax withholding, the lack of a corresponding section in §3121 must mean that these amounts are not wages for FICA tax purposes to be without merit. Section 3402(o)'s requirement that SUB payments be treated "as if" they were wages for federal income tax withholding is fully consistent with the proposition that at least some severance payments are wages and does not support the conclusion that all the payments listed in §3402(o) are not wages. *United States v. Quality Stores, Inc.*, 134 S. Ct. 1395 (2014). For further discussion of FICA and FUTA taxation of SUB benefits, see 392 T.M., *Withholding, Social Security and Unemployment Taxes on Compensation*.

<sup>1164</sup> §3402(s)(2).

<sup>1165</sup> §3402(s)(3).

<sup>1166</sup> §3402(s)(1).

<sup>1167</sup> Announcement 85-113, §4.

exercises ordinary business care and prudence but is nevertheless unable to timely pay the deficiency.<sup>1168</sup>

*b. Accuracy-Related Penalty — §6662*

The accuracy-related penalty is imposed at the rate of 20% on the portion of any underpayment attributable to, inter alia, negligence or disregard of rules or regulations. “Negligence” is defined as any failure to make a reasonable attempt to comply with the I.R.C. “Disregard” includes any careless, reckless or intentional disregard.<sup>1169</sup> Pursuant to §6664(b), the accuracy-related penalty applies only where a return has been filed.

Under §6664(c), the accuracy-related penalty does not apply with respect to any portion of an underpayment if the employer demonstrates that there was reasonable cause for such portion and the employer acted in good faith with respect to that portion. This exception, however, does not apply to any portion of an underpayment attributable to one or more transactions described in §6662(b)(6), e.g., lacking economic substance within the meaning of §7701(o) or failing to meet the requirements of any similar rule of law.<sup>1170</sup>

*c. Failure to Make Deposit of Taxes — §6656*

Section 6656(a) imposes a penalty for a failure to timely deposit FICA and income taxes actually withheld by the employer with an authorized financial institution. The penalty for failure to deposit employment taxes is inapplicable to FICA and income taxes that were not actually withheld from compensation paid to employees. The employer is, however, subject to any penalties that apply for failure to deposit the employer’s portion of the FICA tax and the FUTA tax.<sup>1171</sup>

Section 6656(b)(1) establishes a 4-tiered penalty structure under which the penalty amount varies with the time the employer corrects the failure. The penalty is 2% of the amount of the underpayment if the failure is corrected on or before five days after the due date, 5% if the failure is corrected after the fifth day, but on or before the 15th day, and 10% if the failure is corrected after the 15th day, but on or before the 10th day after the date the first IRS delinquency notice is sent to the employer. The penalty is equal to 15% of the underpayment if the failure is not corrected on or before the tenth day after such a notice. Where notice is given under the jeopardy assessment rules, the penalty is 15% if the failure is not corrected on or before the date on which notice and demand for payment is given under §6861, §6862, or the last sentence of §6331(a).

An underpayment for the purposes of applying this penalty is defined as the excess of the amount of tax required to be deposited over the amount of any deposit of such tax that is deposited on or before its due date.<sup>1172</sup>

An employer may avoid the penalty imposed under this section by demonstrating that its failure to timely and/or fully deposit the particular tax was due to reasonable cause and not to willful neglect.<sup>1173</sup>

Under §6656(c), the IRS may waive the §6656(a) penalty for first-time depositors of employment taxes based on a person’s inadvertent failure to deposit FICA, FUTA, and withheld income taxes if: (1) such person meets the requirements of §7430(c)(4)(A)(ii); (2) such failure occurs during the first quarter that the person was required to deposit the tax; and (3) the return of such tax was filed on or before the due date. Under §6656(d), the IRS also may abate the §6656(a) penalty with respect to the first time a depositor is required to make a deposit if the amount required to be deposited is inadvertently sent to the Treasury instead of to the appropriate government depository.<sup>1174</sup>

*d. Failure to Collect and Pay Over Tax — §6672*

A penalty may be assessed under §6672 against any person required to collect, account for and pay any tax who willfully fails to pay over such tax or who willfully attempts to evade or defeat the tax or its payment. Under this penalty, “responsible persons” such as officers, directors or employees, may be assessed for the total amount of tax evaded or not collected or not accounted for and paid over. The penalty is equal to 100% of the underpayment and may be assessed against any person connected or associated with an employer who has the power to see that any taxes required to be withheld are timely collected and paid over to the government.

This section is not applicable to taxes collected directly, such as the employer’s portion of FICA, but applies to employment taxes required to be withheld from employees’ wages.

*e. Failure to Furnish Correct Payee Statements — §6722*

Section 6722 provides for the imposition of a penalty for the failure to furnish a payee statement to a payee on or before the due date and for the failure to include correct information on the statement or the inclusion of incorrect information. The amount of the penalty is \$100 per statement, up to a maximum of \$1.5 million per calendar year for statements required to be furnished before 2016, and increases to \$250 per statement, up to a maximum of \$3 million per calendar year for statements required to be furnished after December 31, 2015.<sup>1175</sup> This penalty may be reduced depending on how quickly the error is corrected. If the failure is corrected within 30 days after the date the statement must be furnished, the penalty is \$30 per statement up to a maximum of \$250,000 per calendar year, increasing to \$50 per statement up to a maximum of \$500,000 per calendar year for statements required to be furnished after December 31, 2015, and for corrections made after 30 days but before August 2 of the calendar year in which the statement must be furnished, the penalty is \$60 per statement up to a maximum of \$500,000 per calendar year, increasing to \$100 per statement up to a maximum of \$1,500,000 per calendar year for statements required to be furnished after December 31, 2015.<sup>1176</sup> For

<sup>1168</sup> §6651(a)(3); Reg. §301.6651-1(a)(3), §301.6651-1(c).

<sup>1169</sup> §6662(c).

<sup>1170</sup> §6664(c)(2), as amended by Pub. L. No. 111-152, §1409(c), applicable to underpayments attributable to transactions entered into after March 30, 2010.

<sup>1171</sup> Rev. Rul. 75-191.

<sup>1172</sup> §6656(b)(2).

<sup>1173</sup> §6656(a).

<sup>1174</sup> See Reg. §301.6656-1.

<sup>1175</sup> §6722(a)(1), as amended by the Small Business Jobs Act (SBJA), Pub. L. No. 111-240, §2102(g), and by the Trade Preferences Extension Act of 2015, Pub. L. No. 114-27, §806(e)(1) (increasing penalty amounts after 2015).

<sup>1176</sup> §6722(b), as amended by SBJA §2102(g), by the Tax Increase Prevention Act of 2014 (TIPA), Pub. L. No. 113-295, Div. A, §207(a)(2), effective as if included in the SBJA provision to which it relates, and by Pub. L. No.

statements required to be furnished in calendar years beginning after 2014, these amounts are subject to annual cost-of-living adjustments.<sup>1177</sup>

Further, the above maximum penalty amounts are reduced for small taxpayers. If the taxpayer's average annual gross receipts for the three prior taxable years does not exceed \$5 million, the maximum annual penalty is reduced from \$1.5 million to \$500,000 for statements required before 2016 and from \$3 million to \$1 million for statements required after 2015; the maximum annual penalty for quick corrections is reduced from \$250,000 to \$75,000 for statements required before 2016 and from \$500,000 to \$175,000 for statements required after 2015; and the maximum penalty for later corrections is reduced to from \$500,000 to \$200,000 for statements required before 2016 and from \$1.5 million to \$500,000 for statements required after 2015.<sup>1178</sup>

Where there is intentional disregard of the requirement to furnish a payee statement (or the inclusion of incomplete or incorrect information on such statements), the penalty is increased to the greater of \$250 (\$500 for statements required after 2015) or 10% of the aggregate amount of the items required to be reported (5% for certain returns). In addition, the maximum limits do not apply.<sup>1179</sup>

An omission or error on a payee statement can be ignored with respect to a de minimis number of payee statements if the failure is corrected on or before August 1 of the calendar year in which the statement is required to be furnished. For any calendar year, this de minimis rule applies only to the greater of (1) 10 statements or (2) 0.5% of the total number of payee statements required to be furnished by the person during the calendar year.<sup>1180</sup> In addition, under a safe harbor available for returns required to be filed after 2016 that contain at least one incorrect dollar amount, a statement is treated as having been furnished with all of the correct required information, and no correction is needed, as long as no single erroneous dollar amount is off by more than \$100 and no single amount reported for tax withheld on the payee statement differs from the correct amount by more than \$25.<sup>1181</sup>

114-27, §806(e)(2), applicable for statements required to be filed (furnished) after December 31, 2015.

<sup>1177</sup> §6722(f)(1), as amended by TIPA, Pub. L. No. 113-295, Div. B, §208(f), effective for statements required to be furnished after December 31, 2014, Pub. L. No. 115-97, §11002(d)(1)(QQ) (reflecting change to §1(f)(3) inflation adjustment formula), applicable to taxable years beginning after December 31, 2017, and Pub. L. No. 115-141, Div. U, §401(a)(299)(G) (corrections to adjustment formula). See Pub. L. No. 115-141, Div. U, §105(a)(1) (correcting effective date of Pub. L. No. 113-295 amendment). Before the TIPA amendment, these amounts were subject to cost-of-living adjustments for each fifth calendar year beginning after 2012. SBJA §2102(g).

<sup>1178</sup> §6722(d), as added by SBJA §2102(g), and amended by Pub. L. No. 114-27, §806(e)(3), applicable for statements required to be filed (furnished) after December 31, 2015.

<sup>1179</sup> §6722(e), as amended by Pub. L. No. 114-27, §806(e)(4), applicable for statements required to be filed (furnished) after December 31, 2015.

<sup>1180</sup> §6722(c), as amended by SBJA §2102(g) and by TIPA, Pub. L. No. 113-295, Div. A, §207(a)(2)–(3), effective as if included in the SBJA provision to which it relates.

<sup>1181</sup> §6722(c)(3), added by Pub. L. No. 114-113, Div. Q, §202(b), applicable to payee statements required to be furnished after December 31, 2016, and amended by Pub. L. No. 115-141, Div. U, §101(f). See Reg. §301.6722-1(d), as amended by T.D. 9984, 88 Fed. Reg. 87,696 (Dec. 19, 2023), applicable with respect to payee statements required to be furnished on or after January 1, 2024; Notice 2017-9 (de minimis error safe harbor applies for inadvertent

## B. Welfare Benefit Fund Limitations

For legal and tax planning purposes, many employers establish employee benefit trusts and use other types of welfare benefit funds for the payment of self-insured employee benefits. Section 419 and §419A were enacted to provide rules for determining the timing and the amount of an employer's deduction for a contribution to a welfare benefit fund and to correct other perceived abuses involving employer-provided welfare benefits.<sup>1182</sup>

### 1. Definition of Welfare Benefit Fund

#### a. Definition of "Fund"

A "fund," for purposes of the welfare benefit fund deduction limits, is defined to include any tax-exempt social club, voluntary employees' beneficiary association ("VEBA"), supplemental unemployment compensation benefit trust ("SUB"); any trust, corporation or other organization not exempt from tax; and, to the extent provided in regulations, any account held for an employer by any person.<sup>1183</sup>

#### b. Definition of "Welfare Benefit"

Section 419(e)(1) defines "welfare benefit fund" as any fund that is part of a plan of an employer through which the employer provides welfare benefits to its employees or beneficiaries. "Welfare benefits" are defined in §419(e)(2) as all benefits except those:

- provided under a qualified retirement-type plan to which §404 or §404A (relating to certain foreign deferred compensation plans) applies; or
- involving a transfer of property in connection with the performance of services that is deductible by an employer under §83(h).

### 2. Deduction Limits

#### a. In General

Section 419 limits deductions for employer contributions paid or accrued with respect to a welfare benefit fund. Employer contributions to a welfare benefit fund are not deductible under §162 (relating to trade or business expenses) or §212 (relating to expenses for production of income).<sup>1184</sup> However, if the requirements of §162 or §212 are otherwise met, employer contributions are deductible under §419 for the taxable year of the employer in which paid to the extent of the welfare benefit fund's "qualified cost" for the taxable year of the fund that relates to such taxable year of the employer.<sup>1185</sup> "Qualified costs" are the fund's direct costs for the taxable year plus certain additions to "qualified asset accounts" for the taxable year within the limits imposed by §419A(b). The qualified cost of a wel-

errors but not for failure to file or furnish statement; requirements set out for payee election to not apply de minimis error safe harbor; superseded with respect to payee statements required to be furnished after 2023).

<sup>1182</sup> See CCA 200931049 (discussing common issues involving the rules under §419 and §419A).

<sup>1183</sup> §419(e)(3).

<sup>1184</sup> §419(a)(1).

<sup>1185</sup> §419(a)(2), §419(b).

fare benefit fund for any taxable year is reduced by the after-tax income of the fund for the taxable year. In determining the gross income of a welfare benefit fund, contributions and other amounts received from employees are taken into account.<sup>1186</sup>

### b. Qualified Direct Cost

A “qualified direct cost” for any taxable year of the fund is the aggregate amount (including administrative expenses) that would have been allowed as a deduction to a cash method taxpayer with respect to benefits provided during the taxable year if the employer had provided the benefits directly on a current basis.<sup>1187</sup> For purposes of determining the qualified direct cost, a benefit is treated as provided when the benefit would be includible in the employee’s gross income (or would be includible in the employee’s gross income but for a provision of the I.R.C.).<sup>1188</sup>

*Example:* If an employer contributes to a fund to pay insurance premiums, the qualified direct cost for the year would be determined on the basis of the cost of the insurance for the period for which the coverage is provided, without regard to whether any part of that cost is excludible from the gross income of an employee. On the other hand, if the liability is self-insured, the time at which benefits would be includible would be based on the time at which benefits are paid, because this is the time when benefits would be included if they were provided directly by the employer.<sup>1189</sup>

### 3. Qualified Asset Account

#### a. General Limits

Additions to a “qualified asset account” are permitted only where a welfare benefit fund self-funds a reserve set aside to pay specified employee benefits: disability benefits, medical benefits, supplemental unemployment benefits, severance pay benefits or life insurance benefits.<sup>1190</sup> However, no addition to a “qualified asset account” (reserve) is deductible to the extent that such addition results in the amount in the “qualified asset account” exceeding the so-called “account limit.”<sup>1191</sup>

<sup>1186</sup> §419(c)(2), §419(c)(4).

<sup>1187</sup> §419(c)(3); Reg. §1.419-1T, Q&A-6. See Rev. Rul. 2007-65, in which the IRS ruled that, in determining the deduction limitation for employer contributions to a welfare benefit fund, qualified direct cost excludes premiums paid on cash value life insurance if the fund is a beneficiary but includes welfare benefits (other than life insurance) paid for claims incurred that year. Simultaneously with Rev. Rul. 2007-65, the IRS issued Notice 2007-83, stating that certain trust arrangements claiming to be §419(e)(3) welfare benefit funds involving cash value life insurance policies and promoted or used to improperly claim federal income and employment tax benefits are considered listed transactions for purposes of Reg. §1.6011-4(b)(2) and §6111 and §6112. The Sixth Circuit has set aside Notice 2007-83 for failure to comply with Administrative Procedure Act requirements. *Mann Constr., Inc. v. United States*, 27 F.4th 1138 (6th Cir. 2022). For further discussion of these rulings, see 371 T.M., *Employee Plans — Deductions, Contributions, and Funding*.

<sup>1188</sup> §419(c)(3)(B).

