

# **Taxable Fringe Benefit Guide**

**FEDERAL, STATE, AND LOCAL GOVERNMENTS  
THE INTERNAL REVENUE SERVICE**

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## Introduction

The Taxable Fringe Benefits Guide was created by the Internal Revenue Service office of Federal, State and Local Governments (FSLG) to provide governmental entities with a basic understanding of the tax issues related to employee fringe benefits and reporting under the Internal Revenue Code and other Federal tax regulations and procedures.

Used as a supplement to other IRS publications, the Fringe Benefit Guide can be helpful tool for anyone responsible for determining the taxability, withholding, and reporting requirements regarding employee fringe benefits.

This publication covers:

- The tax treatment, reporting and withholding of common employer-provided fringe benefits.
- General procedures for computing the taxable value for those fringe benefits discussed.
- Reporting the taxable value of benefits on Forms W-2 and 1099-MISC.
- Additional Federal reporting requirements that are in effect for certain fringe benefits.
- Procedures for obtaining answers from the Internal Revenue Service to questions throughout the year regarding taxation and reporting requirements.

### **NOTICE**

**This guide is intended to provide basic information on the subjects covered. It reflects the interpretation by the IRS of tax laws, regulations, and court decisions. The explanations in the guide are intended for general guidance only, and are not intended to provide a specific legal determination with respect to a particular set of circumstances. Additional research may be required before a determination may be made on a particular issue. Citations to legal authority are included in the text. You may contact the IRS for additional information. You may also want to consult a tax advisor to address your situation.**

## What Is a Fringe Benefit?

A fringe benefit is a form of pay for the performance of services (including property, services, cash or cash equivalent) in addition to stated pay. This definition applies to services of employees and independent contractors; however, unless otherwise indicated, this guide applies to fringe benefits provided by an employer to an employee. (For a discussion of whether a worker is an employee or independent contractor, see [Publication 15-A](#).) Fringe benefits for employees are taxable wages unless specifically excluded by a section of the Internal Revenue Code (IRC). (IRC § 61 IRC § 3121, 3401) IRC § 61(a)(1)

The IRC may provide that fringe benefits are nontaxable, partially taxable, or tax-deferred. These terms are defined below.

**Taxable** – Includible in gross income unless excluded under an IRC section. If the recipient is an employee, this amount is includible as a wage. For example, bonuses are always taxable because no IRC section excludes them from taxation.

**Nontaxable (excludable)** – Excluded from wages by a specific IRC section; for example, qualified health plan benefits excludable under section 105.

**Partially taxable** - Part is excluded by IRC section and part is taxable. Benefits may be excludable up to dollar limits, such as public transportation subsidy or parking under IRC §132.

**Tax-deferred** – Benefit is not taxable when received, but subject to tax later. For example, employer contributions to an employee's pension plan may not be taxable when made, but retirement distributions may be taxed when made to the employee. *IRC §402(a)*

More than one IRC section may apply to the same benefit. For example, education expenses up to \$5,250 may be excluded from tax under IRC §127. Amounts exceeding \$5,250 may be excluded from tax under IRC §132.

A benefit provided on behalf of an employee is taxable to an employee even if the benefit is received by someone other than the employee, such as a spouse or a child. (Reg. § 1.61-21(a)(4))

“Taxable” means the benefit is included in the employees' wages and reported on Form W-2, and generally is subject to Federal income tax withholding, social security, (unless the employee has already reached the current year wage base limit) and Medicare. An employer's matching contribution is required for social security and Medicare.

If an employee's wages are not normally subject to social security or Medicare taxes (for example, because the employee is covered by a qualifying public retirement system), any taxable fringe benefits would also not be subject to social security or Medicare taxes.

## **General Valuation Rule**

Generally, taxable fringe benefits are valued at the fair market value (FMV). *Reg. §1.61-21(b)*

FMV is the amount a willing buyer would pay an unrelated willing seller, neither one forced to conduct the transaction and both having reasonable knowledge of the facts. In many cases, the cost and FMV are the same; however, there are many exceptions, such as when the employer incurs a cost less than the value to provide the benefit.

FMV of a benefit is reduced by any amount paid by or for the employee. For example, an employee has a taxable fringe benefit with a fair market value of \$3.00 per day. If the employee pays \$1.00 per day for the benefit, the taxable fringe benefit is \$2.00 per day.

Special valuation rules apply for certain fringe benefits and will be covered in other chapters.

## **IRC Sections Excluding Fringe Benefits**

The following Code sections address specific benefits. They are discussed later in the text.

