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STATUTORY (FORMERLY NON-STATUTORY) FRINGE BENEFITS: New § 132*

By
Jerry J. McCoy

I. BACKGROUND AND INTRODUCTION

Non-cash fringe benefits of various types have grown significantly in recent years as a proportion of the total compensation package. The number of statutory rules provided for specific fringe benefits increased steadily in the 1970's until finally the Tax Reform Act of 1984 created the first comprehensive statutory scheme to govern the tax consequences of all incidental fringe benefits. These fringes were formerly identified as "nonstatutory fringe benefits" due to their diverse nature, which appeared to render them incapable of statutory definition. Despite this, these now have an Internal Revenue Code provision, section 132.

The incidental fringe benefit rules in section 132 appear to have been formulated largely with a view toward the large corporate employer and the non-shareholder employee. Application of the resultant structure to closely-held businesses, where the major fringe benefits are enjoyed by dominant owners and their families, raise different considerations.

This paper will review the current statutory framework for taxation of fringe benefits, including the proposed regulations under section 132, and examine some of the special implications those rules have for employees of closely-held corporations and other businesses.

A. *History*

Many of the governing principles in this area originated with ancient rulings by the Bureau of Internal Revenue. In 1920, in O.D. 514, 2 C.B. 90 (1920), the Bureau ruled that supper money paid to employees who worked late on their employer's business was not taxable to them. The issue framed by the Bureau was whether these amounts were "income" of the sort subject to tax. The answer was that these items were not taxable, because these payments were for the convenience of the employer. The following year, in O.D. 946, 4 C.B. 110 (1921), the Bureau ruled on the taxability of railroad passes provided to employees and their families by railroad companies; the holding this time was that the amounts in question were not taxable on grounds they represented gifts to the employees. The reasoning in this ruling may be obsolete, but the result remains the same in most cases, even today. Beyond the actual holdings, however, these old rulings demonstrated something else, for they set a precedent for the handling of these items. In general, noncash fringe benefits were

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simply ignored. They were taxed (or more accurately, were not taxed) largely on the basis of unwritten, administration practice and custom.

Over the years, statutory rules were adopted for a number of particular types of fringe benefits. A partial list of these would be as follows:

Group Term Life Insurance (§ 79)
Reimbursed Moving Expenses (§§ 82 and 217)
Medical Reimbursement Plans (§ 105)
Meals or Lodging Furnished for the Convenience of the Employer (§ 119)
Qualified Group Legal Services Plans (§ 120)
Qualified Employer-Provided Transportation (§ 124)
Cafeteria Plans (§ 125)
Dependent Care Assistance Programs (§ 129)
Qualified Pension, Profit-Sharing, Etc. Plans (§ 401 *et. seq.*)

But for the basic run-of-the-mill fringe benefit, such as the company car, free travel and the like, there was no statutory guidance, and the regulations added very little. As a result, a large amount of dollar value passed from employers to employees free of tax.

B. *Economic Effect*

A major tax saving, or economic gain, arises if an employer pays an expense enjoyed by an employee. An employee must earn more than $1.00 to have a $1.00 left over after taxes to spend on a particular item. At the 50% top bracket, the employee must earn $2.00 to net $1.00 after taxes. The former amount was even higher when Federal income tax rates rose as high as 70% or 92%. If the item in question is deducted, and the employee spends this $1.00 on the item, his net after-tax cost is $.50. However, if the *employer* pays it as a fringe benefit, there was (formerly) usually no cost to the employee (because items of this sort slipped through the system without detection in many cases). Even if the amount in question was included in the employee's income, the only cost to the employee would be the tax on this amount. And if the item is deductible, it doesn't matter to the employee whether it is taxable or not.

This put a lot of pressure on employers to secure for their employees benefits of this sort. This was especially so in a small corporation, where the employees' interests tend to be closer to those of the employer. All of these factors made this the sort of area that attracted the interest and attention of the Internal Revenue Service.