<sup>1189</sup> H.R. Rep. No. 432 (Part 2), 98th Cong., 2d Sess. (1984).

<sup>1190</sup> §419A(a).

<sup>1191</sup> §419A(b). A primary thrust of the welfare fund provisions is to limit accelerated additions to such an account. Before the 1984 TRA, accelerated deductions resulted from basing the deduction on an obligation to fund a plan in the aggregate rather than on an obligation to pay specific benefits. Congress en-

The allowable reserve (or “account limit”) includes amounts for claims estimated to have been incurred but which have not yet been reported as of the close of the fund’s taxable year, as well as claims that have been reported but have not yet been paid. The reserve also includes the administrative expenses with respect to such claims.<sup>1192</sup>

A plan maintained by a bona fide association is permitted to accumulate additional reserves for medical benefits (other than post-retirement medical benefits). The account limit for such plans is up to 35% of annual costs, which include qualified direct costs and the change in claims incurred, but unpaid for such taxable year for medical benefits.<sup>1193</sup> A bona fide association is defined as an association that: has been actively in existence for five or more years; has been formed and maintained in good faith for purposes other than obtaining insurance; does not condition membership on any health status-related factor relating to an individual; makes the health insurance coverage it offers available to all members regardless of any health status-related factor relating to such members (or individuals eligible for coverage through a member); offers the health insurance coverage only in connection with a member of the association; and meets any additional state law requirements.<sup>1194</sup>

An example of an incurred but unpaid claim is the death of an employer under a plan that provides for payment to a survivor of the employee for the survivor’s remaining life. The qualified asset account may include the estimated present value of the future stream of benefits payable to the survivor, using reasonable assumptions as to earnings of the fund and mortality experience.<sup>1195</sup>

#### b. Special Limits for SUB Plans

Section 419A permits reserves up to specified safe harbor limits and permits higher reserves in certain instances provided the employer does not exceed the statutory limits and obtains actuarial certification.<sup>1196</sup> In addition to the general rule for permissible reserve accounts, §419A provides special rules for specific types of benefits.

If the welfare benefit fund provides SUB or severance pay benefits, the account limit is 75% of the average annual qualified direct costs of such benefits for any two of the immediately preceding seven taxable years plus the average annual administrative costs for the relevant two years allocable to SUB or severance pay benefits.<sup>1197</sup> The SUB or severance pay benefit payable to any individual that may be taken into account for this purpose may not exceed an amount that is payable at an

acted the §419A limitations to ensure that no more than the amount actuarially estimated to be necessary is used to fund the plan’s liabilities for the incurred but unpaid benefit claims (as of the close of the taxable year) and for related administrative costs. The (Pub. L. No. 98-369) 1984 Act Conference Report states that claims are incurred only when an event entitling the employee to benefits, such as a medical expense, a separation, a disability or a death, actually occurs. Conf. Rep. at 1156.

<sup>1192</sup> §419A(c)(1).

<sup>1193</sup> §419A(c)(6), added by Pub. L. No. 109-280, §843, effective for taxable years beginning after December 31, 2006.

<sup>1194</sup> See §419A(c)(6)(B) (referencing Public Health Service Act, §2791(d)(3)), 42 U.S.C. §300gg-91(d)(3)).

<sup>1195</sup> Conf. Rep. at 1156.

<sup>1196</sup> §419A(c)(5).

<sup>1197</sup> §419A(c)(3).

annual rate of 150% of the §415(c)(1)(A) defined contribution plan dollar limit.<sup>1198</sup>

Unless there is an actuarial certification of the account limit for any taxable year, the account limit for the year may not be more than the sum of the various safe harbor limits for the different types of benefits in any such year.<sup>1199</sup> For SUB or severance pay benefits, the safe harbor is the same as the amount otherwise permitted to be taken into account (i.e., 75% of the average annual qualified direct costs for such benefits for any two of the immediately preceding seven taxable years).<sup>1200</sup>

*Comment:* These safe harbor limits may not provide a complete safety net. The 1984 Act Conference Report states that, even if the safe harbor limits are satisfied, the taxpayer must show that the reserves are reasonable under the facts of the particular case. Therefore, actuarial input may nevertheless be required.<sup>1201</sup> Further, the §419A(c)(5)(B) “safe harbor limit” is not a true “safe harbor” in the conventional sense of that term in the tax law. According to the IRS, §419A(c)(5) does not give a taxpayer a safe harbor in the form of an alternative standard for determining the account limit that entitles the taxpayer to bypass the general limit applicable to each class of benefits. Instead, the safe harbor is solely an upper limit on the amount that an employer may contribute to a welfare benefit fund and deduct as a reserve for benefits without actuarial certification. To support a deduction, the taxpayer must also show that the amount claimed is within the general limit for benefits under either: (1) §419A(c)(1) because the amount claimed is reasonably and actuarially necessary to pay the incurred but unpaid claims; or (2) for post-retirement medical and life insurance benefits, §419A(c)(2), because the amount claimed is contributed to a reserve for post-retirement medical or life insurance benefits that is being funded on a level basis over the working lives of the covered employees.<sup>1202</sup>

Effective for taxable years beginning after December 31, 2006, a plan maintained by a bona fide association to accumulate reserves of up to 35% of annual costs for medical benefits (other than post-retirement medical benefits).<sup>1203</sup> These costs are qualified direct costs and the change in claims incurred, but unpaid for such taxable year for medical benefits. A bona fide association is defined by reference to Public Health Service Act §2791(d)(3), 42 U.S.C. §300gg-91(d)(3), as an association that: has been actively in existence for five or more years; has been formed and maintained in good faith for purposes other than obtaining insurance; does not condition membership on any health status-related factor relating to an individual; makes

the health insurance coverage it offers available to all members regardless of any health status-related factor relating to such members (or individuals eligible for coverage through a member); offers the health insurance coverage only in connection with a member of the association; and meets any additional state law requirements.<sup>1204</sup>

#### 4. Collectively Bargained Plans

Collectively bargained welfare benefit funds are exempt from the account limits imposed by §419A.<sup>1205</sup>

The determination of whether a welfare benefit fund is maintained pursuant to a collective bargaining agreement is made under the factors set forth in §7701(a)(46) and Reg. §1.419A-2T, Q&A-2. Note that the regulation requires the benefits provided under a collective bargained plan to have been the subject of genuine bargaining but does not require the funding mechanism to have been the subject of such arms-length bargaining.<sup>1206</sup>

In an effort to shut down tax shelters established through “sham” labor negotiations that take advantage of §419A(f)(5), the IRS issued Notice 2003-24. The IRS explained that Reg. §1.419A-2T, Q&A-2, requires that benefits provided through the funds be the subject of arm’s-length bargaining and that the circumstances surrounding the bargaining agreement evidence good faith bargaining. Section 7701(a)(46) requires that a collective bargaining agreement be a bona fide agreement between bona fide employee representatives and one or more employees. The IRS found that the sham arrangements generally do not satisfy these requirements, and it will not allow deductions if the welfare benefit fund is not set up as a result of good faith bargaining. Further, an employer’s deduction for contributions will be subject to the limits of §419 and §419A if it is not a separate welfare benefit fund under the collective bargaining agreement. Future guidance is expected to address the separate funding requirement. Notice 2003-24 also designated certain arrangements that purportedly qualify as collectively bargained welfare benefit funds excepted from the account limits of §419 and §419A as “listed transactions” under Reg. §1.6011-4(b)(2), §301.6111-2(b)(2), and §301.6112-1(b)(2) for tax shelter purposes.<sup>1207</sup>

<sup>1204</sup> See §419A(c)(6)(B), referencing Public Health Service Act, §2791(d)(3), 42 U.S.C. §300gg-91(d)(3).

<sup>1205</sup> §419A(f)(5). See *Parker-Hannifin Corp. v. Commissioner*, 139 F.3d 1090 (6th Cir. 1998) (§419A(f)(5) requires maintenance of separate welfare benefit fund for collectively bargained employees that is distinct and apart from any funds provided for non-collectively bargained employees, i.e., not simply separate from employer and its creditors, but separate from any welfare benefit funds maintained for employer’s nonunion employees).

<sup>1206</sup> See TAM 9215002.

<sup>1207</sup> Reg. §1.6011-4(b)(2) and §301.6112-1(b)(2) were modified by T.D. 9350, 72 Fed. Reg. 43,146 (Aug. 3, 2007), and T.D. 9352, 72 Fed. Reg. 43,154 (Aug. 3, 2007), respectively. See Reg. §1.6011-4(h) and §301.6112-1(g), respectively, for effective dates. See also Notice 2009-59 (enumerating listed transactions). In T.D. 9556, 76 Fed. Reg. 70,340 (Nov. 14, 2011), the IRS issued final regulations providing rules for purposes of the generation-skipping transfer tax that require the disclosure of listed transactions and transactions of interest by certain taxpayers under §6011, including final regulations that modify and clarify some of the above rules relating to the disclosure obligations of material advisors under §6111 and the list maintenance requirements of material advisors with respect to reportable transactions under §6112.

<sup>1198</sup> §419A(c)(4)(B).

<sup>1199</sup> §419A(c)(5).

<sup>1200</sup> §419A(c)(5)(B)(iii).

<sup>1201</sup> Conf. Rep. at 1158. See Pub. L. No. 98-369.

<sup>1202</sup> CCA 201040018; TAM 9334002. See also *General Signal Corp. v. Commissioner*, 103 T.C. 216 (1994), *aff’d*, 142 F.3d 546 (2d Cir. 1998), where the Tax Court held that the employer was not permitted to use the §419A(c)(5)(B)(ii) safe harbor in computing the addition to its account limit for incurred but unpaid medical claims. The court explained that the safe harbor is not automatic but merely allows a taxpayer to claim amounts without obtaining actuarial certification. The court reached the same conclusion in *Square D Co. v. Commissioner*, 109 T.C. 200 (1997).

<sup>1203</sup> §419A(c)(6), added by Pub. L. No. 109-280, §843.

### 5. 10 or More Employer Plans

Plans to which 10 or more-employers contribute and no one employer contributes more than 10% of the total contributions are exempt from the limitations of §419 and §419A, provided the plan does not maintain any experience-rating arrangement for individual employers.<sup>1208</sup> This exception is grounded on the proposition that an employer's relationship to such a welfare benefit fund is similar to the relationship between an insured and an insurer.<sup>1209</sup>

The IRS issued final regulations that provide additional guidance on 10-or-more-employer plans under §419A(f)(6). Under the regulations, a plan is a 10-or-more-employer plan only if it is a single plan:

- to which more than one employer contributes;
- to which no employer normally contributes more than 10% of the total contributions contributed under the plan by all employers;
- that does not maintain an experience-rating arrangement with respect to any individual employer; and
- is maintained pursuant to a written document that requires the plan administrator to maintain records sufficient for the IRS or any participating employer to readily verify that the plan satisfies the I.R.C. and regulatory requirements and that provides the IRS and each participating employer (or a person acting on the participating employer's behalf) with the right, upon written request to the plan administrator, to inspect and copy all such records.<sup>1210</sup>

Under the regulations, a plan maintains an experience-rating arrangement with respect to an employer if the employer's cost of coverage for any period is based, in whole or in part, either on the benefits experience or on the overall experience (or on any proxy for the benefits experience or overall experience) of that employer or one or more employees of that employer. The prohibition against experience rating with respect to individual employers applies under all circumstances, including employer withdrawals and plan terminations.<sup>1211</sup>

The regulations also identify the following five characteristics that are indications that an employer's interest with respect to the plan is more similar to the relationship of an individual employer to a fund than an insured to an insurer, thus indicating that a plan is not a 10-or-more-employer plan:

- the assets of the plan are allocated among the participating employers through a separate accounting of contributions and expenditures for individual employers or otherwise;
- amounts charged under the plan differ among the employers in a manner that is not reflective of differences in risk or rating factors that are commonly taken into account in manual rates used by insurers (such as age, gender, dependents covered, geographic locale, or the benefit package);

- the plan does not provide for fixed welfare benefits for a fixed coverage period for a fixed price;
- the plan charges the participating employers an unreasonably high amount for the covered risk; and
- the plan provides for payment of benefits upon triggering events other than the illness, personal injury, or death of an employee or family member, or the employee's involuntary termination of employment.<sup>1212</sup>

<sup>1212</sup> Reg. §1.419A(f)(6)-1(c). The presence of any of these characteristics generally indicates that the plan is not a 10-or-more-employer plan described in §419A(f)(6). Unless established to the satisfaction of the IRS that the plan satisfies the requirements of §419A(f)(6) and the regulations, a plan having any of these characteristics is not a 10-or-more-employer plan described in §419A(f)(6). However, a plan's lack of all these characteristics does not create any inference that the plan is a 10-or-more-employer plan. See also *Booth v. Commissioner*, 108 T.C. 524 (1997) (trust was a §419 welfare benefit plan but did not qualify for the 10-or-more-employer plan exception under §419A(f)(6)); *Neonatology Associates P.A. v. Commissioner*, 115 T.C. 43 (2000), *aff'd*, 299 F.3d 221 (3d Cir. 2002). See also *V.R. DeAngelis M.D.P.C. & R.T. Domingo M.D.P.C. v. Commissioner*, T.C. Memo 2007-360, in which the Tax Court disallowed deductions under §162(a) for payments to a purported 10-or-more-employer plan that purchased whole life insurance for doctors. The case involved a partnership (P) that had as its partners S corporations (S) that were professional corporations, each of which was solely owned by one of four doctors. Citing *Neonatology Associates*, the court indicated that the plan was nothing more than a subterfuge through which the doctors, through P, used S's surplus cash to purchase cash-laden whole life insurance policies primarily for the personal benefit of the doctors. According to the court, the use of whole life insurance policies and the direct interactions between the participating doctors and the plan representatives supported a finding that the doctors fully expected to get their promised benefits and that no one connected with the life insurance transaction thought that receipt of those benefits rested on any unexpected or contingent event. The court further found that the payment of the premiums by S was a distribution to the doctors of corporate profits instead of a payment that S made to the doctors with a compensatory intent. Citing §1367 and §1368, the court explained that the disallowance of the deductions claimed by S had the effect of increasing pro tanto S's net income, with corresponding increases to the doctors' distributive shares of that income, and concluded that the payments of the premiums would not be taxed to the doctors twice. The Tax Court reached the same result under facts similar to those in *DeAngelis in Curcio v. Commissioner*, T.C. Memo 2010-115, in which the court concluded that the contributions were more properly viewed as constructive dividends to the taxpayers. According to the court in *Curcio*, not only did the taxpayers act as though they personally owned the underlying insurance policies, but the plan itself promoted the implication that it was merely a conduit to the underlying policies and not the actual insurer. The level of control that covered employees exerted over their underlying policies, the degree to which contributions were structured around those underlying policies, and the means through which covered employees could procure a distribution of those underlying policies led the court to conclude that the plan was a thinly disguised vehicle for unlimited tax-deductible investments. In *Goyak v. Commissioner*, T.C. Memo 2012-13, the court held that, because of the access which plan participants had to plan assets, a contribution to a purported §419A(f)(6) plan for life insurance benefits was not an ordinary and necessary business expense deductible by the employer under §162(a), but rather, was a constructive dividend payable to the insured employee under §301 and taxable as ordinary income to him. Although plan participants were permitted to void their transactions, which resulted in the policy being distributed to either the employer or the insured employee with no adjustment to the cash value of the policy, the court found that, while the plan had policies in place to limit the voiding of transactions to certain limited situations, there was ample evidence that the plan regularly breached its internal controls. In *Cadwell v. Commissioner*, 136 T.C. 38 (2011), *aff'd by unpub. op.*, 483 Fed. Appx. 847 (4th Cir. 2012), the taxpayer was the secretary for a corporation that was 100% owned by his spouse. The couple adopted a welfare benefit plan through a third-party plan administrator to obtain employee benefits for the family. The Tax Court held, and the Fourth Circuit affirmed, that the cash value of the life insurance policy under the plan and the excess plan contribution must be included in income in the year the multiemployer welfare benefit plan converted to a single employer, non-tax exempt plan, reasoning that, following the conversion of the plan, the taxpayer's interest in the

<sup>1208</sup> §419A(f)(6).

