



# TAXABLE AND NONTAXABLE COMPENSATION

CHAPTER 3, Part I  
(2016)

# GROSS INCOME

- The IRC uses the term “gross income” to determine a taxpayer’s federal tax bill and defines it as “compensation for services, including fees, commissions, fringe benefits, and similar items.”
- The tax section of the IRC is also worded broadly and defines wages as “all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash.”
- Regardless of what they are called, generally they are included in taxable income and subject to employment tax withholding and depositing rules unless they are specifically excluded under specific codes.

- Examples of included and excluded items:
  - Employer provided cars
  - Flights on employer provided aircraft
  - Prizes
  - Gift cards
  - Discounts on property or services
  - Qualified tuition reductions
  - Dependent care assistance
  - Golf fees
  - Employee discounts
  - De minimis fringes
- Taxable income means:
  - It is subject to federal income tax and tax withholding/reporting
  - It is subject to Social Security and Medicare taxes and FUTA

# DETERMINING VALUE OF TAXABLE COMPENSATION

## ■ Fair Market Value:

- What it would cost to purchase the item in an “arm’s length transaction”
- The amount of the benefit to include in income is the amount by which the fair market value exceeds the amount the employee paid for the benefit after taxes plus any amount the law specifically excludes.

Taxable amount = Fair Market Value – (Employee Payment + Amount Excluded by Law)

$$\$3,000 = \$9,000 - (\$1,000 + \$5,000)$$

- The same rules apply to benefits provided to dependents

# NONTAXABLE FRINGE BENEFITS

- IRC section 132 exempts certain fringe benefits from income:
  - No-additional-cost services
  - Qualified employee discounts
  - Working conditions fringes
  - De minimis fringes
  - Qualified transportation benefits
  - On-premises athletic facilities
  - Qualified retirement planning services
  - Qualified moving expense reimbursements

# NO-ADDITIONAL-COST SERVICES

- Regularly offered for sale to customers in the normal course of the employer's business.
- Employer bears no substantial additional cost
- Employee includes current and former employees who left due to retirement or disability, their spouses and dependent children. For air transportation parent of employee is included.
- Available on equal terms to all member of a group of employees that does not discriminate in favor of highly compensated employees.



# DEFINING HIGHLY COMPENSATED EMPLOYEE

- 5% owner of the employer's stock or capital during the preceding year or
- Received >\$120,000 (2016) in compensation during the preceding year
  - At the employers discretion they can limit this definition to those in the top paid 20% of employees


# QUALIFIED EMPLOYEE DISCOUNTS

- EE discounts are not taxable:
  - Discount on goods does not exceed the gross profit percentage  
(total sales – cost of goods sold) divided by total sales  
 $(\$500,000 - \$300,000) / \$500,000 = 40\%$
  - Discount on services does not exceed 20% of what a customer would pay
  - Is available for sale to customers
  - Available on equal term to each member of a group and does not discriminate in favor of highly compensated employees
  - Is not real estate or things such as stocks, bonds or currency
  - Employee includes current and former employees who left due to retirement or disability, their spouses and dependent children.



# WORKING CONDITION FRINGES

- Work related property or services not includable in taxable income
  - Use of the property or services must relate to employer's trade or business
  - Employee would be able to take a business deduction if he/she paid for it
  - Employee means a current employee, partner, director, or independent contractor
  - Employer must maintain required records to substantiate business deductions

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- Working condition fringes may include:
    - Business use of company cars or planes
    - Chauffeur or bodyguard provided for security
    - Dues and membership fees for professional organizations
    - Job-related education
    - Outplacement services
  - Non-discrimination rules do not apply
  - Not considered working condition fringe:
    - Tax preparation services

# DE MINIMIS FRINGES

- Items of small value do not have to be included:
  - Value is too small to make accounting for it practical
  - How often is it provided
  - The term employee means anyone to whom the benefit is provided
- May include:
  - Occasional use of copy machine
  - Occasional parties and picnics
  - Coffee and donuts
  - Traditional holiday gifts such as a turkey (not cert.)
- Nondiscrimination rules do not apply except for to eating facilities provided at or near premises
- Gift certificates and gift cards are always taxable
- In kind meals provided for the benefit of the employer are excluded

