

Taking Cash Out: More Tax-Favored Fringe Benefits

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If you are an owner and an employee of a C corporation, we encourage you to take full advantage of the many tax-favored employee fringe benefits available in the Internal Revenue Code. Unlike salaries and bonuses, these benefits are free of income and employment taxes. And unlike dividends, the costs of the benefits are fully deductible by the corporation.

True, in some cases, the favorable tax treatment comes at a price: The benefit must be provided on a nondiscriminatory basis to other employees. But, depending on the particular situation, this may not be as much of a hardship as it appears. For example, in a corporation with young owners with families and an older workforce with few children, the corporation can set up a dependent care assistance program and provide the owners with as much as 25% of the program's total benefits [IRC Sec. 129(b)(4)].

And other benefits can be provided solely to owner-employees. For example, a corporation can set up a health insurance plan covering only owner-employees (assuming the plan is not self-insured [see IRC Sec. Sec. 105(h)]).

Now let's take a closer look at some of the key tax-favored fringe benefit plans that are available.

Qualified Fringe Benefits

The tax treatment of a number of fringe benefits is governed by individual sections of the Code, each with its own set of restrictions and limitations. If a fringe benefit does not fall into one of these statutory categories, then it is either (1) includible in the owner-employee's income or (2) excludible under the catchall provision of Section 132 of the code (see below).

Health plan. As a general rule, an employer's payments for and employee's coverage under a health plan are deductible by the employer and tax-free to the employee [IRC Sec. 162, 106]. This rule includes

Contributions to the cost of health insurance;

Contributions to a trust or fund that provides health benefits either directly or through insurance;

Contributions to a health savings account (HSA) or medical savings account (MSA) that can be used by an employee to pay medical expenses;

Direct payment of an employee's medical expenses or reimbursement to an employee for his or her expenses (i.e., payments under a self-insured plan).

Benefits received under an insured plan are generally not taxable to an employee [IRC Sec. 105(e)]. This exclusion applies to benefits for an employee's own medical expenses as well as benefits for expenses of an employee's spouse and dependents. However, benefits paid to highly compensated employees under a discriminatory self-insured health plan are taxable to the extent they represent "excess reimbursements" to those employees.

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Adoption assistance. Employer-provided payments or reimbursements under a qualified adoption assistance program generally are excludable from gross income up to a maximum amount per eligible child, subject to an income limitation [IRC Sec. 137]. The maximum exclusion, adjusted for inflation, is \$10,630 per eligible child for 2005 [Rev. Proc. 2004-71, 2004-50 I.R.B. 1].

A qualified adoption assistance program is a separate written plan of an employer that meets all of the following requirements:

The plan benefits employees under rules that do not favor highly compensated employees or their dependents;

The plan does not give more than 5 percent of its payments during the year to shareholders or owners (or their spouses and dependents) who own more than 5 percent of the stock or capital profits interests in the business;

The employer gives reasonable notice of the plan to eligible employees; and

Employees provide reasonable substantiation that payments or reimbursements are for qualifying expenses [IRC Sec. 137(c)].

Disability income benefits. A disability income plan is a plan that provides income replacement benefits to employees who are unable to work because of illness or accident. The Code provides an income exclusion for the cost of disability insurance coverage received from an employer [IRC Sec. 61(a)(1), 104(a)(3), 105(a), 106].

The tax treatment of disability income benefits received by an employee depends on who paid the premiums for the disability coverage. To the extent that the disability income benefits are attributable to employer contributions or payments, they are taxable. However, to the extent that the disability income benefits are attributable to the employee's own contributions, they are not taxed [IRC Sec. 104(a)(3), 105(a)].

Educational assistance. A tax-qualified education assistance plan (EAP) can provide an employee with up to \$5,250 per year of tax-free educational assistance [IRC Sec. 127]. An EAP must be a separate written plan that provides assistance only to employees. An EAP will qualify only if all of the following tests are met:

The plan benefits employees under rules that do not favor highly compensated employees.