<sup>1209</sup> 1984 TRA Conference Report at p. 1159.

<sup>1210</sup> Reg. §1.419A(f)(6)-1(a)(1).

<sup>1211</sup> Reg. §1.419A(f)(6)-1(b)(1).

## 6. Aggregation of Welfare Benefit Funds

If an employer maintains two or more welfare benefit funds, all such welfare benefit funds must be aggregated in applying:

- the account limits on disability, SUB and severance pay benefits of §419A(c)(4);
- the §415 annual addition treatment accorded individual medical benefit accounts of key employees under §419A(d)(2); and
- the special \$50,000 limit on the amount of life insurance benefits that may be taken into account in computing the additional reserve for post-retirement life insurance benefits under §419A(e)(2).<sup>1213</sup>

An employer also may voluntarily aggregate two or more welfare benefit funds for purposes other than the provisions that are subject to mandatory aggregation.<sup>1214</sup> Although there is no explicit tie-in between §419A (account limits rules) and §505 (nondiscrimination rules), the 1984 Act Conference Report indicates that the election to aggregate must be consistent for deduction and discrimination purposes. For example, if an employer elects to aggregate two plans for deduction purposes, those plans must also be aggregated when testing for discrimination.<sup>1215</sup>

## 7. Carryover of Excess Contributions

Amounts that exceed a fund's qualified cost for the taxable year are treated as paid by the employer to the welfare benefit fund during a succeeding taxable year.<sup>1216</sup> Thus, there is automatic attribution of any excess to a succeeding year.

## 8. Unrelated Business Income

A VEBA or a SUB is taxed on its unrelated business taxable income under §512(a)(3). Section 512(a)(3) provides a complex set of rules for the calculation of the unrelated income of a VEBA or SUB. For taxable years beginning on or after December 10, 2019, the unrelated business taxable income of the taxable year of such a fund is determined as set forth under Reg. §1.512(a)-5.<sup>1217</sup> Under the regulation, the definition of a covered entity, nonrecognition of gain on property sales of VEBAs and SUBS, and the limitations on set aside amounts

plan was substantially vested because the amounts were no longer available to other employers sponsoring the plan. In addition, as the sole officer of the corporation funding the plan, the taxpayer controlled his own eligibility under the plan and whether to terminate the plan and distribute assets. The court did not address whether the pre-conversion plan qualified under §419A(f)(6). See also PLR 201017076 (multiple employer welfare benefit plan that used specified portion of aggregate cash value of life insurance policies to calculate employer's contribution fails to qualify as 10-or-more-employer plan and is listed transaction because it maintains experience-rating arrangements with respect to individual employers).

<sup>1213</sup> §419A(h)(1)(A). Aggregation has no effect on the dollar amounts involved when the affected benefit is not offered by both plans. Also, the required aggregation in determining the §419A(d)(2) amount does not affect the amount deductible under §419 by the employer of the key employee. PLR 9410017.

<sup>1214</sup> §419A(h)(1)(B).

<sup>1215</sup> Conf. Rep. at 1159.

<sup>1216</sup> §419(d).

<sup>1217</sup> See T.D. 9886, 84 Fed. Reg. 67,370 (Dec. 10, 2019), effective December 10, 2019 (modifying covered entity definition and adding clause regarding nonrecognition of gain for VEBAs and SUBS).

for exempt purposes are revised. Covered entities<sup>1218</sup> subject to the UBTI computation rules under §512(a)(3) also include title holding corporations under §501(c)(2) with income payable to a VEBA under §501(c)(9) or a §501(c)(17) SUB with which it files a consolidated return for the taxable year of the exempt function income.<sup>1219</sup>

Under Reg. §1.512(a)-5, when a covered entity sells a property used exclusively in the performance of its exempt function and purchases a new property, any gain is recognized only to the extent the sales price of the old property exceeds the covered entity's purchase cost for the new property, where:

(1) the new property is also used exclusively in the performance of the entity's exempt purpose; and

(2) purchase of the new property takes place within the four year period spanning from the date 1 year prior to, and 3 years after, the date of sale of the old property. This formula applies for the 4-year period beginning from one year prior to the property sale through 3 years after the date of the sale. All income except exempt function income is used to determine the unrelated business income tax VEBA and SUBS.

Investment income set aside by a covered entity may qualify as nontaxable exempt function income only to the extent the income exceeds the modified §419A account limit.<sup>1220</sup>

Under the regulations that applied for taxable years beginning prior to December 10, 2019, the unrelated business taxable income of the taxable year of such a fund generally equaled the lesser of two amounts:

- the income of the fund excluding employee and employer contributions,<sup>1221</sup> or

- the excess of the total amount set aside as of the close of the taxable year (including employee and employer contributions and excluding certain assets with a useful life extending substantially beyond the end of the taxable year to the extent they are used in the provision of welfare benefits) over the account limit (calculated without regard to

<sup>1218</sup> For purposes of Reg. §1.512(a)-5, covered entities under §512(a)(3) include VEBAs and SUBS, but not §501(c)(7) organizations (social clubs).

<sup>1219</sup> A §501(c)(2) title holding organization is deemed to have exempt function income only when it files a consolidated return with the VEBA or SUB to which it owes income.

<sup>1220</sup> §512(a)(3)(E)(i); Reg. §1.512(a)-5(c)(2). The investment activity of VEBAs and SUBS is treated as an unrelated trade or business for purposes of the rule under §512(a)(6) for organizations with more than one unrelated trade or business. UBTI from the investment activities of a VEBA or SUB includes any amount that is attributable to income set aside (and not in excess of the set aside limit described in §512(a)(3)(E)), but not used, for a purpose described in §512(a)(3)(B)(i) (a contribution or gift under §170(c)(4)) or §512(a)(3)(B)(ii) (to provide for the payment of life, sick, accident, or other benefits) and also includes any amount in excess of the set aside limit. Reg. §1.512(a)-6(a), §1.512(a)-6(c)(7), added by T.D. 9933, 85 Fed. Reg. 77,952 (Dec. 2, 2020). See 462 T.M., *Tax-Exempt Organizations — Unrelated Business Income Tax (Sections 511, 512, and 513)* (Estates, Gifts and Trusts Series), for a discussion of unrelated business taxable income for organizations with more than one trade or business.

<sup>1221</sup> Former Reg. §1.512(a)-5T, Q&A-3(b), as amended at 73 Fed. Reg. 59,501 (Oct. 9, 2008) and Announcement 2008-99. For this purpose, income includes gain realized on the sale of any asset. Former Reg. §1.512(a)-5T, Q&A-3(c), removed by T.D. 9886, 84 Fed. Reg. 67,370 (Dec. 10, 2019).

the otherwise permitted reserve for postretirement medical benefits).<sup>1222</sup>

*Note:* A law that was repealed retroactively included in unrelated business taxable income any expenses paid or incurred after 2017 that are not deductible under §274 and are paid or incurred for qualified transportation fringe benefits, a parking facility used in connection with qualified parking, or any on-premises athletic facility. The increase did not apply, however, to the extent the amount paid or incurred was directly connected with an unrelated trade or business which is regularly carried on by the organization.<sup>1223</sup> The IRS provided guidance on its website for claiming a refund or credit of the UBIT reported on Form 990-T for 2017 or 2018 under this repealed law.<sup>1224</sup>

The rules described above for calculating the unrelated business taxable income of a fund do not apply where substantially all of the contributions to the VEBA or SUB are made by employers that are tax-exempt throughout the 5-taxable-year period ending with the taxable year in which the contributions are made.<sup>1225</sup> The limit on the set-aside, however, does apply to 10-or-more-employer VEBAs and SUBs that are otherwise exempt from the deduction limitations.<sup>1226</sup>

*Example:* If a SUB were established for teachers, and substantially all contributions to the SUB were made by tax-exempt school districts employing teachers, the unrelated business income limitation would not apply to the SUB and there would be no restriction on the amount of set-aside other than the requirement that the set-aside be used to provide permissible benefits.

For a further discussion of the welfare benefit fund rules, see 395 T.M., *VEBAs and Other Welfare Benefit Funding Arrangements*.

## C. ERISA Requirements

### 1. Application to Welfare Benefit Plans

The Employee Retirement Income Security Act of 1974 (“ERISA”)<sup>1227</sup> not only applies to retirement plans but also certain “employee welfare benefit plans.” Such plans include any plan, fund or program established by an employer or employee organization to provide for its participants or their beneficiaries through the purchase of insurance or otherwise: medical benefits; benefits in the event of sickness, accident, disability, death

or unemployment; vacation benefits; apprenticeship or other training programs; day care centers; scholarship funds; or pre-paid legal services.<sup>1228</sup> Therefore, ERISA applies explicitly to supplemental unemployment benefit plans discussed in IV.B.2. ERISA apparently does not apply to unfunded plans such as educational assistance programs discussed in III.A., and reimbursement-type dependent care assistance programs discussed in III.B.,<sup>1229</sup> or to unfunded incidental benefit plans or arrangements within the scope of §132.

### 2. Reporting and Disclosure

In Notice 90-24, the IRS suspended the annual return requirement (Schedule F of Form 5500) for employers maintaining fringe benefit plans under §79, §105, and §106, or §129. In Notice 2002-24,<sup>1230</sup> which modifies and supersedes Notice 90-24, the IRS suspended the annual return requirement for employers maintaining fringe benefit plans under §125, §127, or §137. As a result, the IRS modified Form 5500 and removed Schedule F for fringe benefit plans for 2002 and thereafter.

Because supplemental unemployment benefit plans are deemed employee welfare benefit plans covered by ERISA, such plans must submit an annual report on Form 5500 to the IRS within seven months after the end of the plan or trust year.

Each participant of a SUB plan who receives benefits thereunder must receive a Summary Annual Report within nine months after the end of the plan year in which he or she receives the benefit.<sup>1231</sup> The report must contain information regarding the amounts paid under the plan during the year.<sup>1232</sup>

A summary plan description (SPD) must also be submitted to a participant of a SUB plan describing the plan in plain English within 90 days of the date he or she becomes a participant or within 120 days after the plan’s establishment, if later.<sup>1233</sup> Plan administrators must provide such document to the government only on request.

There are serious penalties for noncompliance with the above reporting requirements that may result in imprisonment for up to one year and fines up to \$100,000 for willful violations.<sup>1234</sup> Plan administrators are subject to a civil penalty of up to \$1,000 per day (as adjusted for inflation) for a failure to file an annual report on Form 5500.<sup>1235</sup> In addition, a civil penalty

<sup>1228</sup> ERISA §3(1).

<sup>1229</sup> The DOL has opined that a §129 dependent care assistance program that reimburses participants for expenses and does not provide a specific day care center is not a welfare benefit plan under ERISA. DOL Adv. Op. 93-25A, DOL Adv. Op. 91-25A, DOL Adv. Op. 88-01A. However, an employer may have created a welfare benefit plan if it provides a day care center on its premises.

<sup>1230</sup> Effective April 22, 2002, and applicable to all plan years for which information returns had not been filed.

<sup>1231</sup> 29 C.F.R. §2520.104b-10.

<sup>1232</sup> 29 C.F.R. §2520.104b-10.

<sup>1233</sup> 29 C.F.R. §2520.104b-2, 29 C.F.R. §2520.102-2, §2520.102-3, and §2520.102-4 prescribe the format and contents of the SPD.

<sup>1234</sup> ERISA §501.

<sup>1235</sup> ERISA §502(c)(2); 29 C.F.R. §2560.502c-2, §2575.3. For a table of the current and prior DOL penalties imposed on an ERISA plan, see the Worksheets of 361 T.M., *Reporting and Disclosure Under ERISA*. To encourage delinquent filers to come into compliance with their annual reporting obligations under ERISA, the DOL maintains the Delinquent Filer Voluntary Compliance Program (DFVC). The program allows delinquent plans to file a complete report(s), pay a pre-set penalty, and bring the plan into compliance. See DOL Delinquent Filer Voluntary Compliance Program, RIN 1210-ZA15, 78

<sup>1222</sup> Former Reg. §1.512(a)-5T, Q&A-3(b), as amended at 73 Fed. Reg. 59,501 (Oct. 9, 2008) and Announcement 2008-99, removed by T.D. 9886, 84 Fed. Reg. 67,370 (Dec. 10, 2019).

<sup>1223</sup> Former §512(a)(7), added by Pub. L. No. 115-97, §13703, effective for amounts paid or incurred after December 31, 2017, and repealed by Pub. L. No. 116-94, Div. Q, §302 (enacted December 20, 2019), effective as if included in the amendments made by Pub. L. No. 115-97, §13703. Any amount included under this law was not subject to §512(a)(6) (special rule for organization with more than one trade or business) because the provision of qualified transportation fringe benefits is not an unrelated trade or business. Notice 2018-67, §8.02.

<sup>1224</sup> *How To Claim a Refund or Credit of Unrelated Business Income Tax (UBIT) or adjust Form 990-T for Qualified Transportation Fringe Amounts*, IRS, <https://www.irs.gov/forms-pubs/how-to-claim-a-refund-or-credit-of-unrelated-business-income-tax-ubit-or-adjust-form-990-t-for-qualified-transportation-fringe-amounts>.

<sup>1225</sup> §512(a)(3)(E)(iii).

<sup>1226</sup> §512(a)(3)(E)(i).

<sup>1227</sup> Pub. L. No. 93-406.

of up to \$110 a day may be imposed for unreasonable failure to furnish plan disclosure documents requested by a participant within 30 days of the request.<sup>1236</sup>

The IRS provides administrative relief from late filing penalties imposed under the tax Code for filers who meet the requirements of the Delinquent Filer Voluntary Compliance Program (DFVC) program. The plan administrator obtains relief by satisfying all requirements of the DFVC program, including payment of the applicable penalties, and filing with the IRS by mail any required Form 8955-SA by the later of 30 days after the filer completes the DFVC filing or December 31, 2014. Both the requirements must be satisfied for all DFVC filings submitted after 2009 (that is, those submitted through EFAST2). Thus, plan administrators that have not satisfied both requirements must file the paper Form 8955-SA with the IRS. The IRS coordinates with the DOL in determining which filers are eligible for relief. No separate IRS application for relief is required. Relief is available only to the extent that a Form 5500 is required under Title I of ERISA. Thus, because Form 5500-EZ filers are not subject to Title I, they are not eligible to participate in the DFVC program.<sup>1237</sup>

For a further discussion of ERISA reporting requirements, see 361 T.M., *Reporting and Disclosure Under ERISA*.