# QUALIFIED TRANSPORTATION FRINGES

- Certain transportation fringes are excludable:
  - Between home and work in a commuter highway vehicle provided by the employer if:
    - Seats at least 6 adults not including driver
    - At least 80% of mileage can be expected to be for commuting, and
    - And at least ½ of the seating capacity is used by employees
  - Parking on or near the employer's premises or a park-and-ride
  - 2016 commuting limit = \$255 per month
  - 2016 parking limit = \$255 per month

## Qualified Transportation Fringe Cont.

- Provided to employees only. Employee does not include partners or independent contractors
- Written plan not needed
- If reimbursement is in cash must establish a bona fide reimbursement arrangement requiring substantiation with 180 days after expense is incurred
- Qualified bicycle commuting reimbursement- \$20 per “qualified bicycle commuting month.”
  - Purchase and improvements of bike, repair and storage (no salary reduction)

### ■ Salary Reduction Plans:

- Election amount cannot exceed \$510 (\$255 + \$255)
- Election must be made before period begins
- Election must be in writing or in another form such as electronic
- Include date of election, contribution (fixed \$ or %), and the period. Negative election ok
- Election is irrevocable once the period has begun
- Unused amount can carry over to subsequent month/year

# DETERMINING VALUE

## ■ Parking

- “Arm’s length transaction”
- Person to whom space is assigned is taxed
- Excess amount is included in income
  - Amount by which the fair market value exceeds the IRS exclusion amount plus amount paid by the employee.  
$$\$65 = \$400\text{FMV} - (\$255\text{ex} + \$80\text{ee})$$
- Excess is taxable and can be included in income at any frequency as long as it is done by 12/31 of the year it is provided
- Special accounting rule applies

# Electronic Media

- Smartcards – Value is useable only as fare media for the applicable transit system
- Terminal-restricted debit cards – used only at merchant terminal at POS for applicable transit system
- MCC (Merchant Category Code)restricted debit cards – does not qualify as a transit system because it may be used to purchase items other than transit passes



# ON PREMISES ATHLETIC FACILITIES

- Located on employer's premises
- Operated by employer
- Primarily used by employees, spouses, and dependent children
- Not a resort or residential facility



# PERSONAL USE OF EMPLOYER PROVIDED VEHICLES

- Not taxable if used for business purposes or for minor errands while on business (considered de minimis)
- Qualified non-personal use vehicle, marked cars, delivery truck etc. not taxable
- If use is both business and personal, account for business use (miles, time, place, purpose). Unsubstantiated miles are considered personal use.

# VALUATION METHODS

Employer can use general valuation method or one of three special valuation methods.

- General Valuation Method
  - Fair market value, what it would cost in an arm's length transaction to lease or buy in the area. Cents per mile only if it can be shown that a lease was available in that area
- Special valuation methods are more advantageous (safe harbor)

- Special Valuation Methods (three) for determining value of personal use. Certain rules apply.
  - Commuting valuation method, \$1.50 each way \$3.00 round trip if:
    - Owned or leased by the employer and provided for use in connection with the business
    - Requires employee to commute to and/or from work
    - Written policy prohibiting personal use
    - Not a control employee (private sector, corporate office earning at \$105K in 2016 director earns at least \$215K in 2016 or 1% owner)

## ■ Annual Lease Valuation Method

- FMV of personal use is determined by multiplying annual lease value (see table pg. 3-22) by the percentage of personal miles driven

ALV from table is \$6,100

Total miles 10,000 – personal use 2,000 = 20%

FMV of personal use is  $\$6,100 \times 20\% = \$1,220$

- Fuel is not included – use actual cost of fuel value or IRS rate of 5.5 cents

# Cont.

## ■ Cents-per-mile method

- Personal miles are multiplied by the IRS standard business mileage rate of .54 (2016). To use this method the following must be met:
  - Expect the car to be regularly used for business or must actually be driven at 10,000 miles annually including personal use
  - FMV cannot exceed \$17,700 (2016)
  - If EE pays for fuel reduce by .055 cents
- Adequate records of business use is important