The plan does not provide more than 5 percent of its benefits during the year to shareholders or owners who own more than 5 percent of the stock or capital or profits interest of the business.

The plan does not allow employees to choose to receive cash or taxable benefits instead of education assistance.

The employer gives reasonable notice of the plan to eligible employees [IRC Sec. 127(b)].

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Long-term care insurance. Employer-provided long-term care insurance is treated as health insurance. Therefore, the value of employer-paid coverage is excludable from an employee's income as contributions to a health plan [IRC Sec. 106, 213(d)(1)(c)].

In order to be treated as qualifying long-term care insurance for tax purposes, the insurance contract must meet all of the following requirements:

The only insurance protection provided under the contract is coverage of qualifying long-term care services;

The contract does not pay or reimburse expenses covered by Medicare (including Medicare deductibles or coinsurance amounts) except where Medicare is secondary or the contract makes per diem or other periodic payments without regard to expenses;

The contract is guaranteed renewable;

The contract does not provide for a cash surrender value or other money that can be borrowed or paid, pledged, or assigned as collateral for a loan (this does not prohibit a refund on the death of the insured or on a complete surrender or cancellation of the contract if the refund does not exceed the premiums paid under the contract);

All premium refunds and policyholder dividends must be applied as a reduction in future premiums or to increase future benefits; and

The contract complies with a number of consumer protection provisions [IRC Sec. 7702B].

Amounts received as benefits under a qualified long-term care insurance contract generally are treated as amounts received as reimbursements for expenses incurred for medical care [IRC Sec. 7702B(a)(2)]. Therefore, they are generally excludable from income. However, special exclusion limits may apply if the insurance contract pays benefits on a per diem basis without regard to the actual costs of the qualified long-term care services [IRC Sec. 7702B(d)].

Dependent care assistance program. A dependent care assistance plan is a program sponsored by an employer to provide care for employees' dependents. Benefits may take the form of employer-provided cash, cash reimbursement for dependent care expenses incurred by the employee, or both [IRC Sec. 129]. If the dependent care assistance program satisfies certain requirements, dependent care is excludable from an employee's income up to specified limits. The maximum annual exclusion is \$5,000 if the employee is single or is married and files a joint tax return, or \$2,500 if the employee is married and files a separate tax return [IRC Sec. 129(a)(2)].

The contributions or benefits under the program cannot discriminate in favor of highly compensated employees and not more than 25 percent of the amounts the employer pays or incurs for dependent care assistance during the year may be provided for more than 5 percent owners (or their spouses or dependents) [IRC Sec. 129(d)].

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Section 132 Fringe Benefits

Fringe benefits excludable from an employee's income under Section 132 include:

No-additional-cost services,

Qualified employee discounts,

Working condition fringes;

De minimis fringe benefits;

On premises athletic facilities;

Qualified transportation fringe benefits, and

Employer-provided retirement advice.

A highly compensated employee who receives a no-additional cost service or a qualified employee discount can't exclude the benefit from income unless the benefit is available on substantially the same terms to all employees of the employer or to a particular qualified group of employees [IRC Sec. 132(j)(1)].

No additional cost service. This exclusion applies to a service an employer provides to an employee if it does not cause the employer any substantial additional costs. The service must be offered to customers in the ordinary course of the employer's line of business [IRC Sec. 132(b)].

Generally, no-additional-cost services are excess capacity services, such as airline, bus, or train tickets; hotel rooms; or telephone services provided free or at a reduced price to employees working in those lines of business.

Qualified employee discounts. This exclusion applies to a price reduction an employer gives an employee on property or services it offers to customers in the ordinary course of business [IRC Sec. 132(c)]. However, it does not apply to discounts on real property or discounts on personal property of a kind commonly held for investment (such as stocks or bonds).

There are limits on the employee discount exclusion.

For a discount on services, the exclusion cannot exceed 20% of the price charged non-employee customers for the service.

For a discount on merchandise or other property, the exclusion cannot exceed the employer's gross profit percentage times the price charged non-employee customers for the property [IRC Sec. 132(c)(1)].