C. *Pre-1984 Developments*

The modern era in fringe benefit taxation began in 1975, when the Internal Revenue Service came up with the first set of regulations designed to deal definitively with the taxability of miscellaneous non-cash fringe benefits. These were published in the Federal Register as a "discussion draft," and they

did indeed spark considerable discussion. Even though these proposed rules were fairly generous as a general matter, they caused great excitement in the tax world. Eventually, in December of 1976, Treasury Secretary Simon announced (in his last full month on the job) that the draft fringe benefit regulations were being withdrawn.

Subsequently, Congress began to play an active role in this area. Acting out of concern that the Internal Revenue Service still harbored plans to make an administrative move toward taxing fringe benefits, Congress passed in 1978 the first moratorium on the issuance of final regulations on this subject. This legislation forbade the Internal Revenue Service from issuing final regulations on the subject before 1980. Subsequently, in 1979, the moratorium was extended until 1981. Thereafter, the Economic Recovery Tax Act of 1981 extended the moratorium again, this time to December 31, 1983. Along the way, the Treasury Department prepared some revised draft regulations on the subject in 1981, as a sort of trial balloon. These regulations were never officially issued, presumably due to the moratorium.

Congress began consideration of a comprehensive statute dealing with non-cash fringe benefits in 1983, and in the following year, in Rev. Proc. 84-14, the Internal Revenue Service announced a voluntary moratorium, promising it would not promulgate rules before 1985. Finally, as part of the Tax Reform Act of 1984, the first statute on this subject was enacted, generally effective January 1, 1985.

Throughout the period just described, the actual taxation of fringe benefits existed in a sort of limbo. The old rules (which lacked clarity and definiteness) continued to be applicable without new administrative guidance. Taxpayers were understandably nervous, since the Internal Revenue Service obviously had its eye on fringe benefits. This period was thus marked by an abundance of activity, with no real action.

II. INCIDENTAL FRINGE BENEFIT TAX RULES (§ 132)

Section 132, which took effect January 1, 1985, provides exclusions for four categories of incidental fringe benefits, as described below. The 1984 Act, which created section 132, also added the term "fringe benefits" to the categories of compensation includible in gross income under section 61. Thus, any fringe benefit not excludible under section 132 (or another Code provision) will be included in gross income for income tax purposes.

The purpose of this statute was to end all the prior uncertainty. Like any new statute, however, this one brought primarily a new and unfamiliar uncertainty. It should be noted that the most vexing problem of all in many cases is valuation of fringe benefits, and section 132 provides no help on this score. Thus, even if taxpayers and their advisors are able to find peace with the new rules themselves, this field is likely to be a continuing source of controversy, at least from a valuation standpoint.

It is worth nothing, however, that the Internal Revenue Service has provided

some help on valuation. The temporary regulations under the 1984 amendment to section 61 do address the problem in some context. See, for example, Temp. Regs. § 1.61-2T, providing rules for employee-provided automobiles, commuting uses of vehicles, flights on employee planes, and free or discounted commercial airline flights, respectively.

A. *No-Additional-Cost Service Exclusion (§ 132(b))*

1. *General Rule*

An employer-provided service may be excluded by an employee if —

a. The service is offered for sale to customers during the ordinary course of the line of business of the employer in which the employee works, and
b. The employer incurs no substantial additional cost (including foregone revenue) in providing the service to the employee (without regard to amounts the employee pays for the service).

2. *Specific Problem Areas*

a. *Line of Business Restriction*—The classic example is an employer operating both an airline and a hotel; such an employer may not provide excludible air travel to hotel employees and vice versa. Managerial, accounting, and similar personnel may render services which directly benefit more than one line of business; if so, they may exclude value of services from all lines of businesses benefitted.

