

Avoiding Fringe Benefit Pitfalls

Tax Traps, De Minimis Rules, Correction Procedures, Fiduciary Risks

Tax Issues

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General Considerations

- When looking at the taxation of fringe benefits, we are concerned about several issues:
 - Income taxation to the employee
 - Income tax withholding
 - FICA (Social Security and Medicare) taxes on both employer and employee
 - Form W-2 reporting
 - Excise taxes if Code section 409A is violated
 - Excise taxes on excess compensation or excess parachute payments

Income and FICA Taxes, and Income Tax Withholding: General Rule

- In the absence of a specific exemption, an employee is subject to the following on the value of all fringe benefits:
 - Income taxation.
 - Income tax withholding.
 - FICA (Social Security and Medicare) taxation of both employer and employee.
- With limited exceptions, an employer can deduct the cost of a fringe benefit provided to an employee, regardless of whether the benefit is taxable to the employee.
- **Examples:**
 - If an employer buys a car for an employee, the employee is taxed on the value of the car, and the employer can deduct the cost of the car.
 - If the employer supplies an employee with housing, the employee is taxed on the fair rental value of the housing, and the employer can deduct the expenses associated with the housing.

Income and FICA Taxes, and Income Tax Withholding: Exceptions to the General Rule

- **Exceptions fall into three categories:**
 - Exclusions to properly reflect income.
 - Exclusions to foster public policy goals.
 - Exclusions due to difficulty in measuring value.
- **In some instances, an employee can be permitted to pay for an excludable benefit out of wages on a pre-tax basis.**

Exclusions to Properly Reflect Income

- Dependent care (Code section 129)
- Working condition fringe benefits (Code section 132(a)(3))
- Qualified transportation fringe benefits (Code section 132(a)(5))
- Qualified moving expense reimbursement (Code section 132(a)(6); suspended except for military personnel for 2018 through 2025)
- Qualified retirement planning services (Code section 132(a)(7))
- Qualified military base realignment and closure fringe (Code section 132(a)(8))
- Meals provided for the convenience of the employer (Code section 119)

Exclusions to Properly Reflect Income (cont.)

Tax Tip

- **These benefits primarily relate to expenses that have mixed business and personal purposes.**
 - For example, is a dependent care expense necessary because the parents need to work, or because the parents chose to have children?
 - Is a parking expense necessary because the employee has to park to get to work, or because the employee chose to live far enough from work that driving was necessary?
- **For this reason, the expenses typically receive tax benefits only in the context of an employer plan. And they are generally subject to overall dollar limits.**
 - For example, the employee cannot take a tax deduction for parking expenses if the employer does not have a plan that covers parking. And there is an overall limit of \$265 a month on parking expenses that can be excluded from income.

Dependent Care

- Exclusion is limited to \$2,500 a year (\$5,000 for married couples filing jointly or single parents filing as head of household).
- Cost must be for a tax dependent, or a child of the employee.
- If for an adult, the adult must be incapable of taking care of themselves.
- The payments may not be to certain related individuals.
- Dependent care centers must meet federal and state requirements.
- The employee who receives dependent care assistance cannot also take the credit for dependent care expenses.
- The plan may not discriminate in favor of certain highly compensated employees, or provide more than 25% of the benefit to principal shareholders or owners.

Dependent Care (cont.)



Tax Tip

- Employees should be advised that the limits apply to the aggregate of the employee's and the spouse's dependent care programs.
 - For example, if the employee and spouse each put aside \$5,000, the overall limit will be exceeded.

Working Condition Fringe Benefits

- No limit on exclusion.
- Amounts provided to an employee to the extent that, if the employee paid for such property or services, such payment would be allowable as an employee business expense deduction under Code section 162 or 167.
- However, the 2% floor on employee business expenses does not apply.



Working Condition Fringe Benefits (cont.)

Tax Tip

- Only actual expenses, not estimated expenses, can be reimbursed.
 - For example, suppose that an employer wants to cover employees' uniforms. If it provides the uniforms, or requires that employees provide proof of expenses incurred for uniforms, the amount will be tax-free. If it provides a uniform allowance payable in the absence of proof, that allowance will be taxable.
- If the employer provides advance payments, the employee must have the obligation to verify the expenses, and return any excess amounts, after the fact.

Qualified Transportation Fringe Benefits

- Exclusion is limited to \$265 a month.
- Covers parking expenses or expenses of public transportation.
 - Bicycle transportation is no longer covered.
- Verification of expense is required.



Qualified Transportation Fringe Benefits (cont.)