### 3. Fiduciary Standards

Any employer maintaining a SUB plan and any other person having control over the operation or assets of such a plan is a fiduciary<sup>1238</sup> and must perform his or her duties pursuant to the standard described in ERISA §404(a). A fiduciary must discharge his or her duties with respect to the plan for the exclusive purpose of providing benefits to participants and their beneficiaries, with care, skill, prudence and diligence and in accordance with plan documents. Abrogation of these duties may result in statutory liability for resulting losses, despite exculpatory plan language.<sup>1239</sup>

A fiduciary may not engage in a “prohibited transaction” involving the sale, loan or purchase of assets between a SUB plan and a party-in-interest. Parties-in-interest include the plan sponsor and participants.<sup>1240</sup> An excise tax of 5% of the amount involved in the prohibited transaction may be imposed. The tax

increases to 100% if the transaction is not corrected within a 90-day statutory correction period.<sup>1241</sup>

Every fiduciary, other than a bank, who has the right to affect the investment or disposition of the assets of a SUB plan must be bonded in the amount of 10% of the plan assets, subject to a minimum bond of \$1,000 and a maximum of \$500,000.<sup>1242</sup> In the case of a plan that holds employer securities (within the meaning of ERISA §407(d)(1)), the maximum bond amount is \$1,000,000 instead of \$500,000.<sup>1243</sup> However, no bond is required of any entity that is registered as a broker or a dealer under §15(b) of the Securities Exchange Act of 1934 (15 U.S.C. §78o(b)) if the broker or dealer is subject to the fidelity bond requirements of a self-regulatory organization (within the meaning of §3(a)(26) of the 1934 Act (15 U.S.C. §78c(a)(26))).<sup>1244</sup> The plan should be named as the insured with respect to the bond.<sup>1245</sup>

### 4. Plan Requirements

Every SUB plan must be in writing. This is required by ERISA<sup>1246</sup> as well as by §501(c)(17).<sup>1247</sup> The plan must name a fiduciary that is responsible for administering the plan.<sup>1248</sup> If the plan is funded, plan assets must be held in trust for the benefit of participants and their beneficiaries.<sup>1249</sup>

Under ERISA §503, every participant in a SUB plan must be afforded a procedure for adjudicating claims. Generally, a participant must be given written notice of a denial of claimed benefits and must have the right to appeal any denial.<sup>1250</sup>

### 5. Preemption of State Law

ERISA §514 generally overrides all state laws as they apply to SUB plans, with the exception of state laws governing insurance, banking or securities, and criminal laws of general application.

<sup>1241</sup> ERISA §502(i). See §4975.

<sup>1242</sup> ERISA §412. See also DOL FAB 2008-04.

<sup>1243</sup> ERISA §412(a)(2), as amended by Pub. L. No. 109-280, §622(a). See DOL FAB 2008-04, Q&As-35, -38.

<sup>1244</sup> See DOL FAB 2008-04, Q&A-15.

<sup>1245</sup> 29 C.F.R. §2580.412-18.

<sup>1246</sup> ERISA §402(a)(1). Note further that under ERISA §402(b), such plans must contain: (1) a procedure for establishing and carrying out a funding policy and method; (2) a description of any procedure under the plan for allocating responsibilities for the operation and administration of the plan; (3) a procedure for amending the plan and for identifying who has the authority to amend the plan; and (4) the basis on which payments are to be made to and from the plan. See also *Curtiss-Wright Corp. v. Schoonejongen*, 115 S. Ct. 1223 (1995); *compare Ackerman v. Warnaco, Inc.*, 55 F.3d 117 (3d Cir. 1995) with *Aldridge v. Lily-Tulip, Inc. Salary Retirement Plan Benefits Comm.*, 40 F.3d 1202 (11th Cir. 1994) (each dealing with the amendment procedure requirement).

<sup>1247</sup> See discussion at IV.B.2.c.(2).

<sup>1248</sup> ERISA §402(a)(1).

<sup>1249</sup> ERISA §403(a).

<sup>1250</sup> 29 C.F.R. §2560.503-1.

Fed. Reg. 6135 (Jan. 29, 2013), updating and restating RIN 1210-AA86, 67 Fed. Reg. 15,051 (Mar. 28, 2002). Thus, Form 5500-EZ filers and Form 5500 filers for plans without employees as described in 29 C.F.R. §2510.3-3(b), are not subject to Title I, and thus are not eligible to participate in the DFVC program.

<sup>1236</sup> ERISA §502(c)(1); 29 C.F.R. §2575.502c-1.

<sup>1237</sup> Notice 2014-35, *superseding* Notice 2002-23.

<sup>1238</sup> ERISA §3(21)(A).

<sup>1239</sup> ERISA §404(a), §405.

<sup>1240</sup> ERISA §3(14), §406.



## VI. “Separate Line of Business” for Employee Benefit Plan Purposes

### A. Introduction

While the nondiscrimination provisions applicable to qualified retirement plans and welfare benefit plans generally continue to require the aggregation of employees of controlled groups, affiliated groups or businesses under common control, §414(r) permits an employer to satisfy §129(d)(8), §401(a)(26), and §410(b) on a “separate line of business” basis if certain requirements are met. The line of business rule primarily is a tool to ease the burdens of compliance with the nondiscrimination rules, a task that is especially onerous for conglomerates with holdings in industries with varying benefit practices and businesses that have grown through acquisitions but preserved the acquired enterprises’ benefit structures.

Regulations under §414(r), referred to as the “QSLOB” regulations, set forth, among other things, the rules for determining whether a separate line of business is a “qualified” separate line of business (QSLOB). Pursuant to Reg. §1.414(r)-1(b)(2), a line of business is a qualified separate line of business if: (a) it is a line of business as identified by the property or services provided by the employer; (b) it is separate from other lines of business of the employer; and (c) it meets the three statutory threshold requirements of §414(r)(2). The process that an employer must follow in determining its qualified separate lines of business is illustrated in a flow chart contained in Reg. §1.414(r)-0(c). Compliance with the QSLOB regulations is deemed to be a reasonable determination that the employer has satisfied §414(r).<sup>1251</sup>

*Note:* The IRS has not issued rules under Reg. §1.414(r)-10, regarding the application of the separate line of business rules to the average benefits test of §129(d)(8).

#### 1. Conceptual Approach

The IRS discussed in the preamble to the then-proposed QSLOB regulations three approaches it considered to identify an employer’s lines of business. The first approach would have required the employer to identify its lines of business with reference to the economic markets in which it competed. This approach was rejected on the grounds that it would have required sophisticated economic analysis and would have been difficult to administer. The second approach would have utilized an existing classification scheme, such as the Standard Industrial Classification (SIC) code system, for the identification of a line of business. This approach was also rejected, on the grounds that it would have produced arbitrary distinctions and could have divided business activities into lines of business that would not conform to actual business operations and practices.<sup>1252</sup>

The approach ultimately adopted by the IRS allows the employer significant flexibility in determining its lines of business so long as the designation is reasonable and consistent with the employer’s bona fide business operations. This approach requires the employer to focus on the separateness of its

operations, which is demonstrated by satisfying certain objective criteria set forth in Reg. §1.414(r)-3.<sup>1253</sup>

#### 2. Gateway Testing

Section 410(b)(5)(B) provides that separate line of business testing is not available to a plan unless it benefits a nondiscriminatory classification of employees. Because this employer-wide nondiscriminatory classification is a prerequisite to QSLOB testing, it is known as the “gateway.” The QSLOB regulations apply the gateway in the same manner as the nondiscriminatory classification test under the §410(b) regulations, which establish an unsafe harbor ratio percentage for a plan, i.e., a minimum ratio of the relative coverage rates of nonhighly compensated and highly compensated employees.<sup>1254</sup> The unsafe harbor percentage applicable to a plan depends on the concentration of nonhighly compensated employees in the employer’s workforce.

If a QSLOB has a disproportionate share of the employer’s highly compensated employees, the plan maintained for that line may have a very low ratio percentage on an employer-wide basis, even though it covers a large percentage of the nonhighly compensated employees in that line. The QSLOB regulations provide a reduced unsafe harbor percentage if the plan has a ratio percentage (percentage of nonhighly compensated employees covered as compared with percentage of highly compensated employees covered) of at least 90% on a QSLOB basis.<sup>1255</sup> The QSLOB rules provide that, if a plan has a ratio percentage of at least 90% on a QSLOB basis, but its employer-wide ratio percentage falls below the plan’s reduced unsafe harbor percentage, the plan nonetheless will satisfy §410(b)(5)(B) on an employer-wide basis if the IRS determines that, based on the surrounding facts and circumstances, the plan benefits a nondiscriminatory classification of employees.<sup>1256</sup>

#### 3. Definitions

Several defined terms are used in applying the QSLOB rules.

##### a. Testing Year

The term “testing year” means the calendar year.<sup>1257</sup>

##### b. Testing Day

The term “testing day” means any day on which a plan must satisfy the coverage rules of §410(b) with respect to a plan year that begins in the testing year.<sup>1258</sup> For example, if a plan is required to satisfy §410(b) on one day of each quarter within a plan year, each of those four days is a testing day for purposes of the QSLOB rules. Similarly, if a plan is required to satisfy §410(b) on every day of the plan year, every day of the plan year is a testing day.<sup>1259</sup>

<sup>1253</sup> 56 Fed. Reg. 63,420 (Dec. 14, 1991), as amended by 59 Fed. Reg. 32,911 (June 27, 1994).

<sup>1254</sup> Reg. §1.414(r)-8(b)(2)(i).

<sup>1255</sup> Reg. §1.414(r)-8(b)(2)(iii)(A).

<sup>1256</sup> Reg. §1.414(r)-8(b)(2)(iii)(B). See VI.F.2. for a further discussion of this test.

<sup>1257</sup> Reg. §1.414(r)-11(b)(5).

<sup>1258</sup> Reg. §1.414(r)-11(b)(6).

<sup>1259</sup> Reg. §1.414(r)-11(b)(6).

<sup>1251</sup> Reg. §1.414(r)-1(d)(9).

<sup>1252</sup> 56 Fed. Reg. 3988, 3990 (Feb. 1, 1991).

### c. First Testing Day

The term “first testing day” means the testing day that occurs first in the testing year. If a plan is tested under the annual testing option under §410(b), then, solely for purposes of determining the first testing day, the employer may treat any day in the plan year as a testing day if the coverage of the plan on the day selected is reasonably representative of the coverage of the plan over the entire plan year.<sup>1260</sup>

### d. Section 401(a)(26) Testing Day

The term “§401(a)(26) testing day” means any day on which a plan must satisfy §401(a)(26) with respect to a plan year that begins in the testing year.<sup>1261</sup>

## B. Separate Line of Business

### 1. Defining a Line of Business

An employer’s first step in showing that it operates qualified separate lines of business is to determine its lines of business. An employer may designate its lines of business in a reasonable manner and in a way that is consistent with its bona fide business operations. However, the rules set forth in the QS-LOB regulations may not be applied in a manner that evades the requirements of any I.R.C. section.<sup>1262</sup>

An employer first must identify all property and services provided to customers during the testing year. The employer must then designate which portion of such property and services is provided by each of its lines of business.<sup>1263</sup> Subject to the reasonableness standard, the employer has considerable flexibility to designate its lines of business. The employer may combine dissimilar types of property or services into one line of business or may separate related properties or services into two or more lines of business.<sup>1264</sup> This separation may be based on reasonable business criteria such as differences in the geographic market served by each line of business, in the chain of distribution, the types of transactions or customers served, legal constraints, or historically separate development of the lines of business.<sup>1265</sup>

Certain restrictions apply and an employer is not permitted to separate property or services if those properties or services are not provided separately to the employer’s customers. Further, a separation is deemed to be unreasonable if the property or service provided is merely ancillary or incidental to, or regularly associated with, another type of property or service.<sup>1266</sup>

### 2. Defining a Separate Line of Business

After the employer has designated its lines of business, the next step is to determine whether the line of business is operated and organized separately from the remainder of the employer such that the “separateness” test is met. The separateness test

is met by satisfying each of the four objective criteria set forth in Reg. §1.414(r)-3(b), i.e., the line of business must:

- be a separate organizational unit;
- have separate financial accountability;
- have a separate workforce; and
- have separate management.

#### a. Separate Organizational Unit

A separate organizational unit is a unit within the employer such as a corporation, partnership, limited liability company, division or other structural element with similar organizational formality. This requirement must be met on each day of the testing year.<sup>1267</sup> An absence of organizational formality is deemed to indicate a lack of independence from the remainder of the employer’s operation.

#### b. Separate Financial Accountability

To meet the separate financial accountability requirement, the line of business must be a separate profit center or group of profit centers within the employer. This requirement must be met on each day of the testing year.<sup>1268</sup>

In addition, the employer must maintain books and records that provide separate revenue and expense information that is used for internal planning and control with respect to each line of business or profit center. Failure to account for profits and losses separately is deemed to indicate that the employer does not consider the line of business to be separate.

#### c. Separate Workforce

Satisfaction of the separate workforce requirement depends upon the degree to which each line of business shares personnel with other portions of the employer. A line of business has its own separate workforce only if at least 90% of the employees who provide services to the line of business provide substantial services to the line of business and are not substantial-service employees of any other line of business.<sup>1269</sup> This percentage is calculated by determining a fraction, the numerator of which is the number of employees who provide substantial services to the line of business and the denominator of which is the total number of employees who provide services to the line of business and are not substantial-service employees of another line of business.<sup>1270</sup>

An employee provides services to a line of business if more than a negligible portion of the employee’s services contributes to providing the property or services provided by the line of business to the employer’s customers.<sup>1271</sup>

Although the term “substantial” does not on its face indicate that the employee’s services to a line of business be predominant, the QSLOB regulations provide that an employee is

<sup>1260</sup> Reg. §1.414(r)-11(b)(7).

<sup>1261</sup> Reg. §1.401(a)(26)-7(a), §1.401(a)(26)-7(b), §1.414(r)-11(b)(8).

<sup>1262</sup> Reg. §1.414(r)-1(d)(2).

<sup>1263</sup> Reg. §1.414(r)-2(b)(1).

<sup>1264</sup> Reg. §1.414(r)-2(b)(3)(ii), §1.414(r)-2(b)(3)(iii).

<sup>1265</sup> Reg. §1.414(r)-2(b)(3)(iii).

<sup>1266</sup> Reg. §1.414(r)-2(b)(3)(iii).

<sup>1267</sup> Reg. §1.414(r)-3(b)(2).

<sup>1268</sup> Reg. §1.414(r)-3(b)(3).

<sup>1269</sup> Reg. §1.414(r)-3(b)(4); see Reg. §1.414(r)-3(c)(6) for examples of the determination of the separate employee workforce.

<sup>1270</sup> Reg. §1.414(r)-3(c)(2). The separate workforce test may be applied without regard to the “substantial-service” employees (as defined below) of other lines of business.

<sup>1271</sup> Reg. §1.414(r)-3(c)(5)(i).

deemed to provide substantial services to a line of business only if at least 75% of the employee's services are provided to the line of business.<sup>1272</sup> In addition, if an employee provides at least 50% and less than 75% of his or her services to a line of business for the testing year, the employer may treat that employee as a "substantial-service employee" with respect to that line of business. The employer may choose such treatment separately with respect to each employee.