- IRC 104 – Amounts received as health reimbursements from employer
- IRC 106 – Health insurance premiums paid by employer
- IRC §117(d) - Qualified tuition reductions
- IRC §119 - Meals or lodging for employer's convenience
- IRC §125 - Cafeteria plans
- IRC §127 - Educational assistance program
- IRC §129 - Dependent care assistance program
- IRC §132 – Specifies certain fringe benefits, if not covered by another Code section, including:

§132(b) - No additional-cost service

§132(c) - Qualified employee discounts

§132(d) - Working condition fringe

§132(e) - De minimis benefit

§132(f) - Qualified transportation expenses

§132(g) - Qualified moving expense reimbursements

§132(m) - Qualified retirement planning services

§132(n) – Qualified military base realignment and closure fringe

## Reporting Fringe Benefits

In general, taxable fringe benefits are reported when received by the employee and are included in employees' wages in the year the benefit is received. However, there are many special rules and elections for different benefits, which are discussed in this section. *IRC 451(a); IRS Ann. 85-113, 1985-31*

### Employer's Election of When To Withhold

The employer may elect to treat taxable fringe benefits as paid in a pay period, quarterly, semiannual, or annual basis, but annual basis, but no less frequently than annually. *IRS Ann. 85-113, 1985-31*

### Alternative Rule for Income Tax Withholding

The employer may elect to add taxable fringe benefits to employees' regular wages and withhold on the total or may withhold on the benefit at the supplemental wage rate of 25%. *Reg. §31.3402(g)-1; Reg. §31.3501(a)-1T*

### Special Accounting Period

Benefits provided in November and December, or a shorter period in the last 2 months of the year. Only the value of benefits actually provided during the last 2 months may be treated as paid in the subsequent year. You do not have to notify the IRS that you are using this special accounting rule. *IRS Ann. 85-113*

An employer may use this rule for some fringe benefits and not others. The special accounting period need not be the same for each fringe benefit. However, if an employer uses the special accounting period rule for a particular benefit, the rule must be used for all employees who receive the same fringe benefit.

### Employer's Election Not To Withhold Income Tax

Employer may elect not to withhold **income taxes** on the taxable use of an employer's vehicle that is includible in wages if: (1) the employer notifies the employee, and (2) the employer includes the benefit in the employee's wages on the W-2 and withholds social security and Medicare tax. *IRC §3402(s)(1)*

**Note:** This election is available for employer-provided vehicles only. An employer does not have a choice whether to withhold on other taxable fringe benefits.

### Accountable Plan

An allowance or reimbursement policy (does not have to be a written plan) where amounts are nontaxable to the recipient if certain requirements are met:

- There must be a business connection to the expenditure.
- There must be adequate accounting by the recipient within a reasonable period of time.
- Excess reimbursements or advances must be returned within a reasonable period of time. *IRC §62(c)*

## **Business Connection**

Business connection means that the expense must be a deductible business expense incurred in connection with services performed as an employee. If not reimbursed by the employer, the expense would be deductible by the employee on the employee's 1040 income tax return as a business expense. *Reg. §1.62-2(d)*

## **Adequate Accounting**

The employee must verify the date, time, place, amount and business purpose of expenses. Receipts are required unless the reimbursement is made under a per diem plan. *Reg. §1.62-2(e); Reg. §1.274-5T(b)(2)*

## **Documentary Evidence**

Employees generally should have documentary evidence, such as bills, receipts, canceled checks, or similar items to support their claimed expenses. This rule does not apply in the following circumstances:

1. Meal expenses that you reimburse expenses on a per diem basis (discussed later), at a rate at or below the allowable maximum, under an accountable plan.
2. The individual expenditure (except for lodging) is less than \$75. Lodging expenses always requires receipts.
3. The expenditure is for transportation expense for which a receipt is not readily available. *Reg. §1.274-5T(c)(2)*

## **Timely Return of Excess Reimbursements**

The employee must return any excess reimbursement within a reasonable period of time. A reasonable period of time depends on facts and circumstances. The determination of a reasonable period of time will depend on the facts and circumstances. The rules in the next section provide "safe harbors" for meeting the test of timeliness. *Reg. §1.62-2(g)(1)*

## **Safe Harbors for Substantiating Expenses and Excess Reimbursements**

If an employer uses either of the following methods, the requirements of timely substantiation and return of excess advances/reimbursements will be considered met. *Reg. §1.62-2(g)*

### **Fixed Date Method**

If the fixed date method is elected, the following conditions must be met:

- The advance is made within 30 days of when an expense is paid or incurred, and
- The expense is substantiated within 60 days after it is paid or incurred, and
- Any excess amount is returned to the employer within 120 days after the expense is paid or incurred. *Reg. §1.62-2(g)(2)(i)*

**Note:** Maximum number of days for advance is 150 (up to 30 days in advance plus 120 days maximum for settlement).

### **Periodic Statement Method**

Under this method, substantiation and return of excess is within 120 days after the employer provides employee with a periodic statement (at least quarterly) stating any excess amounts are required to be returned. *Reg. §1.62-2(g)(2)(ii)*

**Note:** Maximum number of days for advance is 210 (90 days for the calendar quarter plus 120 days maximum for settlement).

### **Other Reasonable Method**

If an arrangement doesn't meet one of the safe-harbor methods, it may still be considered timely, if it is reasonable based on the facts and circumstances. *Reg. §1.62-2(g)(1)*

**Example:** An employee on an extended travel assignment might have a longer period to substantiate expenses and return any excess allowance than an employee on a single overnight trip.