Special Election—By December 31, 1985, a multi-line business may elect to *continue* providing excludible no-additional-cost services and qualified employee discount fringe (see below) to all employees of all lines of business in existence as of January 1, 1984. A 30% excise tax applies to excess fringe benefits. See section 4977 and Temp. Reg. § 54.4977-1T (1/2/85); an original March 31, 1985 deadline was extended to December 31, 1985 by IRB 85-31.

b. *Reciprocal Arrangements*—An employee may exclude no-additional-cost fringes provided by another employer pursuant to a bona fide reciprocal agreement. Thus, for example, employees of Pan Am may exclude free flights on United if the two airlines enter into such an agreement. Where an agreement is in effect, the services in question are treated as provided by the employee's own employer, and must meet all the other applicable tests.

c. *Discrimination*—The no-additional-cost exclusion is available to officers, owners and highly-compensated employees only if the benefit is made available on a nondiscriminatory basis. Under the Temporary Regulations (§ 1.132-1T, Q12), a "highly-compensated" employee is one whose compensation exceeds that of 90% of all employees, except that (1) any

employee who is paid over $50,000 for a year is highly compensated, and (2) no one paid $20,000 or less is highly compensated unless no employee is paid over $35,000.

B. *Qualified Employee Discount Exclusion*

1. *General Rule*

An employee may exclude a discount on services or property (other than real property and investment property) of the sort offered for sale to customers in the ordinary course of the line of business of the employer in which the employee works. The amount of this exclusion is limited to the employer's gross profit percentage in the case of property, and 20% of the ordinary selling price in the case of services.

2. *Specific Problem Area*

a. *Line of Business Limitation*—This limitation is the same as for no-additional-cost service (described *supra*), except (1) a special grandfather rule is provided for affiliated groups which include a department store operation, where non-store employees had department store discount privileges as of October 5, 1983; (2) another special rule is provided for leased sections of a department store which allows employees, in effect, to treat the entire store as a single line of business; and (3) there is *no* reciprocal agreement rule.

Note: The special election, to be made by multi-line businesses by December 31, 1985, *does* apply. See II. A. 2. a., *supra*.

b. *Discrimination*—The qualified employee discount exclusion is available with respect to officers, owners and highly-compensated employees only if the benefit is made available on a nondiscriminatory basis. Rules here are the same as for the no-additional-cost service exclusion, as described above.

C. *Working Condition Fringes*

1. *General Rule*

An employee may exclude from income the value of any property or services provided by his/her employer to the extent that, if the employee paid for the property or services directly, the payments would be deductible under sections 162 or 167. For example, payment of bar association dues by a law firm/employer would be excludible as a working condition fringe.

Under section 132(h) (4), the term "working condition fringe" specifically includes parking provided to an employee on or near the employer's business premises, without regard to deductibility under section 162.

2. *Specific Problem Areas*

a. *Use of Company Car or Plane*—Such items are excludible as

a working condition fringe only if and to the extent used for business purposes. However, incidental personal use may be excludible as a de minimis fringe (discussed below).

b. *Valuation of Auto Use*—Taxability is generally determined under the "annual lease value" tables in Temporary Regs. § 1.61-2T. These figures are based upon the fair market value of the car, and seek to approximate the annual cost of leasing the car under a four-year lease including maintenance and insurance. Other costs (*e.g.*, fuel, driver, tolls, etc.) are *not* included and must be separately taken into account.

c. *Optional Daily Rate for Commuting*—An employee who is *not* an officer or a 1% owner of the employer (5% between 1/1/85 and 3/22/85), and who is using a vehicle subject to an employer policy that he or she may make personal use of it only for commuting or other de minimis purposes, may elect to value the personal use at a flat $3 per day.

D. *De Minimis Fringes*

1. *General Rule*

An employee may exclude from income the value of any property or service which has the value (taking into account the frequency with which similar fringes are provided) so small as to make accounting for it unreasonable or administratively impractical. A typical example would be occasional personal use of an employer's photocopy machine.