# PERSONAL USE OF CO. AIRCRAFT

Business use is excluded, personal use is taxable

- General Valuation Rule – what it would cost in an arm's length transaction to charter a comparable aircraft and pilot
  - If used by more than one EE, allocate value
- Non-Commercial Flight Valuation Rule – based on Standard Industry Fare Level  
(SIFL X mileage) X weight-based aircraft multiple]  
+ terminal charge = value

See example of calculation on page 3-25

# CLUB MEMBERSHIP

- Although ER can no longer take a business deduction, business use can still be excluded
- Qualifies as a working condition fringe to the extent:
  - It is not treated as wages
  - Deductible by the EE had Section 274(a)(3) not been added by OBRA and
  - Employee substantiates business use
  - Personal use must be included as income

# LIFE INSURANCE

- Group Term Life Insurance
  - Value of coverage up to \$50,000 is excluded from taxable income
  - Value for coverage over \$50,000 is taxable if:
    - Paid by the ER
    - Paid with pre tax deduction
- Value of excess coverage is included in wages and subject to SS, M/C and FIT but not FITW
- Reported on form W-2 boxes 1, 3, 5, and 12 (code C). Form 940 (part 2, lines 3 and 4). Form 941 (lines 2, 5a, and 5c)



- Exception to excess value (over 50K). Not included in taxable income if:
  - ER or charitable organization is the beneficiary
  - EE terminates due to permanent disability
- Nondiscrimination Testing: If plan is discriminatory key employees are not allowed exclusion
  - Key EE – corp. officer >\$170K in 2016, 5% owner or 1% owner whose annual earning are >\$150K
- Plan is not discriminatory if:
  - 70% of EEs benefit
  - At least 85% of participants are not key EEs
  - Participants belong to a classification that the IRS has determined to be nondiscriminatory or
  - The plan is part of a qualified cafeteria plan

# GTL IMPUTED INCOME CALC.

## ■ Calculating Excess Value

- 50 year old with \$100,000 of coverage

$$\$100,000 - \$50,000 = \$50,000$$

$$\$50,000 / \$1,000 = 50$$

$$50 \times .23 \text{ (IRS Table I pg. 3-29)} = \$11.50 \text{ taxable income per month}$$

- Age is as of December 31
- Watch out for plan rules
- Consider impact of EE contributions (after tax or pre tax)

## ■ Coverage Provided to Former EEs

- ER is relieved of SS and M/C tax withholding for coverage provided after employment relationship ended e.g. retirees.
  - Report uncollected amount in box 12 of form W-2, code M for SS and code N for M/C
  - This does not apply to coverage provided when employed. SS and M/C not collect cannot be reported in box 12 using code M and N.

## ■ Dependent Group Term Life

- Up to \$2,000 not taxable
- If excess of \$2,000 full value is taxable, no exclusion.


# RELOCATION REIMBURSEMENT

## ■ Initial Test of Deductibility:

- Distance test – new work place must be at least 50 miles farther from the old residence than the previous work place
- Time test – during the 12 months immediately after the move must work full-time for at least 39 weeks at the new location unless it is due to death, disability, involuntary termination or transfer for employer's benefit

## ■ Deductible Moving Expenses:

- Limited to moving of household goods and travel from old residence to new residence. Includes lodging but not meals
- Mileage rate for 2016 is .19 cents
- Members of household included

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- Qualified reimbursements are non-taxable fringe benefits under IRC section 132(g) if they qualify for a deduction on the EE's personal tax return
  - Must be an accountable plan
  - Nondeductible moving reimbursements are subject to FIT, FITW, SS, M/C and FUTA taxes
    - Meals
    - House hunting
    - Temporary living
    - Real estate expenses such as commissions, closing costs, filing fees, etc.