Tax Tip

- Employees should be cautioned that Metro cards and the like can only be used for commuting, not sold to third parties.
- In the case of certain nonprofit employers, the benefit will not be taxable to the employee, but the employer will incur an excise tax to the extent it provides the benefit.



Meals Provided for the Convenience of the Employer

- Exemption is very limited.
 - For example, free meals provided on site in order to encourage employees to take a shorter lunch hour are not covered.
- Exemption is most common for on-call employees, e.g., doctors who cannot leave a hospital to take lunch because they are on call.
- The employer's deduction for meals is limited, even if the meals are excludible from the employee's income.
- When this exemption is not available, an employer can still subsidize meals under the rules applicable to qualified employee discounts (described on the next slide) by providing a cafeteria in which the employees pay only for the cost of the food, not the maintenance of the facility.



Exclusions to Foster Public Policy Goals

- Types:

- Retirement plans (beyond the scope of this webinar)
- Health plans (Code sections 105 and 106)
- Disability plans (Code section 105)
- Group term life insurance (Code section 79)
- Educational assistance (Code section 127)
- Adoption assistance (Code section 137)
- Achievement awards (Code section 74)

- Example:

- In the absence of tax benefits, employers might be inclined simply to pay higher wages rather than providing health benefits.
- However, recognizing that a healthy citizenry is important to the country as a whole, the Code provides that health benefits that meet certain criteria will receive favorable tax treatment.

Health Plans

- Health insurance (or comparable self-funded plans).
- Flexible spending accounts for health benefits.
- Health savings accounts.
- Health reimbursement accounts.
- Exclusion covers both amounts paid (e.g., for premiums) and benefits received (e.g., doctors' bills).



Health Insurance or Self Funded Plan

- No dollar limit on exclusion.
- Can provide benefits for employee, spouse, dependents, and children through age 26.
- Self-funded plan cannot discriminate in favor of highly compensated employees.
- Provides benefits during period of coverage, which includes COBRA coverage under certain circumstances, but not benefits extending out to years beyond when premiums are paid.

Health Flexible Spending Accounts

- Exclusion is limited to \$2,650 per year.
- Use it or lose it rule generally means you must use the benefits for medical expenses in the current plan year.
- Exceptions:
 - Plan can provide a "grace period" of up to 2½ extra months after the end of the year.
 - Plan can allow you to carry over up to \$500 per year to use in the following year.

Health Flexible Spending Accounts (cont.)

Tax Tip

- For an employee with a health savings account (see next section), the money can only be spent on noncore (vision and dental) expenses.



Health Savings Accounts

- **Exclusion is limited to:**
 - Generally, \$3,500 per year if you have single coverage or \$7,000 for family coverage.
 - Extra \$1,000 for someone 55 or older.
 - Combined limit applies if employee has an HSA that is not an employer plan.
- **Available only to an employee with a high deductible health plan.**
 - Deductible of at least \$1,350 for single coverage or \$2,700 for family coverage.
- **During employment, can be used for medical copays, deductibles, and amounts not covered by insurance.**
- **Amounts not used for copays or deductibles can be carried over to future years including into retirement, when they can be used for premiums as well as unreimbursed expenses.**
- **If not used for medical expenses, can be paid in cash to the employee or a death beneficiary, but the amounts will be taxable.**

Health Savings Accounts (cont.)

Tax Tip

- Employees covered by Medicare are not eligible for contributions, although they can still spend down amounts previously contributed.
- Contributions should be discontinued six months before Medicare starts.
- Only Medicare coverage, not Medicare eligibility, is an issue.
- Medicare coverage begins on the earlier of receipt of Social Security benefits or application by an employee who is at least 65.
- Thus, an employee who is under age 70 and still covered by an employer's high deductible health plan may wish to defer applying for Medicare, even though Medicare Part A is free.

Health Reimbursement Accounts

- Exclusion is limited to contributions of \$5,150 per year for self-only employees and \$10,450 for employees with a family.
- Amounts must be paid by the employer, rather than taken out of the employee's paycheck.
- Amounts can be carried over from year to year.
- Amounts can be used:
 - During the employee's life, for medical care of the employee, spouse, or dependent.
 - After the employee's death, for medical care of the employee's spouse or dependent.

Health Reimbursement Accounts (cont.)

Tax Tip

- Amounts can never be used for nonmedical expenses, or for beneficiaries other than a spouse or dependent.
- Thus, the amount must be forfeited if the employee dies without having used the amount, and has no spouse or dependents.