2. *Subsidized Eating Facility*

An eating facility located on or near the employer's business premises will be treated as an excludible de minimis fringe if the revenue from the facility normally equals or exceeds its direct operating cost. While the non-discrimination rules are not generally applicable for de minimis fringes, they are applicable in the case of such eating facilities.

E. *On-Premises Gyms and Other Athletic Facilities*

A separate exclusion is provided under section 132(h) (5) for the value of a gym or other athletic facility operated by the employer on the employer's premises, provided substantially all the use of the facility is by the employees and their spouses and dependent children. The non-discrimination rules are not applicable to these benefits.

III. SPECIFIC FRINGES

A. *Below-Market Rate Loans*

Another provision enacted by the 1984 Act, new section 7872, attempts to deal comprehensively with a growing taxpayer abuse—the below-market rate loan. The statute takes the simple tack of recharacterizing such loans as market rate loans. The foregoing interest is deemed paid to the lender

by the borrower, and the borrower will generally receive a deduction for this amount. The same amount is deemed paid over to the borrower from the lender and characterized according to the context involved. In the case of an employment relationship, this amount would be treated as compensation.

If the loan in question is a demand loan, the tax treatment is basically as outlined above. Under these circumstances, the result is a "wash" for the employee, with an income inclusion and a deduction in offsetting amounts. The only exception would be the requirement that FICA and FUTA taxes be taken into account. On the other hand, there can be mismatching if the loan is a term loan; under these circumstances, the constructive interest amount is includible in the employee's income in the year in which the loan was made, but the offsetting deductions are allowed rateably over the term.

Subject to these wrinkles, the interest-free or low-interest loan can work fine as a modern fringe benefit.

B. *Employer-Provided Automobiles*

The major fringe benefit for most small businesses is the company car. Application of the new fringe benefit rules and other 1984 Act rules to the company car provides an instructive example of how the rules work.

Initially, two of the new rules in section 132 are potentially applicable. First, and most important, the "working condition fringe" rules of section 132(d) apply to exclude the value of the car if and to the extent that the employee could have deducted this item if he/she had paid for it directly.

Second, and less important, is the de minimis fringe exclusion under section 132(e). Items with a small value which are too small to justify accounting for them individually can be excluded under this rule. In the case of a car, it would most frequently be applied to provide an exclusion for the occasionally personal use made of a car primarily devoted to business uses.

The working condition fringe rules are designed to place the employee who is given a car to use on the same basis for tax purposes as one who buys a car for business use. This would seem calculated to take our inquiry into another murky tax area—the so-called "luxury car" rules of section 280F and the related limitations on personal use of "listed property" in the same Code provision. However, the temporary regulations provide that section 280F is not applicable in determining the amount of the working condition fringe exclusion. (See Temp. Regs. § 1.132-1T, Q/A5.) The example given in that regulation shows how we approach the subject. Assume that an employee has available for a full year a car with a fair market value of $28,000, and the car is used entirely for business (*i.e.*, there is no personal use). We proceed initially to the section 61 temporary regulations where we find, at section 1.61-2T(Q/A13), a table of annual lease values. For a $28,000 car, the annual lease value is $7,750. Section 280F normally limits automobile depreciation or recovery deductions to $4,000 for the first year and $6,000 per year thereafter for the balance of the recovery period. As a result, our employee could not

deduct more than $6,000 in any one year ($4,000 in the first year) under section 167. Moreover, the exclusion for a working condition fringe is available only to the extent the employee could deduct the amount himself if he paid for it himself. Nevertheless, even though our annual lease value is $7,750, and the section 167 deduction could not exceed $6,000, the regulations excuse this, and provide that the value of the car is excludible in full on these facts.