The determination of whether the 90% separate workforce test is met is made on the first testing day. Employees hired after the first testing day (or who terminate employment before this date) are disregarded for purposes of the test. All employees of the employer are taken into account, including those covered by a collective bargaining agreement, except that nonresident aliens with no U.S.-source earned income may be excluded.<sup>1273</sup>

Only those services performed by an employee during the testing year are taken into account. An employee's services contribute to the property or services provided by the employer if the services are used for this purpose during the testing year or it is reasonably anticipated that the employee's services during the testing year will contribute to providing such property and services to customers of the employer after the close of the testing year.<sup>1274</sup>

The QSLOB regulations include a helpful rule applicable to employees who are no longer substantial-service employees in a subsequent testing year or who change status from a residual shared employee to a substantial-service employee. Under this optional rule, an employee may be deemed to provide the same level of service to the employer's lines of business for up to three testing years following a base testing year.<sup>1275</sup>

#### d. Separate Management

The IRS's view is that without separate management, a line of business is not a separate, self-sustaining economic unit within the overall employer. A line of business has separate management only if at least 80% of the "top-paid" employees who provide services to the line of business are substantial-service employees with respect to the line of business.<sup>1276</sup> This percentage is calculated by determining a fraction, the numerator of which is the number of employees who are both top-paid employees and substantial-service employees with respect to the line of business and the denominator of which is the total number of top-paid employees with respect to the line of business.<sup>1277</sup>

A "top-paid employee" is an employee who is among the top 10% by compensation of those employees who provide services to the line of business and who are not substantial-service employees of any other line of business. In determining the group of top-paid employees, the employer may disregard employees who provide less than 25% of their services to the line of business.<sup>1278</sup> "Compensation" for this purpose has the same meaning as compensation as defined for purposes of the de-

termination of highly compensated employee under §414(q).<sup>1279</sup> Those top-paid employees who provide services to the line of business and those who provide substantial services to the line of business are determined by applying the rules for determining whether an employee is part of a separate workforce.<sup>1280</sup>

*Example:* Employer D operates three lines of business, one of which is a hardware store. Sixty employees provide services to the hardware store. Of the six employees that constitute the top 10% by compensation of those 60 employees, five of the six, or 83%, are substantial-service employees. D's hardware store line of business thus satisfies the separate management test. If, however, only four of the six top-paid employees, or 67%, were substantial-service employees, the 80% test would not be satisfied.

#### e. Optional Rule for Vertically Integrated Lines of Business

Consistent with the legislative history to §414(r),<sup>1281</sup> the QSLOB regulations provide an optional rule to assist employers in satisfying the separateness criteria in the limited circumstances when two lines of business are vertically integrated.<sup>1282</sup> A vertically integrated operation is eligible to use the optional rule if any upstream line of business provides property or services to a downstream line of business, the upstream line of business provides the same type of property or service to customers of the employer, and the following additional requirements are met:

- (1) One of the lines of business (the upstream line of business) provides a type of property or service to the other line of business (the downstream line of business);
- (2) the downstream line of business either:
  - (a) Uses, consumes, or substantially modifies the property or service in the course of itself providing property or services to customers of the employer; or
  - (b) Provides the same property or service to customers of the employer at a different level in the chain of commercial distribution from the upstream line of business (e.g., retail versus wholesale); and
- (3) The upstream line of business either:
  - (a) Provides the same type of property or service to customers of the employer, and at least 25% of the total number of units of the same type of property or service provided by the upstream line of business to all persons (including customers of the employer, the downstream line of business, and all other lines of business of the employer) are provided to customers of the employer by the upstream line of business, when measured on a uniform basis; or

<sup>1272</sup> Reg. §1.414(r)-11(b)(2).

<sup>1273</sup> Reg. §1.414(r)-3(c)(4).

<sup>1274</sup> Reg. §1.414(r)-3(c)(5)(ii); see also Reg. §1.414(r)-3(c)(6) Ex. (12).

<sup>1275</sup> Reg. §1.414(r)-3(c)(5)(iii).

<sup>1276</sup> Reg. §1.414(r)-3(b)(5).

<sup>1277</sup> Reg. §1.414(r)-3(c)(3).

<sup>1278</sup> Reg. §1.414(r)-11(b)(3). See Reg. §1.414(r)-3(c)(7) for examples of the determination of top-paid employees.

<sup>1279</sup> Reg. §1.414(r)-11(b)(3).

<sup>1280</sup> Reg. §1.414(r)-3(c)(4), §1.414(r)-3(c)(5). See discussion at VI.B.2.c.

<sup>1281</sup> 1986 Conf. Rep. 523 (1986).

<sup>1282</sup> Reg. §1.414(r)-3(d).

(b) Provides to the downstream line of business property consisting primarily of a type of tangible property (i.e., goods, not services) that it produces or manufactures, and some entities outside the employer's controlled group that are engaged in a similar business as the upstream line of business provide the same type of tangible property to unrelated customers (i.e., customers outside those entities' respective controlled groups).<sup>1283</sup>

If a vertically integrated operation satisfies the above requirements, an employee is not treated as providing services to the downstream line of business if: (1) the employee is considered to provide services to the downstream line of business under the general rule of Reg. §1.414(r)-3(c)(5)(i) (i.e., more than a negligible portion of the employee's services contributes to the provision of property or services to customers by the downstream line of business and the employee is not a substantial-service employee of another separate line); and (2) the employee is so considered solely because the employee's services contribute to the provision of services from the upstream line of business to the downstream line of business.<sup>1284</sup> Note that this rule does not permit an employer to allocate an employee solely to an upstream line of business if the employee's services contribute directly to the provision of property or services by the downstream line of business to its customers.<sup>1285</sup>

The special rule for vertically integrated operations applies only for purposes of:

- the separate employee workforce and separate management requirements of Reg. §1.414(r)-3(b)(4) and §1.414(r)-3(b)(5);
- the 50-employee requirement of Reg. §1.414(r)-4(b); and
- the determination of the employees of a qualified separate line of business under Reg. §1.414(r)-7.<sup>1286</sup>

### C. Threshold Requirements

To be considered a separate line of business, §414(r)(2) requires that three threshold conditions be met: (1) the line of business must have at least 50 nonexcludible employees; (2) the employer must notify the IRS that it is treating a line of business separately for purposes of the nondiscrimination rules; and (3) the line of business must meet the regulatory guidelines or the employer must receive a determination from the IRS that the line of business may be treated as separate.

#### 1. Fifty-Employee Requirement

The 50-employee requirement of §414(r)(2)(A) must be met on each day of the testing year. In satisfying this requirement, the employer must take into account, subject to the exclusions described below, all employees who provide services exclusively to the line of business, including those who are covered by a collective bargaining agreement.<sup>1287</sup>

<sup>1283</sup> Reg. §1.414(r)-3(d)(2).

<sup>1284</sup> Reg. §1.414(r)-3(d)(3)(i).

<sup>1285</sup> See Reg. §1.414(r)-3(d)(4) Ex. (5).

<sup>1286</sup> Reg. §1.414(r)-3(d)(3)(ii).

<sup>1287</sup> Reg. §1.414(r)-4(b).

The employer is required to exclude those employees who are excluded in determining the number of top-paid employees for purposes of the highly compensated employee determination under §414(q), with certain modifications.<sup>1288</sup> Other employees who are excluded are similar to the exclusions permitted with respect to qualified plans:

- employees with less than six months of service;
- employees who normally work less than 17½ hours per week;
- employees who normally work less than six months per year;
- employees under age 21; and
- nonresident aliens with no U.S.-source earned income from the employer.<sup>1289</sup>

For purposes of determining the number of excludible employees for separate line of business determinations: (1) an employer is not permitted to substitute lower age or service requirements; (2) employees covered by a collective bargaining agreement are included;<sup>1290</sup> and (3) the period in which the determination is made is the testing year rather than the determination year or the look-back year.<sup>1291</sup>

#### 2. Notice Requirement

Under §414(r)(2)(B), an employer must notify the IRS that it is operating qualified separate lines of business for the testing year. The notice must specify each of the employer's qualified separate lines of business and the I.R.C. section(s) that will be applied separately.<sup>1292</sup> Once the notice has been filed and the time for filing has expired without it being withdrawn, modified or revoked, the employer is deemed to have irrevocably elected to apply the designated I.R.C. section(s) separately with respect to each qualified separate line of business for all plan years that begin in the testing year for each of its plans.<sup>1293</sup>

The IRS provides guidance with respect to the notice requirement of §414(r)(2)(B) in Rev. Proc. 93-40.<sup>1294</sup>

Rev. Proc. 93-40 requires an employer to file notice that it elects to be treated as operating qualified separate lines of business on Form 5310-A.

Notice for a testing year must be given on or before the notification date for the testing year, i.e., the later of October 15 of the year following the testing year or the 15th day of the 10th month after the close of the plan year of the plan of the employer that begins earliest in the testing year. Notice given by an employer applies to all plans maintained by the employer for plan years beginning in the testing year. Once the notification date for a testing year has passed, the employer is deemed to have irrevocably elected to apply the specified section(s) of

<sup>1288</sup> Reg. §1.414(r)-4(b).

<sup>1289</sup> Reg. §1.414(q)-1, Q&A-9(g)(2); see also Reg. §1.414(q)-1, Q&A-9(b)(1).

<sup>1290</sup> Reg. §1.414(q)-1, Q&A-9(g)(2).

<sup>1291</sup> Reg. §1.414(q)-1, Q&A-9(g)(3).

<sup>1292</sup> Reg. §1.414(r)-4(c)(1).

<sup>1293</sup> Reg. §1.414(r)-4(c)(2). This regulation provides that the IRS may, in revenue procedures or other guidance of general applicability, provide for exceptions to this rule.

<sup>1294</sup> Superseding Notice 90-57.

the Code on the basis of the qualified separate lines of business specified in the notice for all plan years beginning in the testing year. Rev. Proc. 93-40 also provides that notice cannot be modified, withdrawn or revoked after the notification date and will be treated as applying to subsequent testing years unless the employer provides new notice any time before the notification date for the subsequent testing year.

In PLR 9644061, an attorney inadvertently filed Form 5310-A two months late and the employer's representative sought a ruling from the IRS that the filing nevertheless would apply to the 1994 plan year. The IRS granted the relief requested after an analysis indicated that the taxpayer satisfied the requirements of Reg. §301.9100-1 through §301.9100-3<sup>1295</sup> and that the taxpayer acted reasonably and in good faith with respect to making the election. Similarly, in PLR 9816031, the IRS granted a 30-day extension to elect QSLOB treatment under Rev. Proc. 93-40 when, around the time of the due date, the lawyers responsible for the election filing terminated employment with the law firm that had been engaged by the employer. An extension also was granted in PLR 9648049, where the IRS concluded that the request was necessary due to the geographic separation of and lack of regular communication between different company plan administrators with respect to when notices for the different plans involved had to be filed under Rev. Proc. 93-40, and that the employer acted reasonably and in good faith with respect to making the election. In PLR 200421004, the IRS granted the taxpayer's request for an extension of time to file the QSLOB election after determining that the taxpayer had reasonably relied on a qualified tax professional that failed to make or advise the taxpayer to make the election. In PLR 201822005, the IRS granted a request for an extension where the taxpayer had failed to file a new Form 5310-A following a series of corporate acquisitions, because, after receiving legal advice, the taxpayer believed that a prior Form 5310-A filing was sufficient to effect its QSLOB approach for all future years, no updates needed to be made, the extension had been requested before the IRS discovered the failure to file, and the taxpayer otherwise satisfied the requirements of Reg. §301.9100-3(b)(1). Additionally, in PLR 201904006, the IRS granted the taxpayer's extension request where the employee with supervisory responsibility over the plan had no employee benefits experience or expertise, the employee relied on outside counsel with regard to plan compliance matters, and outside counsel did not advise the employee of the QSLOB election requirement.

### 3. Administrative Scrutiny

To satisfy the administrative scrutiny requirement of §414(r)(2)(C), a separate line of business must meet either the statutory safe harbor test of §414(r)(3) or one of the five regulatory safe harbors of Reg. §1.414(r)-5(c) through §1.414(r)-5(g).<sup>1296</sup> A separate line of business that does not sat-

<sup>1295</sup> For a further discussion of so-called Reg. §301.9100-1 relief for late/missed elections and other deadlines, see 621 T.M., *IRS National Office Procedures — Rulings, Closing Agreements*.

isfy any of these safe harbors may, nonetheless, meet the requirement of administrative scrutiny if the employer receives an individual determination from the IRS that such requirement is met.<sup>1297</sup> Each separate line of business may satisfy the administrative scrutiny requirement under a different rule than any other separate line of business.<sup>1298</sup>

#### a. Statutory Safe Harbor

Section 414(r)(3) provides a safe harbor rule under which a separate line of business may be treated as meeting the requirement of administrative scrutiny. If the separate line of business is maintained for bona fide business purposes and the safe harbor rule is satisfied, the line of business is deemed to meet the regulatory guidelines and is treated as separate.<sup>1299</sup>

A line of business comes within the statutory safe harbor if the "highly compensated employee percentage" ratio of the line of business is: (1) not less than one-half (the "50% rule"); and (2) not more than twice (the "200% rule") the percentage of all employees of the employer who are highly compensated.<sup>1300</sup> The safe harbor is based on the premise that it is unlikely that the benefits provided by the employer will unduly disadvantage its nonhighly compensated employees or unduly advantage its highly compensated employees if the percentage of highly compensated employees in a line of business does not significantly differ from the percentage of employees on an employer-wide basis.<sup>1301</sup> The 50% rule is deemed satisfied if at least 10% of all highly compensated employees of the employer provide services exclusively to that line of business.<sup>1302</sup> A separate line of business that satisfies this special 10% rule still must be within the 200% rule of the statutory safe harbor.<sup>1303</sup>

The "highly compensated employee percentage ratio" is calculated by determining a fraction, the numerator of which is the percentage of highly compensated employees of the separate line of business and the denominator of which is the percentage of all highly compensated employees of the employer.<sup>1304</sup> A highly compensated employee for this purpose is defined under §414(q).<sup>1305</sup>

*Example:* The calculation of the highly compensated employee percentage ratio is illustrated in the following chart. Employer B operates two separate lines of business, C and D. The distribution of employees is as follows:

<sup>1296</sup> See, e.g., PLR 201850011 (determining that a company acquired by the taxpayer satisfied the administrative scrutiny requirement of §414(r)(2) for a separate line of business).

<sup>1297</sup> Reg. §1.414(r)-5(a).

<sup>1298</sup> 56 Fed. Reg. 63,424 (Dec. 4, 1991).

<sup>1299</sup> Likewise, no determination from the IRS is required. §414(r)(3)(A).

<sup>1300</sup> §414(r)(3)(A); Reg. §1.414(r)-5(b)(1).

<sup>1301</sup> 56 Fed. Reg. 3993 (Feb. 1, 1991).

<sup>1302</sup> §414(r)(3)(A); Reg. §1.414(r)-5(b)(4).

<sup>1303</sup> 56 Fed. Reg. 63,424 (Dec. 4, 1991).

<sup>1304</sup> Reg. §1.414(r)-5(b)(2).

<sup>1305</sup> Reg. §1.414(r)-5(b)(3), by cross-reference to §410(b)(6)(A).

	Employer-wide	SLOB “C”	SLOB “D”
Number of employees	500	300	200
Number of HCEs	150	100	50
Number of non-HCEs	350	200	150
HCE percentage	30%	33%	25%
HCE percentage ratio	N/A	33/30	25/30
		(110%)	(83%)

Because the highly compensated employee percentage ratio of each separate line of business is at least 50% and no more than 200%, each of Employer B’s separate lines of business satisfies the statutory safe harbor.

*Comment:* The determination of the highly compensated employee percentage ratio is made after residual shared employees have been allocated to the employer’s separate lines of business. See discussion at VI.E.2.