Disability Benefits

- No dollar limit on exclusion.
- Benefits are only for employee, not spouse or dependents.
- If premiums are not included in the employee's income, any benefits will be taxable. Conversely, having the premiums paid on an after-tax basis will avoid taxation on any benefits paid.

Tax Tip

- Having disability premiums paid with after-tax money obviously increases taxes immediately.
- However, it effectively increases the disability protection the employee receives, as any disability benefits will not be subject to tax.

Group Term Life Insurance

- Exclusion for contributions limited to \$50,000 in coverage.
- Death benefits from life insurance are excluded from income, regardless of the amount (although interest due to delayed payment is taxable).



Tax Tips

- Most employers that provide group term life insurance do not limit the coverage to \$50,000.
- Providing life insurance of more than that amount is permissible, and still provides the tax benefit of having the death benefits excluded from income.
- However, the cost of the excess life insurance must be included in the employee's Form W-2, and will be taxable.

Educational Assistance

- Exclusion is limited to \$5,250 a year.
- Must be paid by the employer, without reduction in the employee's pay.
- Can provide any form of instruction or training that improves or develops the capabilities of an individual, other than for sports, games, or hobbies.
- Benefits must be only for the employee, not spouses or dependents.

Tax Tip

- Amounts in excess of \$5,250 for job-related education cannot be excluded as educational assistance, but may in some instances be excluded as a working condition fringe.

Adoption Assistance

- Exclusion is limited to:
 - \$10,000 for a special needs child.
 - The lesser of actual expenses or \$10,000 for any other child.
- The exclusion is phased out for adjusted gross income of over \$150,000.
- As with dependent care expenses, an employee must choose between an excludible benefit and a tax credit.
- Underlying policy:
 - In the case of the birth of a child, a health plan can cover the cost.
 - Adoption assistance plans are intended to provide at least some comparable benefits in the case of an adopted child.

Achievement awards

- Limited to \$1,600 a year
- Defined as an item of tangible personal property which is:
 - transferred by an employer to an employee for length of service achievement or safety achievement,
 - awarded as part of a meaningful presentation, and
 - awarded under conditions and circumstances that do not create a significant likelihood of the payment of disguised compensation.

Exclusions Due to Difficulty in Measuring Income

- **Types:**

- No-additional-cost service (Code section 132(a)(1)).
- Qualified employee discount (Code section 132(a)(2)).
- De minimis fringe (Code section 132(a)(4)).
- On-premises athletic facility (Code section 132(j)(4)).

- In some instances, an employer provides a benefit to employees generally, but it is difficult or impossible to allocate the cost among individual employees.
- In others, the amount at issue is small enough that it is not worth the administrative cost of including it in Form W-2 income.

No-Additional-Cost Service

- A “no-additional-cost service” is any service provided by an employer to an employee for the employee's personal use if:
 - The service is offered for sale by the employer to its customers in the ordinary course of the line of business of the employer in which the employee performs substantial services, and
 - The employer incurs no substantial additional cost in providing the service to the employee including foregone revenue and excluding any amount paid by or on behalf of the employee for the service.
- An example would be an airline that allows its employees to travel standby for free.
- If the service is provided to a highly compensated employee, it qualifies for the exclusion only if it is also provided on the same terms to other employees.

No-Additional-Cost Service (cont.)

Tax Tip

- If the provision of a service does not qualify as a no-additional-cost service, a discount of up to 20% of the value may still fall under the rules for a qualified employee discount. (See next slide.)



Qualified Employee Discount

- A qualified employee discount is any discount on qualified property or services provided by the employer.
- Qualified property or services is any property or services offered for sale to customers in the ordinary course of the line of business in which the employee performs substantial services.
- For property, the discount cannot result in the employee paying less than the cost to the employer.
- For services, the discount cannot be more than 20%.

De Minimis Fringe

- A de minimis fringe benefit is any property or service that an employer provides to employees that has such a small value that accounting for it would be unreasonable.
 - An example would be snacks provided in an employee break room.
- Frequency is taken into consideration in determining whether a benefit is de minimis.
- Cash and cash equivalent fringe benefits (for example, a gift card), no matter how small the amount, cannot qualify as a de minimis benefit.
- While snacks are not taxable to employees, meals are taxable unless they meet the standards for meals provided for the convenience of the employer or no-additional-cost services.
- The dividing line between “snacks” and “meals” is not well developed.

On-Premises Athletic Facility

- This covers a gym or similar facility on the employer's business premises.
- Memberships in off-premises athletic facilities are not covered.
- To the extent that an employer is in the business of running athletic facilities, such a facility may be excluded as a no-additional-cost fringe benefit even if it does not qualify as an on-premises athletic facility.