Thus, employees and their tax advisors find their lives greatly simplified, as they avoid the luxury automobile rules and the listed property (mixed personal and business use) rules, both prescribed under section 280F. However, several things should be noted about this. First, while the regulations provide in effect that section 280F is not to be read into secton 132, they specifically remind taxpayers that this aspect of the matter does not affect the applicability of section 280F to the employer. Thus, on the facts posed above, the employer who owns the car in question cannot deduct more than the $4,000 or $6,000 deduction otherwise allowable. Moreover, all of the other limitations of section 280F apply to the employer's deduction. Second, the assumption above was that the car was used entirely for business. This is typically not realistic, as most company cars do experience commuting or family usage. Those amounts would not be deductible under section 167 in any event, notwithstanding section 280F. Accordingly, the value of these nonconforming uses would fall out of the exclusion for working condition fringes.

Finally, the deduction limitation rules of section 274 apply to this situation. Thus, the substantiation quandary is apparently a problem which the employee must be prepared to face. Presumably, he/she must maintain records or other "sufficient evidence" to corroborate his/her own statement about the business use of the car. The 1984 Act included an obscure provision changing the substantiation rules of section 274 to require adequate contemporaneous records for cars and all similar "listed property." When the taxpaying world learned of this, a great hue and cry went up, since many taxpayers had become accustomed to living with rough approximations in this area. Indeed, abuses of this sort was the reason for the enactment of the contemporaneous record rule. In practice, taxpayers would simply tell their accountants or other tax return preparers in broad terms something like "this car is used 100% for business and that one is 85% business."

Last spring, Congress amended its work of the preceding year to say, instead of "adequate contemporaneous records," taxpayers could get by on "adequate records or sufficient evidence corroborating the taxpayer's own statement." Unfortunately, most taxpayers who took an interest in this area have a conception something like the following: "The IRS wanted to make me keep a diary showing every time I moved the car, but Congress slapped them down." In fact, Congress did not change the law on this point as much as most people think. A taxpayer claiming a deduction (or an exclusion) will still need either *adequate* records or *sufficient* corroborating evidence. While the House bill would have required written records, the Conferees went along with the

concept that oral testimony should be considered. However, the Committee report makes it clear that rather stringent standards are to be applied in this area:

> "The conferees believe that oral evidence corroborating the taxpayer's own statement, such as oral tesimony from a disinterested, unrelated party describing the taxpayer's activity may be of sufficient probative value that it should not be automatically excluded from consideration section 274(d).
>
> The conferees emphasize, however, that different types of evidence have different degrees of probative value. The conferees believe that oral evidence alone has considerably less probative value than written evidence. In addition, the conferees believe that the probative value of written evidence is greater the closer in time it relates to the expenditure. Thus, written evidence arising at or near the time of the expenditure absent unusual circumstances, has much more probative value than evidence created years later, such as written evidence first prepared for audit or court."

Obviously, the Internal Revenue Service and the Treasury have no choice but to draft the regulations along this same line. When Congress went over the same ground twice in less than a year, it is hard to say that it is unclear what is intended. As a result, it would appear that an employee desiring an exclusion under section 132(d) for a working condition fringe will have to meet the substantiation rules. Moreover, it would appear that a "trip diary" or other contemporaneous record is still the best evidence on this point.

Finally, it is important to remember that there are a number of pre-1984 Act ways in which a taxpayer can lose a section 162 deduction (and hence the section 132 exclusion for working condition fringes). For example, the provision of office facilities to an employee would not normally give rise to income, even if they were exceedingly comfortable. The reason for this is that, if the employee paid for the facilities himself, he would be entitled to a deduction under either section 162 or 167. But what would be the result if the office is simply so lavish that a section 162 business deduction would be questionable. It seems possible that the exclusion, as well as the deduction, could be lost on this basis. Thus, an office with a lavish bedroom suite, sauna, hot tub, movie theater, and other non-business luxuries could end up being taxed to the employee recipient. This result seems even more likely in the case of a small business, where the owner is the recipient of this luxury.