The employees taken into account under the statutory safe harbor are those considered for purposes of §410(b) with respect to the first testing day. Thus, excludible employees include those covered by a collective bargaining agreement, non-resident aliens with no U.S.-source earned income from the employer and employees not meeting minimum age and service requirements under a qualified plan.<sup>1306</sup> The exclusion based on minimum age and service requirements is applied with reference to the lowest age and service requirement applicable under any plan of the employer.<sup>1307</sup>

Section 414(r)(3)(B) provides that the statutory safe harbor is satisfied for any line of business if the requirements are met for the preceding testing year and if either: (1) no more than a de minimis number of employees were shifted to or from the line of business after the close of that year; or (2) “a substantially proportional number” of highly compensated employees were included in any group of employees that was shifted.

The QSLOB regulations provide guidelines to implement this special rule. To utilize the special rule, the employer must have designated the same line of business in the immediately preceding testing year as in the current testing year and either:

(1) the highly compensated employee percentage ratio of the separate line of business for the current testing year does not deviate by more than 10% from the highly compensated employee percentage ratio of the separate line of business for the immediately preceding testing year; or

(2) no more than 5% of the employees of the separate line of business for the current testing year were employees of a different separate line of business for the immediately

<sup>1306</sup> Reg. §1.414(r)-5(b)(3), by cross-reference to §410(b)(3) and §410(b)(4).

<sup>1307</sup> Reg. §1.414(r)-5(b)(3).

preceding testing year, and no more than 5% of the employees of the separate line of business for the immediately preceding testing year are employees of a different separate line of business for the current testing year.<sup>1308</sup>

#### b. Administrative Safe Harbors

The IRS has promulgated five administrative safe harbors to satisfy the administrative scrutiny requirement of §414(r)(2) (C) without the need for an individual determination from the IRS: (1) the industry category safe harbor; (2) the merger and acquisition safe harbor; (3) the reportable business segments safe harbor; (4) the average benefits safe harbor; and (5) the minimum or maximum benefits safe harbor.<sup>1309</sup>

##### (1) Industry Category Safe Harbor

The industry category safe harbor is satisfied if the separate line of business is in a different industry or industries from every other separate line of business of the employer. A separate line of business is in a different industry if:

- the property or services provided to customers by the separate line of business fall exclusively within one or more industry categories established by the IRS; and
- none of the property or services provided to customers of the employer by any other separate line of business fall within the same industry category or categories.<sup>1310</sup>

Concurrent with the release of the QSLOB regulations, the IRS issued a revenue procedure — Rev. Proc. 91-64 — setting forth the industry categories for purposes of the administrative safe harbor.<sup>1311</sup> Rev. Proc. 91-64 lists 12 industry categories that were developed by the IRS based on the SIC code system at the 2-digit level with modifications. Although the SIC code system was rejected as the definitive means of establishing an employer’s lines of business, use of the SIC codes for purposes of establishing an administrative safe harbor is consistent with the legislative intent that differences in products or services are relevant considerations in determining whether an employer operates a qualified separate line of business.<sup>1312</sup> Thus, for example, an employer operating a commercial airline and a chain of restaurants as separate lines of business would satisfy the administrative industry category safe harbor.

In determining whether the industry category safe harbor is satisfied, the employer may disregard services provided by its foreign operations if the foreign subsidiaries do not generate income that is effectively connected with the conduct of a trade or business within the United States.<sup>1313</sup>

##### (2) Merger and Acquisition Safe Harbor

A line of business that is acquired through a merger or acquisition will satisfy this safe harbor during a transition period if the following requirements are met:

<sup>1308</sup> Reg. §1.414(r)-5(b)(5).

<sup>1309</sup> Reg. §1.414(r)-5(a).

<sup>1310</sup> Reg. §1.414(r)-5(c)(1).

<sup>1311</sup> Rev. Proc. 91-64.

<sup>1312</sup> 56 Fed. Reg. 3993 (Feb. 1, 1991); 1986 Conf. Rep. at II-523-524.

<sup>1313</sup> Reg. §1.414(r)-5(c)(2).

- the employer designates the acquired line of business as a line of business;
- the acquired line of business meets the four separateness tests of Reg. §1.414(r)-3;
- no more than 10% of the substantial-service employees of the acquired line of business were substantial-service employees of a different separate line of business for the immediately preceding testing year; and
- no more than 10% of the substantial-service employees of the acquired line of business for the immediately preceding testing year are substantial-service employees of a different separate line of business in the respective testing year. Requirements (2), (3), and (4) must be met on the first testing day of each testing year in the transition period.<sup>1314</sup>

An acquired line of business is deemed to satisfy the qualified separate line of business requirements (other than the 50-employee requirement and the notice requirement) for those testing years with first testing days that fall within the transition period described in §410(b)(6)(C).<sup>1315</sup>

The transition period begins with the first testing year beginning after the date that the transaction occurs. The employer is permitted to extend the transition period to include one, two or three of the testing years immediately succeeding that first testing year,<sup>1316</sup> by the end of which time, the acquiring company should have had sufficient time: (1) to determine that the acquired line of business will meet the statutory or one of the other administrative safe harbors; or (2) to have pursued an IRS ruling permitting continued treatment as a separate line of business.

*Example:* In 2012, Employer C acquires a company that employs 2,000 employees that manufacture seats for automobiles and designates that company as a line of business. Under Reg. §1.414(r)-1(d)(4), the automobile seating line of business is deemed to satisfy the qualified separate line of business requirements (other than the 50-employee and notice requirements) for testing year 2012. By the first testing day in 2013 (Transition Year 1), C employs an additional 100 employees who provide substantial services for the automobile seating line of business, increasing the number of substantial-service employees from 2,000 to 2,100. Of those 100 employees, 75 were substantial-service employees of a different separate line of business in 2011 and 25 are newly hired employees. The automobile seating line of business satisfies the separateness tests of Reg. §1.414(r)-3. Because 75 is 3.6% of 2,100, no more than 10% of the substantial-service employees of the automobile seating line of business for Transition Year 1 were substantial service employees of a different line of business for testing year 2012. Thus, the automobile seating separate line of business satisfies the merger and acquisition safe harbor for Transition Year 1.

<sup>1314</sup> Reg. §1.414(r)-5(d)(1).

<sup>1315</sup> Reg. §1.414(r)-1(d)(4).

<sup>1316</sup> Reg. §1.414(r)-5(d)(3).

### (3) Reportable Business Segments Safe Harbor

The reportable business segments safe harbor requires that a separate line of business be reported as one or more industry segments in accordance with Statement of Financial Accounting Standards No. 14, *Financial Reporting for Segments of a Business Enterprise* (FAS 14), on the employer's Form 10-K or Form 20-F as timely filed with the Securities and Exchange Commission (SEC).<sup>1317</sup> For purposes of this rule, the property or services provided to customers by the separate line of business must be identical to the products or services provided to customers by the industry segment or segments.<sup>1318</sup>

### (4) Average Benefits Safe Harbor

A separate line of business will satisfy this safe harbor if the average benefits provided to employees of the separate line of business meet the requirements set forth in Reg. §1.414(r)-5(f). This safe harbor is available to a separate line of business with either a disproportionate number of nonhighly compensated employees or a disproportionate number of highly compensated employees.

If the separate line of business fails to meet the statutory safe harbor because it has a highly compensated employee percentage ratio of less than 50%, the separate line of business will satisfy the average benefits safe harbor if the actual benefit percentage of the nonhighly compensated employees of the separate line of business is at least equal to the actual benefit percentage of all other nonhighly compensated employees of the employer.<sup>1319</sup>

If the separate line of business fails to meet the statutory safe harbor because it has a highly compensated employee percentage ratio of more than 200%, the separate line of business will satisfy the average benefits safe harbor if the actual benefit percentage of the highly compensated employees of the separate line of business is no greater than the actual benefit percentage of all other highly compensated employees of the employer.<sup>1320</sup>

In either case, "actual benefit percentage" is determined under Reg. §1.410(b)-5(c). The determination is made for the testing period (as defined in Reg. §1.410(b)-5(d)(3)(ii)) that ends with or within the testing year.<sup>1321</sup>

An employee of a separate line of business is taken into account if the employee is an employee of the separate line of business on the first testing day and would not be an excludible employee for purposes of applying the average benefit percentage test of §410(b).<sup>1322</sup>

<sup>1317</sup> Reg. §1.414(r)-5(e)(1), §1.414(r)-5(e)(2). FAS 131 superseded FAS 14, effective for fiscal years beginning after December 15, 1997, even though the Treasury regulations continue to cite to FAS 14. Effective for interim and annual periods ending after September 15, 2009, the Financial Accounting Standards Board codified all of its authoritative non-governmental U.S. generally accepted principles (US GAAP) into a single source in its Accounting Standards Codification (FASB ASC), available at <http://asc.fasb.org>. FAS 131 was codified as FASB ASC ¶280-10 (Topic 280, Subtopic 10).

<sup>1318</sup> Reg. §1.414(r)-5(e)(2)(ii).

<sup>1319</sup> Reg. §1.414(r)-5(f)(2).

<sup>1320</sup> Reg. §1.414(r)-5(f)(3).

<sup>1321</sup> Reg. §1.414(r)-5(f)(2), §1.414(r)-5(f)(3).

<sup>1322</sup> Reg. §1.414(r)-5(f)(4).

*(5) Minimum or Maximum Benefits Safe Harbor*

The minimum or maximum benefits safe harbor is an extension of the statutory safe harbor of §414(r)(3). Rather than focusing on the ratio of highly compensated employees, this safe harbor focuses on the benefits provided to employees of the separate line of business.

If a separate line of business has a highly compensated employee percentage ratio of less than 50%, the separate line of business will satisfy the safe harbor if the separate line of business provides a minimum level of benefits to its nonhighly compensated employees. The separate line of business meets this requirement if either:

- at least 80% of the nonhighly compensated employees of the separate line of business receive a specified minimum benefit;<sup>1323</sup> or
- at least 60% of the nonhighly compensated employees of the separate line of business receive a specified minimum benefit and the average of the accrual rates or allocation rates of the nonhighly compensated employees of the separate line of business equals or exceeds the specified minimum benefit.<sup>1324</sup>

For defined benefit plans, the minimum benefit is the accrued benefit that would result from calculating a single life annuity at a normal accrual rate equal to 0.75% of compensation and a normal retirement age of 65.<sup>1325</sup> For defined contribution plans, the minimum benefit is an allocation rate of at least 3% of an employee's compensation for the year.<sup>1326</sup>

If a separate line of business has a highly compensated employee percentage ratio of more than 200%, the separate line of business will satisfy the safe harbor if either:

- no highly compensated employee of the separate line of business receives a benefit that exceeds a specified maximum benefit;<sup>1327</sup> or
- the average of the accrual rates or allocation rates of all highly compensated employees of the separate line of business is no more than 80% of the maximum amount for any individual highly compensated employee.<sup>1328</sup>

For defined benefit plans, the maximum benefit is the accrued benefit that would result from calculating a single life annuity at a normal accrual rate equal to 2.5% of compensation and a normal retirement age of 65.<sup>1329</sup> For defined contribution plans, the maximum benefit is an allocation rate equal to 10% of an employee's compensation for the year.<sup>1330</sup>

Rules are also provided for determining an employee's benefit if he or she benefits under more than one plan of the same type or plans of different types.<sup>1331</sup>

*c. Individual Determinations*

If a separate line of business does not satisfy the statutory safe harbor or any of the administrative safe harbors, the employer may apply to the IRS for an individual determination that the administrative scrutiny requirement is satisfied under Reg. §1.414(r)-6. According to Rev. Proc. 93-41, an employer may apply for an individual determination if the separate line of business: (1) meets the criteria for a line of business for the testing year under Reg. §1.414(r)-2 and for a separate line of business for the testing year under Reg. §1.414(r)-3; (2) meets the 50-employee requirement of §414(r)(2)(A) on each day of the testing year; and (3) satisfies one of the following standard alternatives:

(A) the highly compensated employee percentage ratio of the separate line of business is at least 40% and not more than 250%;

(B) 90% of the gross revenues of the separate line of business are derived from the provision of property or services that fall exclusively within one or more industry categories (as established by the IRS in Rev. Proc. 91-64), and no more than 10% of the gross revenues of the employer's other separate lines of business are derived from the provision of property or services that come within the same industry category or categories;

(C) the employer is not required to file Form 10-K or 20-F, but an independent certified public accountant certifies that the employer would have been required to report the separate line of business as one or more reportable industry segments if the employer had been required to file the applicable SEC report;

(D) the separate line of business has a highly compensated employee percentage ratio of less than 40%, and either:

- (i) the separate line of business would satisfy the average benefits safe harbor if the actual benefit percentage of the nonhighly compensated employees of the other separate lines of business were reduced by one-third; or
- (ii) the separate line of business would satisfy the minimum benefit safe harbor if the minimum benefit were reduced by one-third;

(E) the separate line of business has a highly compensated employee percentage ratio of more than 250%, and either:

- (i) the separate line of business would satisfy the average benefits safe harbor if the actual benefit percentage of the highly compensated employees of the other separate lines of business were increased by one-third; or
- (ii) the separate line of business would satisfy the maximum benefit safe harbor if the maximum benefit were increased by one-third; or

(F) the separate line of business manages a government facility pursuant to a government contract that specifies the benefits to be provided under a qualified plan.

Even if a line of business is unable to satisfy one of the standard alternatives listed in (A)–(F), above, an employer may be able in exceptional circumstances to obtain a favorable determination that administrative scrutiny is met. The IRS will

<sup>1323</sup> Reg. §1.414(r)-5(g)(2)(ii)(A).

<sup>1324</sup> Reg. §1.414(r)-5(g)(2)(ii)(B).

<sup>1325</sup> Reg. §1.414(r)-5(g)(2)(iii).

<sup>1326</sup> Reg. §1.414(r)-5(g)(2)(iv).

<sup>1327</sup> Reg. §1.414(r)-5(g)(3)(i), §1.414(r)-5(g)(3)(ii)(A).

<sup>1328</sup> Reg. §1.414(r)-5(g)(3)(ii)(B).

<sup>1329</sup> Reg. §1.414(r)-5(g)(3)(iii).

<sup>1330</sup> Reg. §1.414(r)-5(g)(3)(iv).