Cafeteria Plans (Code section 125)

- Costs of benefits is payable by the employee, not the employer.
- Effect is to reduce the employee's income, and wages for income tax withholding and FICA purposes, by the amount paid for fringe benefits.
- This is in some ways comparable to a tax deduction, except that the payment simply reduces the amount shown on the employee's Form W-2, instead of being deducted on the employee's tax return.
- Mechanism is a fiction that the employee's salary is reduced, and that the employer pays the cost of the benefits.
- **Example:** Employee has a salary of \$50,000, and wants to contribute \$5,000 for dependent care. Under the cafeteria plan, the tax law treats the employee as having wages of \$45,000, and treats the dependent care as having been provided by the employer on a tax-free basis.
- Special requirements such as a requirement that a plan not discriminate in favor of highly compensated employees apply to benefits funded through cafeteria plans.
- Only certain benefits (primarily health insurance, health FSAs, life insurance, disability benefits, dependent care benefits, and transportation fringe benefits) can be provided through a cafeteria plan.
 - For example, a health reimbursement account cannot be provided under a cafeteria plan.

Section 409A Issues

- Section 409A governs plans that provide for the deferral of compensation.
- While we normally think of this in the context of retirement-type plans, it can affect certain fringe benefit plans:
 - Vacation and sick pay plans
 - Disability plans
 - Severance plans

Effects of Section 409A

- Section 409A provides special rules for deferred compensation:
 - Timing of deferrals or designation of time and form of payment.
 - Acceleration and further deferral of benefits.
 - Events which can give rise to distributions.
- Consequences of 409A failures:
 - **Immediate income inclusion:** all compensation previously deferred is included in the employee's gross income to the extent that the amounts are vested;
 - **20% Penalty** (in addition to regular income taxes) on the amount required to be included in income; and
 - **Interest:** the employee must pay interest (at 1% above the normal underpayment penalty rate) based on the underpayment that would have occurred had the deferred compensation been includible in income in the year first deferred (or, if later, the first taxable year the deferred amounts were vested).

Section 409A: Vacation and Sick Pay Plans

- A bona fide sick leave or vacation leave plan is not considered deferred compensation if the plan's primary purpose is providing an employee with paid time off from work because of sickness, vacation, or for other personal reasons.



Section 409A: Vacation and Sick Pay Plans (cont.)

- Whether a plan's primary purpose is to provide for sick leave or vacation leave is based on the facts and circumstances. Factors to consider include:
 - Whether the leave could reasonably be expected to be used by the employee in the normal course;
 - The employee's ability to exchange accrued unused leave for cash or other benefits (including nontaxable benefits or the use of leave to postpone termination of employment);
 - Any restraints on the ability to accumulate unused leave and carry it forward to subsequent years where the accrued leave may be exchanged for cash or other benefits;
 - The amount and frequency of any in-service distributions of cash or other benefits offered in exchange for accrued, unused leave;
 - Whether accrued unused leave is paid promptly upon severance from employment or over a period after severance from employment; and
 - Whether the plan or any plan features are available only to a limited number of employees.

Section 409A: Disability Plans

- A plan that pays benefits only in the event of an employee's disability is not considered a deferred compensation plan.
- An employee is considered disabled only if the employee:
 - Is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or last for a continuous period of not less than 12 months;
 - Is, by reason of any medically determinable physical or mental impairment that can be expected to result in death or last for a continuous period of not less than 12 months, receiving income replacement benefits for at least three months under an accident and health plan covering employees of the employer;
or
 - Is determined to be totally disabled by the Social Security Administration or Railroad Retirement Board.

Section 409A: Severance Plans

- A severance plan is not considered deferred compensation plan if:
 - The amount is payable only in the event of an involuntary severance (not retirement or other voluntary termination).
 - The amount paid does not exceed the lesser of twice the annual salary of the affected employee or the compensation limit under retirement plans (\$280,000 for 2019); and,
 - The severance payments will not extend beyond two years from the date of termination.
 - Severance plans for executives frequently exceed the maximum dollar limits or extend beyond two years. In this case, the rules of Code section 409A must be followed.

Excise Tax on Excess Compensation or Excess Parachute Payments

- These taxes are in general beyond the scope of this presentation.
- To the extent that certain top employees may be subject to these taxes, fringe benefits that are includible in income may be part of the remuneration counted for purposes of the excise tax on excess compensation.
- Large severance payments may trigger the excise tax on excess parachute payments.

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