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Working condition fringe benefits. This exclusion applies to property and services an employer provides to an employee so that the employee can perform his or her job. It applies to the extent the employee could deduct the cost of the property or services as a business expense or depreciation expense if he or she had paid for it. The employee must meet any substantiation requirements that apply to the deduction [IRC Sec. 132(d)].

Examples of excludable working condition fringe benefits include

Cars used for business or demonstration.

Chauffeur services.

Transportation required because of security concerns (such as terrorist activity, death threats, and threat of kidnapping or serious bodily harm).

Airplanes and air transportation.

Bodyguards.

Use of consumer goods for product testing and evaluation.

Travel expenses, including meals and lodging.

Computers.

Entertainment directly related or associated with business.

This exclusion also applies to a cash payment provided for an employee's expenses for a specific or prearranged business activity for which a deduction is allowable to the employee. The employee must verify that the payment is actually used for those expenses and to return any unused part of the payment.

De minimis fringe benefits. A *de minimis* benefit is any property or service an employer provides to an employee that has so little value that accounting for it would be unreasonable or administratively impracticable [IRC Sec. 132(e)]. Cash, no matter how little, is never excludable as a *de minimis* benefit, except for occasional meal money or transportation fare.

Examples of *de minimis* benefits include the following:

Occasional personal use of a company copying machine if the employer sufficiently controls its use so that at least 85% of its use is for business purposes.

Holiday gifts, other than cash, with a low fair market value.

Group-term life insurance payable on the death of an employee's spouse or dependent if the face amount is not more than \$2,000.

Occasional parties or picnics for employees and their guests.

Occasional tickets for entertainment or sporting events.

Occasional typing of personal letters by a company secretary.

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On premises athletic facilities. The exclusion is available for an employee's use of an on-premises gym or other athletic facility (e.g., a swimming pool or golf course) [Reg §1.132-1(e)(1)]. Substantially all of the facility's use during the calendar year must be by the employer's employees, their spouses, and dependent children. Thus, the exclusion does not apply if the athletic facility is made available to the general public through membership sales, rental, or similar arrangements [Reg. 1.132-1(e)(1)].

An athletic facility must be located on premises owned or leased by the employer, but need not be located on the employer's business premises. However, athletic facilities that are facilities for residential use (such as a resort with accompanying athletic facilities) do not qualify [Reg. 1.132-1(e)(2)].

Qualified transportation fringe benefits. Qualified transportation fringe benefits are assistance for commuting costs that may be excluded from employees' incomes. There are three types of qualified transportation benefits:

Transportation in a commuter highway vehicle (van pooling) between an employee's home and the workplace,

Transit passes, and

Qualified parking [IRC Sec. 132(a)(4)].

For 2005, the exclusion is limited to: (1) \$105 a month for any combination of transit passes and other commuter transportation, and (2) \$200 a month for parking.

The exclusion for qualified parking applies to parking provided by an employer for an employee at or near-

the employer's business, or

the place from which the employee commutes to work by carpool, mass transit, commuter highway vehicle, or commercial vehicle seating at least six passengers not counting the driver.

Parking provided at or near the employee's residence doesn't qualify for the exclusion [IRC Sec. 132(a)(5)(D)].

Employer-provided retirement advice. This exclusion covers any retirement planning advice or information provide to an employee or his or her spouse if the employer maintains a qualified retirement plan. In addition to advice and information about the employer-provided plan, the services provided may include general advice and information on retirement. However, the exclusion does not apply to tax preparation, accounting, legal, or brokerage services [IRC Sec. 132(m)].

Terence M. Myers, J.D. and Dorinda D. DeScherer, J.D. are nationally renowned writers on tax topics for such publications as Accountants Tax Weekly, Tax Return Preparer's Letter, Nonprofit Tax and Financial Strategies, and Executive's Tax and Management Report. For many years Myers was Managing Editor and DeScherer Assistant Managing Editor for many Prentice Hall tax newsletters. Myers and DeScherer have published books and other publications with Harcourt Professional Publishing, Aspen Publishers, Prentice Hall, and the AICPA.