<sup>1331</sup> Reg. §1.414(r)-5(g)(4).

scrutinize all relevant facts and circumstances more closely, and the employer has an additional burden to demonstrate to the IRS that relevant facts and circumstances unique to the employer support a determination that the separate line of business meets administrative scrutiny despite its failure to satisfy any of the standard alternatives.<sup>1332</sup>

The factors that the IRS will consider in issuing a determination that the administrative scrutiny requirement is met are:

- differences in property or services;
- separateness of organization and operation;
- nature of business competition;
- historical factors;
- geographic factors;
- safe harbors;
- size and composition of the separate line of business;
- allocation method for residual shared employees;
- the relative level of benefits provided by each separate line of business;
- whether other lines of business are qualified separate lines of business;
- whether the separate line of business is in a regulated industry; and
- other relevant factors.<sup>1333</sup>

A request for an administrative determination must contain a submission from the employer demonstrating that each separate line of business for which a determination is desired satisfies administrative scrutiny and other procedural items.<sup>1334</sup>

In addition, each request must contain certain supporting information including an identification of each separate line of business for which a request is made and the testing year covered by the request, sufficient data to verify that the separate line of business satisfies the requirements of a separate line of business as well as sufficient information relating to the factors the IRS will consider, and a statement as to whether the employer has submitted or intends to submit a request for a determination letter that relies on the designation of qualified separate line of business. A user fee is required.<sup>1335</sup>

Finally, reliance on an administrative scrutiny determination issued by the IRS is limited to a determination only as to whether a separate line of business satisfies administrative scrutiny.<sup>1336</sup>

#### D. Separate Operating Units

Section 414(r)(7) provides that the term “separate line of business” includes an operating unit in a separate geographic area separately operated for a bona fide business reason. The legislative history contemplated that an operating unit would

provide the same property or service as another portion of the employer but in a separate geographic area, while a line of business would provide different property or services from another portion of the employer.<sup>1337</sup>

Because the QSLOB regulations give employers the flexibility to designate two or more lines of business that provide the same property or services, the concept of a separate operating unit is effectively subsumed into the more general test.<sup>1338</sup> A separate operating unit need not satisfy any additional requirements beyond those applicable to a separate line of business.<sup>1339</sup>

#### E. Determination of Employees of a Qualified Separate Line of Business

An employer must determine which employees are treated as employees of each qualified separate line of business for purposes of: (1) testing plans under the §410(b) coverage rules, the §401(a)(4) nondiscrimination rules and the §401(a)(26) minimum participation rules; (2) the statutory safe harbor of administrative scrutiny under §414(r)(3); or (3) the merger and acquisition safe harbor, the average benefits safe harbor and the minimum or maximum benefits safe harbor.<sup>1340</sup> Each employee of an employer must be allocated to one and only one qualified separate line of business.<sup>1341</sup> As directed by §414(r)(6) and the legislative history,<sup>1342</sup> the QSLOB regulations provide a procedure for assigning employees to a qualified separate line of business.<sup>1343</sup> Under these rules, an employee who performs substantial services for a separate line of business is assigned to that separate line of business. Employees who do not perform substantial services for a separate line of business, referred to as “residual shared employees,” are assigned to a separate line of business according to one of four allocation methods provided in the QSLOB regulations. Residual shared employees generally would include headquarters or home office employees and employees providing administrative services to more than one line of business, such as accounting, legal or data processing.

##### 1. Substantial-Service Employees

Consistent with the legislative history, the QSLOB regulations provide that employees who perform substantial services for a line of business are assigned to that line of business.<sup>1344</sup> A substantial service employee is one who provides at least 75% of his or her services for a testing year to the qualified separate line of business. In addition, if an employee provides at least 50% and less than 75% of his or her services to a line of business for the testing year, the employer may treat that employee as a substantial service employee with the respect to that line. The employer may elect such treatment separately with respect to each employee.<sup>1345</sup> If the employer does not elect this option for an employee, that employee is treated as a residual shared

<sup>1332</sup> Rev. Proc. 93-41.

<sup>1333</sup> Rev. Proc. 93-41, §5. No one factor is necessarily determinative. Rev. Proc. 93-41, §5.

<sup>1334</sup> Rev. Proc. 93-41.

<sup>1335</sup> See Rev. Proc. 2026-1, apps. A and F.

<sup>1336</sup> Rev. Proc. 93-41.

<sup>1337</sup> 1986 Conf. Rep. at II-524.

<sup>1338</sup> Reg. §1.414(r)-2(b)(3)(iii); 56 Fed. Reg. 63,427 (Dec. 4, 1991).

<sup>1339</sup> Reg. §1.414(r)-1(d)(3).

<sup>1340</sup> Reg. §1.414(r)-7(a)(2).

<sup>1341</sup> Reg. §1.414(r)-1(d)(6)(i).

<sup>1342</sup> 1986 Conf. Rep. at II-524.

<sup>1343</sup> Reg. §1.414(r)-7.

<sup>1344</sup> Reg. §1.414(r)-7(b)(2)(i); 1986 Conf. Rep. at II-524.

<sup>1345</sup> Reg. §1.414(r)-11(b)(2).

employee and assigned to a line under the allocation method selected by the employer, as described below.<sup>1346</sup>

### 2. Allocation of Residual Shared Employees

Employees who are not substantial-service employees are referred to as “residual shared employees.”<sup>1347</sup> Such employees are assigned to a qualified separate line of business under one of the four allocation methods described below:

- the dominant line of business method;
- the pro-rata method;
- the highly compensated employee percentage ratio method; or
- the small group method.

The employer may select which allocation method to apply for the testing year. However, the same allocation method must be used for all residual shared employees.<sup>1348</sup>

The four alternative allocation methods for such employees contained in the QSLOB regulations are intended to assure that, as a group, these employees receive benefits that are representative of the benefits provided to the employer’s workforce generally. Thus, the regulations allow as one alternative the allocation of all residual shared employees to the employer’s dominant line of business. The other three allocation methods, the pro-rata method, the highly compensated employee percentage ratio method, and the small group method, each provide formulas under which residual shared employees may be allocated among the employer’s various lines under conditions that are designed to assure that this purpose is not subverted.

#### a. Dominant Line of Business Method

Under the dominant line of business allocation method, an employer is permitted, if it has a dominant line of business, to allocate all of its residual shared employees to the dominant line of business. If the employer has more than one dominant line of business, it must select which qualified separate line of business is its dominant line.<sup>1349</sup> For this purpose, the dominant line of business is determined based on the number of employees assigned to the qualified separate line of business. In general, the dominant line of business is the qualified separate line of business that has an employee assignment percentage of at least 50%.<sup>1350</sup> The employee assignment percentage of a qualified separate line of business is determined by combining the number of substantial-service employees with respect to the qualified separate line of business and dividing that figure by the total number of all substantial-service employees.<sup>1351</sup>

Under an alternative definition, the employer is permitted to reduce the employee assignment percentage to 25%<sup>1352</sup> if: (1) the qualified separate line of business accounts for at least 60% of the employer’s total gross revenues for the latest fiscal year; (2) the employee assignment percentage would be at least 60%

if collectively bargained employees were taken into account; (3) each qualified separate line of business satisfies either the statutory safe harbor, the average benefits safe harbor or the minimum or maximum benefits safe harbor, determined after allocating residual shared employees to the dominant line of business; or (4) the employee assignment percentage is at least twice the employee assignment percentages of each other qualified separate line of business.<sup>1353</sup>

#### b. Pro-Rata Method

Under the second allocation method, which is also consistent with the legislative history,<sup>1354</sup> residual shared employees are allocated on a pro-rata basis in proportion to the employee assignment percentage of each qualified separate line of business, as determined under Reg. §1.414(r)-7(c)(2)(iii).<sup>1355</sup> The employer must divide its residual shared employees into two groups, those who are highly compensated and those who are nonhighly compensated. These two groups of residual shared employees are then allocated among the qualified separate lines of business based on the employee assignment percentage. For purposes of this allocation procedure, the employer is permitted to designate which residual shared employee will be assigned to each qualified separate line of business, provided that the appropriate number of highly compensated and nonhighly compensated residual shared employees is allocated to each qualified separate line of business.<sup>1356</sup>

*Example:* Employer S operates four qualified separate lines of business. S has 6,500 employees of which 6,000 are substantial-service employees and are assigned to each qualified separate line of business as shown in the following chart. Of the 500 residual shared employees, 400 are highly compensated and 100 are nonhighly compensated. Under the pro-rata method, the residual shared employees are allocated as follows:

	QSLOB “A”	QSLOB “B”	QSLOB “C”	QSLOB “D”
Substantial-service employees	1,500	600	1,500	2,400
Percentage assigned to QSLOB	25%	10%	25%	40%
Residual Shared HCEs	100	40	100	160
Allocated to QSLOB	$(25\% \times 400)$	$(10\% \times 400)$	$(25\% \times 400)$	$(40\% \times 400)$
Residual Shared non-HCEs	25	10	25	40
Allocated to QSLOB	$(25\% \times 100)$	$(10\% \times 100)$	$(25\% \times 100)$	$(40\% \times 100)$

<sup>1346</sup> Reg. §1.414(r)-7(c)(1).

<sup>1347</sup> Reg. §1.414(r)-11(b)(4).

<sup>1348</sup> Reg. §1.414(r)-7(c)(1).

<sup>1349</sup> Reg. §1.414(r)-7(c)(2)(i).

<sup>1350</sup> Reg. §1.414(r)-7(c)(2)(ii).

<sup>1351</sup> Reg. §1.414(r)-7(c)(2)(iii).

<sup>1352</sup> Reg. §1.414(r)-7(c)(2)(iv).

<sup>1353</sup> Reg. §1.414(r)-7(c)(2)(iv).

<sup>1354</sup> 1986 Conf. Rep. at II-524.

<sup>1355</sup> Reg. §1.414(r)-7(c)(3)(i).

<sup>1356</sup> Reg. §1.414(r)-7(c)(3)(ii).

*c. Highly Compensated Employee Percentage Ratio Method*

The third method of allocation permits the employer to allocate residual shared employees in a manner consistent with the statutory safe harbor for satisfying administrative scrutiny.<sup>1357</sup> Under this method, residual shared employees are allocated among the employer's qualified separate lines of business based on the highly compensated employee (HCE) percentage assignment ratio of each qualified separate line of business.<sup>1358</sup> For this purpose, the HCE percentage assignment ratio is a fraction, the numerator of which is the percentage of HCEs previously assigned to a particular qualified separate line of business and the denominator of which is the percentage of HCEs previously assigned to all qualified separate lines of business. The HCE percentage assignment ratio must be recalculated each time a residual shared employee is allocated to a qualified separate line of business.<sup>1359</sup>

A residual shared HCE is allocated to any qualified separate line of business with an HCE percentage assignment ratio less than 50%. Similarly, a residual shared non-HCE is allocated to any qualified separate line of business with an HCE percentage assignment ratio greater than 200%.<sup>1360</sup> This procedure is repeated until all qualified separate lines of business have an HCE percentage assignment ratio of between 50% and 200% or no residual shared employees remain to be allocated. Any remaining residual shared employees may be allocated to any qualified separate line of business as long as the allocation does not cause the qualified separate line of business to violate the 50% or 200% limits.<sup>1361</sup>

For purposes of this allocation procedure, the employer is permitted to designate which residual shared employee will be assigned to each qualified separate line of business, provided that the rules described in the preceding paragraph are met.<sup>1362</sup>

*d. Small Group Method*

Under the small group method, an employer may allocate each residual shared employee to one of its qualified separate lines of business. Residual shared employees need not all be allocated to the same line, giving the employer flexibility in selecting the plans under which such employees benefit.<sup>1363</sup> To prevent this allocation method from being used in a discriminatory manner, its use is subject to the following three requirements:

- Residual shared employees cannot exceed 3% of the employees taken into account in applying the §410(b) minimum coverage rules.
- The line to which the employer allocates a residual shared employee must include at least 10% of the employer's substantial-service employees and must satisfy the administrative scrutiny statutory safe harbor after the allo-

cation; i.e., the concentration of highly compensated employees in the line must be between 50% and 200% of the concentration of highly compensated employees in the workforce generally.

- The allocation of residual shared employees must be reasonable. Reasonable allocations generally include allocations that are based on the level of services provided by the residual shared employees and other bona fide business reasons. Allocations designed to maximize benefits for select employees are not considered to be reasonable.<sup>1364</sup>

*3. Optional Rule for Assigning Employees Who Change Status*

For purposes of assigning employees to a qualified separate line of business, an employer is permitted to apply an optional rule to an employee who is no longer a substantial-service employee in a subsequent testing year or who changes status from a residual shared employee to a substantial-service employer. Under the optional rule, the employee may be deemed to provide the same level of service (i.e., remain a substantial-service employee or a residual shared employee) for up to three testing years following a base testing year.<sup>1365</sup>

*4. Assignment Procedures*

All substantial-service and residual shared employees must be assigned to a qualified separate line of business on the first testing day and remain assigned to that qualified separate line of business for all subsequent testing days within the testing year.<sup>1366</sup> Employees not previously assigned, including newly hired employees and previously excludible employees, must be assigned on a subsequent testing day.<sup>1367</sup>

However, if an employer elects to use the annual testing option under §410(b), an employee must be assigned on every day of the plan year, even if the employee terminates employment before the first testing day.<sup>1368</sup>

*F. Separate Application of Statutory Requirements*

*1. Fifty-Five Percent Average Benefits Test*

The QSLOB regulations do not address application of the separate line of business rules to the 55% average benefits test applicable to dependent care assistance programs under §129(d)(8). Until guidance is issued on the application of §414(r) to the average benefits test, an employer is treated as operating qualified separate lines of business if it reasonably determines that it meets the requirements of §414(r).<sup>1369</sup>

*2. Minimum Coverage Requirements*

*a. General*

If an employer is treated as operating qualified separate lines of business, it may apply §410(b) separately with respect

<sup>1357</sup> 56 Fed. Reg. 63,428 (Dec. 4, 1991).

<sup>1358</sup> Reg. §1.414(r)-7(c)(4)(i).

<sup>1359</sup> Reg. §1.414(r)-7(c)(4)(ii).

<sup>1360</sup> Reg. §1.414(r)-7(c)(4)(iii)(A), §1.414(r)-7(c)(4)(iii)(B).

<sup>1361</sup> Reg. §1.414(r)-7(c)(4)(iii)(C), §1.414(r)-7(c)(4)(iii)(D).

<sup>1362</sup> Reg. §1.414(r)-7(c)(4)(iii)(E).

<sup>1363</sup> Reg. §1.414(r)-7(c)(5)(i).

<sup>1364</sup> Reg. §1.414(r)-7(c)(5)(ii), §1.414(r)-7(c)(5)(iii), §1.414(r)-7(c)(5)(iv).

<sup>1365</sup> Reg. §1.414(r)-3(c)(5)(iii).

<sup>1366</sup> Reg. §1.414(r)-7(b)(2).

<sup>1367</sup> Reg. §1.414(r)-7(b)(3).

<sup>1368</sup> Reg. §1.414(r)-7(b)(4).

<sup>1369</sup> 56 Fed. Reg. 63,430 (Dec. 4, 1991); Pub. L. No. 101-140, §204(b).

to employees in each separate line of business.<sup>1370</sup> In general, if an employer decides to apply §410(b) separately with respect to its separate lines of business, it must do so for all of its plans, all its employees and all its qualified separate lines of business.<sup>1371</sup> However, under a special rule for employer-wide plans, even if an employer elects to test on a separate line of business basis, it may apply §410(b) on an employer-wide basis to any plan that benefits at least 70% of the employer's nonexcludible nonhighly compensated employees.<sup>1372</sup>

Under §410(b)(5), a plan satisfies §410(b) only if the plan meets the reasonable classification test of §410(b)(5)(B) on an employer-wide basis. As discussed in VI.A.2., because this employer-wide nondiscriminatory classification is a prerequisite to QSLOB testing, it is commonly referred to as the "gateway." In addition to meeting the gateway test, the plan must also satisfy §410(b) on a qualified separate line of business basis. Reg. §1.414(r)-8 implements these statutory requirements.