A possible argument to counteract such an allegation is that, for some taxpayers, the lavish nature of the facilities in question is an element of their business necessity. See, for example, *International Artists, Ltd. v. Comm'r.*, 55 T.C. 94 (1970), acq. 1971-2 C.B. 3, in which the Tax Court held

that a "lavishly decorated and furnished house provided to noted entertainer Walter Liberace served such a business purpose; note also, however, that Mr. Liberace was charged with dividend income for his personal usage of this house.

C. *Non-Discrimination Rules*

The exclusions in section 132 for no-additional-cost services, qualified employee discounts, subsidized eating facilities, and qualified tuition reductions are subject to non-discrimination limitations. These exclusions are available to an officer, owner, or highly-compensated employee only if the benefit is available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer which does not discriminate in favor of officers, owners or highly-compensated employees. This limitation assumes major importance in the case of the typical closely-held business, where the tendency toward discriminatory compensation arrangements is strongest.

1. *Factual Determination*

A classification which on its face restricts benefits and makes them available only to the highly paid group is per se discriminatory.

2. *Classifications*

A reasonable classification based on appropriate factors (e.g., seniority, full-time versus part-time employment or job descriptions) will suffice if it is nondiscriminatory in effect.

3. *Relationship to Other Nondiscrimination Rules*

"A determination that a classification is reasonable for purposes of applying the nondiscrimination rules of [section 132] is not to be taken as an indication as to whether or not the classification is reasonable for purposes of applying other nondiscrimination rules in the Code, such as the rules in section 401(a)(4) for qualified plans." H.R. Rept. No. 98-432 (Part 2), 98th Cong. 2d Sess., pg. 1606.

4. *Practical Applications*

The effect of these rules upon traditional fringes will depend upon individual facts or circumstances, but could be dramatic. For example, executive dining room facilities are normally designed to be discriminatory; exclusion of resultant benefit would apparently turn upon whether the employer can point to a business reason for the restrictions on the use of the facility.

D. *Application of Section 162 Principles*

As a practical matter, primary reliance for continued exclusion of

many traditional management perks must be placed on the working condition fringe rule of section 132(d). While this category of expenditure is free of the non-discrimination rules described above, it adopts instead a set of rules which can be every bit as rigorous. Specifically, the exclusion for working condition fringes is available only if the amount in question would be deductible by the recipient employee under section 162 as an ordinary and necessary business expense or under section 167 (depreciation and amortization) if paid for directly.

Theoretically, this has probably been the effect of present law for many years. If a given amount is deductible by the recipient, he/she will generally not care if it is includible. The available deduction will offset the inclusion, giving the same net effect as an exclusion.

E. *Audit Implications*

The existence of a new statutory framework for the tax treatment of fringe benefits, coupled with new rules governing mixed business and personal use of property, suggests that taxpayers and practitioners may expect increased audit scrutiny on these issues.

The scope of the changes is such that many owners of closely-held businesses face a threat to their company-financed lifestyle. Past practices which can objectively be described as abuses are now more likely to be detected and challenged on audit.

For example, many taxpayers have a company car which is used in part for commuting. Relatively few taxpayers in this position accept the notion that driving from home to their place of business and back is not a business use, although this has long been true. The Conference Committee Report states that this is the case even if the car is used to place business telephone calls or hold business meetings while the taxpayer is commuting. H.R. Rept. No. 98-861, 98th Cong., 2d Sess., pg. 1028.

F. *Avoiding Problems*

With the new law now in effect, employers who have not already done so should undertake a thorough review of existing fringe benefit practices and evaluate whether any restructuring might be desirable. In the long run, it is likely that a principal effect of section 132 will be to modify employer practices by conforming available benefits to the categories for which exclusions are available.

To the extent it is determined a given benefit should be continued notwithstanding possible adverse tax consequences, other changes may prove desirable. At a minimum, taxpayers should maintain careful records to document the actual extent of any claimed business usage of corporate property. Now more than ever, any ambiguities or unsubstantiated allegations are likely to be construed against the taxpayer.