- Nonqualified reimbursements report on:

- Form W-2

- Form 941

- Form 940

- Qualified reimbursements:

- Paid to a 3<sup>rd</sup> party not reported at all

- Paid to EE, reported on W-2 in box 12 code “P” only

- Not reported on form 941

- Reported on form 940

# EDUCATIONAL REIMBURSEMENT

## ■ Job related fringe vs. tuition reimbursement

### □ Job related

- Must not be necessary to meet the minimum education requirements of the current job
- Not taken to qualify for promotion or transfer
- Must be related to current job and help maintain or improve knowledge and skills required for that job

### □ Tuition Reimbursement (American Taxpayer Relief Act of 2012 permanently extended this benefit)

- Non job related
- Exclusion \$5,250 for both graduate and non-graduate

# EDUCATIONAL REIMBURSEMENT

## CONT.

- ❑ Must be part of an Education Assistance Program for the benefit of employees; includes those on military leave, self employed, retired disabled or terminate
- ❑ Separate written plan required
- ❑ Cannot discriminate in favor of highly compensated
- ❑ No more than 5% of assistance may go to shareholders or owners owning more than 5% of stock or capital
- ❑ Not part of cafeteria plan
- ❑ Notification to employees required
- ❑ Can be tied to course grade
- ❑ Qualified assistance only
- ❑ Substantiation required



# EMPLOYEE BUSINESS TRAVEL

- To be nontaxable, reimbursements must be under an accountable plan. If part of a non-accountable plan, fully taxable
- Travel must be away from home and temporary
- Substantiation required:
  - Amount, time, place and business purpose
  - Reported within a reasonable time after paid or incurred
  - Receipts required for amounts over \$75
  - Hotel bills must be itemized

# PER DIEM ALLOWANCES

- Amount of per diem considered substantiated if it does not exceed IRS limit and EE substantiates the business purpose, time and place.
- Lodging per diem does not include taxes
- Amounts in excess of the per diem rate are taxable and reported on form W-2

Pattern of abuse – treated as non-accountable

# SPOUSAL TRAVEL REIMBURSEMENTS

- Travel for spouse accompanying EE is fully taxable unless certain conditions are met:
  - Bona fide business connection is established and if the EE paid it, it can be deducted as business expense on EE's personal tax return
  - Reimbursement is substantiated
  - Not treated as wages

# EMPLOYER PROVIDED MEALS AND LODGING

- In kind meals are not taxable if
  - Furnished on employer's premises
  - Provided during working hours for the convenience of the employer
  - More than half of employees benefit
- Lodging – not taxable if
  - On employer's premises
  - For employer's convenience
  - Condition of employment
- Cash allowances, always taxable

# ADOPTION ASSISTANCE

- Exclusion applies if part of an adoption assistance program
  - 2016 limit is \$13,460
  - Not an annual limit but a per adoption limit
  - Income limits apply (EEs should be aware)
  - Eligible child – under age 18 or physically or mentally disabled
  - Qualified expenses – directly related to adoption such as court costs, attorney fees, travel expenses
  - Separate written plan required
  - Cannot discriminate in favor of highly compensated
  - Notification to EEs required

# ADOPTION ASSISTANCE (CONT.)

- Can be part of a cafeteria plan
- Reimbursement up to limit is not subject to FIT but is subject to SS and M/C and reported on form W-2
- Reported in box 12 with code “T” including amounts in excess of limit and EE pre tax contribution
- Amounts in excess of limit are taxable
- Foreign adoptions – if eligible child is not a citizen or resident of the US exclusion is only available after adoption is final
- Adoption is considered final when child received an IR2, IR3 or IR4 visa

# ADVANCES AND OVERPAYMENTS

- Returned in same year
  - Amount excluded from taxable income
- Returned in subsequent year
  - Remains in taxable income
  - Subject to limitation EE may take a tax deduction in year repaid
- Social Security and Medicare taxes
  - Provide receipt for refund and obtain affidavit from EE