#### b. Employer-Wide Application

A plan satisfies the reasonable classification test of §410(b)(5)(B) on an employer-wide basis if the plan satisfies the ratio percentage test of Reg. §1.410(b)-2(b)(2) or the nondiscriminatory classification test of Reg. §1.410(b)-4 (without regard to the average benefit percentage test of Reg. §1.410(b)-5).<sup>1373</sup> For this purpose, all otherwise nonexcludible employees of all qualified separate lines of business are included.<sup>1374</sup>

Under the nondiscriminatory classification test for each qualified separate line of business, the employer must compare the percentage of nonhighly compensated employees who benefit under the plan with the percentage of highly compensated employees who benefit under the plan. This comparison yields a ratio. If the ratio is high enough, it is within a "safe harbor" and the test is satisfied. If the ratio is too low, it is below an "unsafe harbor" and the test is failed. If the ratio is between the safe harbor and the unsafe harbor, an additional facts and circumstances test is imposed.<sup>1375</sup>

The unsafe harbor percentage ranges from 40% to 20%, depending on the percentage of employees who are nonhighly compensated. However, under a special rule for qualified separate lines of business, the unsafe harbor percentage may be low-

<sup>1370</sup> Reg. §1.410(b)-7(c) clarifies the treatment of employees transferring between mandatorily disaggregated portions of certain plans. In these situations, an employee's status at the time accruals or allocations are provided to the employee determines the portion of the plan under which those accruals or allocations are tested. Notwithstanding, Reg. §1.410(b)-7(c)(4)(C)(2) provides a special rule that applies where an employee who was benefiting under a particular disaggregated portion of a plan incurs a change in status that results in the employee being treated as benefiting under a different disaggregated portion of the plan. The rule allows benefits accrued after the change in status that are attributable to years of service previously credited in the employee's prior status to be treated as provided to the employee in that prior status. In addition, as an alternative, Reg. §1.410(b)-7(c)(4)(C)(2) permits benefits accrued in employees' prior status to be treated as provided to the employee in his or her current status. This alternative rule must be applied to a consistent basis and is available only if this treatment does not result in significant discrimination in favor of HCEs.

<sup>1371</sup> Reg. §1.414(r)-1(c)(2)(i).

<sup>1372</sup> Reg. §1.414(r)-1(c)(2)(ii).

<sup>1373</sup> Reg. §1.414(r)-8(b)(2)(i).

<sup>1374</sup> Reg. §1.414(r)-8(b)(2)(i); Reg. §1.410(b)-6(e).

<sup>1375</sup> Reg. §1.410(b)-4.

er than 20%. If the percentage of nonhighly compensated employees who benefit under the plan as a whole is at least 90% of the percentage of highly compensated employees who benefit, the unsafe harbor percentage (for each qualified separate line of business) is reduced by five percentage points, so that it ranges from 35% to 15%.<sup>1376</sup>

Under another special rule, the fact that an employer has satisfied the qualified separate line of business requirements is taken into account in determining whether a classification of employees benefiting under a plan that falls between the safe and unsafe harbors satisfied the facts and circumstances test. Except in unusual circumstances, this fact is determinative.<sup>1377</sup>

#### c. Qualified Separate Line of Business Application

A plan satisfies §410(b) on a qualified separate line of business basis if the plan satisfies either the ratio percentage test of Reg. §1.410(b)-2(b)(2) or the average benefit test of Reg. §1.410(b)-2(b)(3) (including the nondiscriminatory classification test of Reg. §1.410(b)-4 and the average benefit percentage test of Reg. §1.410(b)-5).<sup>1378</sup> For this purpose, employees of other qualified separate lines of business are excluded.<sup>1379</sup>

#### d. Special Rule for Employer-Wide Plans

In general, if the employer chooses to apply §410(b) on a qualified separate line of business basis, it must do so for all of its plans, employees and lines of business.<sup>1380</sup> Under a special rule for certain employer-wide plans, however, a plan need not be tested on a qualified separate line of business basis if it passes the §410(b)(1)(A) percentage test (i.e., it benefits at least 70% of the employer's non-highly compensated employees).<sup>1381</sup> Conversely, if the employer is not treated as operating qualified separate lines of business for §410(b) purposes for a testing year, §410(b) must be applied on an employer-wide basis in testing all plans of the employer for plan years that begin in the testing year.<sup>1382</sup>

#### e. Definition of "Plan"

In applying §410(b) and §401(a)(4), the term "plan" has the meaning supplied by Reg. §1.410(b)-7. Therefore, pursuant to Reg. §1.410(b)-7(c)(5), the portion of the plan that benefits employees of one qualified separate line of business is treated as a separate plan from the other portions of the same plan that benefit employees of other qualified separate lines of business unless the plan is an employer-wide plan tested under the employer-wide rule described above.<sup>1383</sup>

#### f. Coordination with §401(a)(4)

If an employer applies §410(b) on a qualified separate line of business basis, it must also apply the §401(a)(4) nondiscrimination rules on a qualified separate line of business basis. For this purpose, the §401(a)(4) requirements include the per-

<sup>1376</sup> Reg. §1.414(r)-8(b)(2)(iii).

<sup>1377</sup> Reg. §1.414(r)-8(b)(2)(ii).

<sup>1378</sup> Reg. §1.414(r)-8(b)(3).

<sup>1379</sup> Reg. §1.414(r)-8(b)(3); Reg. §1.410(b)-6(e).

<sup>1380</sup> Reg. §1.414(r)-8(a).

<sup>1381</sup> Reg. §1.414(r)-1(c)(2)(ii).

<sup>1382</sup> Reg. §1.414(r)-8(b)(2).

<sup>1383</sup> See Reg. §1.414(r)-8(d)(2).

mitted disparity rules of §401(l), the actual deferral percentage test of §401(k)(3) and the actual contribution percentage test of §401(m)(2).<sup>1384</sup>

If §401(a)(4) requires that a group of employees under the plan satisfy §410(b) separately, then that group of employees must satisfy the reasonable classification test on an employer-wide basis and on a qualified separate line of business basis. This would occur, for example, under Reg. §1.401(a)(4)-4(b), which requires that the group of employees to whom each benefit, right or feature is currently available must satisfy §410(b), or under Reg. §1.401(a)(4)-9(c)(1), which requires that the group of employees included in each component plan into which a plan is restructured must satisfy §410(b).<sup>1385</sup>

#### *g. Failure to Comply*

If the employer applies §410(b) on a qualified separate line of business basis and any of its lines of business fail to meet the regulations' requirements, all of its lines of business will fail to satisfy §414(r). In such event, each plan must satisfy §410(b) on an employer-wide basis to satisfy §401(a).

If the employer applies §410(b) separately with respect to the employees of each qualified separate line of business and a plan fails to satisfy §410(b), the plan (and any plan of which it constitutes a portion) will not satisfy §401(a). Further, such a plan may not attempt to satisfy the minimum coverage rules and the general nondiscrimination rule on an employer-wide basis unless it is being tested under the special rule for employer-wide plans described above. This failure, however, generally will not affect the employer's being treated as operating qualified separate lines of business unless the employer is relying on benefits provided under the plan to satisfy the minimum benefit portion of the minimum/maximum benefit safe harbor of Reg. §1.414(r)-5(g)(2) with respect to at least one of its qualified separate lines of business.<sup>1386</sup>

#### *3. Minimum Participation Rules*

Section 401(a)(26)(F) provides that the minimum participation rules of §401(a)(26) may be applied on a separate line of business basis at the employer's election and with the consent of the IRS. If the employer chooses to apply §401(a)(26) on a qualified separate line of business basis, then, in general, it must do so for all its plans, all its employees and all its qualified separate lines of business.<sup>1387</sup> However, §401(a)(26) may be applied on an employer-wide basis to any plan that covers at least 70% of the employer's nonexcludible nonhighly compensated employees and the employer applies §410(b) on a qualified separate line of business basis.<sup>1388</sup>

An employer may apply §401(a)(26) on a qualified separate line of business basis even if it does not apply the separate line of business rules for purposes of §410(b).<sup>1389</sup>

In applying §401(a)(26) on a qualified separate line of business basis, the employer must exclude the employees of other qualified separate lines of business.<sup>1390</sup> A "plan" is defined

as that portion of the plan that benefits employees of the qualified separate line of business, unless the plan is tested under the special rule for employer-wide plans.<sup>1391</sup>

If a portion of a plan benefiting employees of a qualified separate line of business fails to satisfy §401(a)(26), then the entire plan fails to satisfy §401(a). This failure, however, generally will not affect the employer being treated as operating a qualified separate lines of business unless the employer is relying on benefits provided under the plan to satisfy the minimum benefit portion of the minimum/maximum benefit safe harbor of Reg. §1.414(r)-5(g)(2) with respect to at least one of its qualified separate lines of business.<sup>1392</sup>

### ***G. Application of Separate Line of Business Requirements and Special Rules***

#### *1. Testing Year Basis*

Whether an employer operates qualified separate lines of business is determined on a year-by-year basis with respect to the testing year. An employer may, therefore, satisfy the §414(r) rules with respect to one testing year and fail them for another. An employer may satisfy the §414(r) rules for two testing years by designating its lines of business differently in each of the testing years.<sup>1393</sup> If an employer designated its lines of business for a testing year differently than in the immediately preceding testing year, the employer would be required to so notify the IRS.<sup>1394</sup>

For purposes of applying §410(b) and §401(a)(26) on a qualified separate line of business basis, the §414(r) rules generally apply for all plan years beginning in the testing year.<sup>1395</sup>

#### *2. Averaging Rules*

To provide stability in the application of line of business qualification, an employer is permitted to apply certain of the qualified separate line of business requirements on the basis of up to a five-year moving average (absent large fluctuations). In determining whether specific percentages have been satisfied, an employer may average the results for the current testing year with the results for up to the preceding four testing years.<sup>1396</sup>

The special averaging rule may be applied to the following specific percentage determinations:

- the 90% separate employee workforce requirement of Reg. §1.414(r)-3(b)(4);
- the 80% separate management requirement of Reg. §1.414(r)-3(b)(5);
- the 25% provision-to-customers requirement applicable to the upstream line of business of a vertically integrated operation under Reg. §1.414(r)-3(d)(2)(iii);

<sup>1390</sup> Reg. §1.414(r)-9(b); Reg. §1.401(a)(26)-6(b)(8).

<sup>1391</sup> Reg. §1.414(r)-9(c)(2); Reg. §1.401(a)(26)-2(c).

<sup>1392</sup> Reg. §1.414(r)-9(c)(4).

<sup>1393</sup> Reg. §1.414(r)-1(d)(6)(i).

<sup>1394</sup> Reg. §1.414(r)-4(c)(1) (the required notice must specify each of the employer's qualified separate lines of business). See Rev. Proc. 93-40 and Instructions to Form 5310-A.

<sup>1395</sup> Reg. §1.414(r)-1(d)(6)(ii).

<sup>1396</sup> Reg. §1.414(r)-11(c)(1).

<sup>1384</sup> Reg. §1.414(r)-8(c)(1).

<sup>1385</sup> Reg. §1.414(r)-8(c)(1).

<sup>1386</sup> Reg. §1.414(r)-8(d)(4).

<sup>1387</sup> Reg. §1.414(r)-1(c)(3)(i).

<sup>1388</sup> Reg. §1.414(r)-1(c)(3)(ii).

<sup>1389</sup> Reg. §1.414(r)-1(c)(3)(i).

- the minimum and maximum highly compensated employee percentage ratios under the statutory safe harbor of Reg. §1.414(r)-5(b)(1) (but not the 10% exception under Reg. §1.414(r)-5(b)(4)); and
- the employee assignment percentage applied for purposes of the dominant line of business allocation method of Reg. §1.414(r)-7(c)(2) and the pro-rata allocation method of Reg. §1.414(r)-7(c)(3).<sup>1397</sup> The provisions specified above may not be applied based on an average if the percentage in any testing year falls below a minimum percentage or exceeds a maximum percentage by more than 10%.<sup>1398</sup>

The employer is given the flexibility to apply the averaging rules to each provision separately, except that the separate employee workforce and separate management requirements must be applied on the same basis. Further, the averaging rules may be applied in a testing year regardless of how they were applied in any other testing year. However, once a provision is applied on an averaging basis for a testing year, it must be applied on the same basis with respect to all qualified separate lines of business to which the provision is applied for the testing year.<sup>1399</sup>

### 3. Mergers and Acquisitions

A person that becomes part of an employer under §410(b)(6)(C) is deemed to satisfy the requirements of a qualified separate line of business, other than the 50-employee requirement and the notice requirement, for a period beginning on the date of the change in members of a group and ending on the last day of the first plan year beginning after such date (the “transition period”).<sup>1400</sup> In addition, the acquired employees are not taken into account and the property and services provided by the acquired business are disregarded for purposes of determining whether the employer’s other lines of business meet the requirements of Reg. §1.414(r)-3 through §1.414(r)-6. An employer may take advantage of this special rule only if the coverage under the plan covering employees of the newly acquired person is not significantly changed during the transition period.<sup>1401</sup>

<sup>1397</sup> Reg. §1.414(r)-11(c)(2).

<sup>1398</sup> Reg. §1.414(r)-11(c)(3).

<sup>1399</sup> Reg. §1.414(r)-11(c)(4).

<sup>1400</sup> Reg. §1.414(r)-1(d)(4); §410(b)(6)(C)(ii).

<sup>1401</sup> §410(b)(6)(C)(i).

The merger and acquisition administrative safe harbor may apply after the transition period expires. See the discussion at VI.C.3.b.(2).

### 4. Affiliated Service Groups

An employer may not designate its lines of business in a manner that results in separating employees of an affiliated service group from other employees of the employer.<sup>1402</sup>

### 5. Governmental and Tax-Exempt Employers

In general, the qualified separate line of business rules apply to plans sponsored by tax-exempt employers that are subject to §401(a)(26) and §410(b).<sup>1403</sup> The IRS acknowledges that plans maintained by such employers may have unique features that arise because the plan sponsor is tax-exempt, and a section is reserved in the QSLOB regulations to address these unique features. Pending issuance of further guidance, a reasonable good faith effort by tax-exempt employers to satisfy §414(r) consistent with the statutory and regulatory requirements is acceptable.<sup>1404</sup>

<sup>1402</sup> §414(r)(8); Reg. §1.414(r)-2(b)(3)(iv).

<sup>1403</sup> Reg. §1.414(r)-1(d)(5)(i). Section 1505 of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, permanently exempts state and local governmental plans, as defined in §414(d), from the provisions of §401(a)(3), §401(a)(4), and §401(a)(26), and §410, among others, for taxable years beginning on or after August 5, 1997, and treats such plans as satisfying those requirements for all previous taxable years. Section 861(a)(2) of the Pension Protection Act of 2006 (2006 PPA), Pub. L. No. 109-280, amends §1505(d)(2) of Pub. L. No. 105-34, effective for taxable years beginning on or after August 17, 2006, to exempt all governmental plans from the nondiscrimination and minimum participation rules. In addition, §906(a) of the 2006 PPA amends I.R.C. §414(d), effective for taxable years beginning on or after August 17, 2006, to provide that a governmental plan includes a plan which is established and maintained by an Indian tribal government (as defined in §7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with §7871(d)), or an agency or instrumentality of either, and all of the participants of which are employees of such entity substantially all of whose services as such an employee are in the performance of essential governmental functions but not in the performance of commercial activities (whether or not an essential government function).

<sup>1404</sup> Announcement 95-48 (obsoleted by Rev. Rul. 2009-18), which extended the effective date of the §414(r) regulations to plan years beginning on or after January 1, 1997, for plans maintained by tax-exempt organizations. In Notice 96-64, the IRS extended the date for applying the regulations under §414(r) until the first plan year beginning on or after October 1, 1997 for plans maintained by tax-exempt organizations.

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Working Papers for this Portfolio can be found online at <https://bloombergtax.com>.

### *Additional Resources*

The following resources are available on Bloomberg Law: Tax. For information on how to obtain this material, call 1-800-372-1033.

### **Bloomberg Tax Elections & Compliance Statements:**

- Vehicle Fringe Benefit: Employer's Election to Forgo Withholding Tax (§3402(s)).
- Qualified Plan: Separate Line of Business Notification (§414(r)).