### **Other Rules for Employer Accountable Plan**

- Employers may have multiple expense allowance policies.
- Employers may have both accountable and nonaccountable plans for different types of reimbursements.
- Employers may establish more restrictive conditions for the plan than imposed the accountable plan requirements.
- Employees cannot compel the employer to establish a plan. *Reg. §1.62-2(j)*

### **Nonaccountable Plan**

A nonaccountable plan is an allowance or reimbursement program that does not meet all three requirements for an accountable plan. Payments made under a **nonaccountable** plan are taxable wages when paid or when constructively received by an employee. The employees



may be able to deduct these expenses as itemized deductions on their individual tax returns.  
*Reg. §1.62-2(c)(3)*

## **Withholding Requirements**

When to withhold depends on whether payments are made under an accountable or nonaccountable plan. *Reg. §1.62-2(h)*

### **Under an Accountable Plan**

If an employer has an accountable plan but an employee does not timely account for expenses or return excess amounts, the employer must withhold employment taxes no later than the first payroll period following the end of the reasonable period. *Reg. §1.62-2(h)(2)(i)*

### **Under a Nonaccountable Plan**

If advances and reimbursements are made under a nonaccountable plan, they are treated as wages and withholding is required when the advances or reimbursements are made to the employee. *Reg. §1.62-2(h)(4)(ii)*

### **Late Substantiation or Return of Excess**

If an employee substantiates expenses and returns excess advances *after* the employer has treated amounts as wages, the employer is not required to return any withholding or treat amounts as nontaxable. *Reg. §1.62-2(h)(2)*

## **Travel Advances**

To prevent a financial hardship to employees who will be traveling away from home on business, employers will often provide advance payments to cover the costs incurred while traveling. There must be a reasonable timing relationship from when the advance is given to the employee, when the travel occurs and when it is substantiated. There must also be a relationship between the size of the advance and the estimated expenses to be incurred.

### **Accountable plan advances**

Travel advances are not treated as wages and are not subject to income and employment taxes when they are paid under an accountable plan. They must be for travel expenses related to the business of the employer, substantiated by the employee, and any excess returned in a reasonable period of time. *Reg. §1.62-2(c)(4)*

If an employee does not timely substantiate expenses or return excess advances, the advance is includible in wages and subject to income and employment taxes no later than the first payroll period following the end of the reasonable period. *Reg. §1.62-2(h)(2)*

## Nonaccountable plan advances

Advances from nonaccountable plans to the employee are subject to withholding when the advances or reimbursements are made to the employee. *Reg. §1.62-2(h)(4)(ii)*

### When advances are included in income

Advances become taxable to the extent they are not substantiated by the employee no later than the first payroll period following the end of the reasonable period. A reasonable period may end in the year after the advance was made. After the end of the calendar year and once included in wages, an employer cannot reverse the transaction, unless the amount was erroneously treated as a wage at the time of inclusion. *Reg. §1.62-2(h)(2)*

**Example:** A small state agency pays a monthly mileage allowance of \$200 to certain employees. The agency does not require the employees to substantiate their expenses or return any excess. Is the allowance taxable wages to the employees, and if so, when?

The mileage allowance does not meet the rules for an accountable plan and therefore is a nonaccountable plan. The \$200 allowances are taxable wages to the employees when paid to them; therefore, withholding should be done for social security, Medicare and income taxes. Also, the employer must match the social security and Medicare contributions.

**Example:** An agency puts an accountable plan into effect that requires employees to account for their business mileage and return any excess allowance. Two of the employees account for their mileage but fail to return the excess. Is the allowance taxable wages to the employees and if so, when?

The mileage allowance meets the requirements of an accountable plan. But because the excess allowance was not returned, the excess is a wage to the two employees and is subject to withholding for income, social security, and Medicare taxes. The withholding is required no later than the first payroll period following the end of the reasonable period.

## Form W-2 Reporting

Generally, payments made under an accountable plan are excluded from the employee's gross income and are not reported on Form W-2. However, if you pay a per diem or mileage allowance and the amount paid exceeds the amount the employee substantiated under IRS rules, you must report the excess as wages on Form W-2. The excess amount is subject to income tax withholding and social security and Medicare taxes. Report the amount substantiated (i.e., the nontaxable portion) in box 12 using code L. (See Form W-2 Instructions.)

**Note: This chart refers to the 2008 Form W-2.** If you are considering another year, check the instructions for that year. Check the Form W-2 instructions for the appropriate years. Make sure you have the current year's correct form and instructions. The box numbers and codes are subject to change annually.

TYPE OF REIMBURSEMENT	EMPLOYER W-2 REPORTING*
<b>Under an Accountable Plan</b>	
<i>Actual expense reimbursement:</i> Adequate accounting made and excess returned	No amount reported
<i>Actual expense reimbursement:</i> Adequate accounting and return of excess both required but <b>excess</b> <u>not</u> returned	The <b>excess</b> amount reported as wages in Boxes 1, 3, and 5. Taxes withheld are reported in Boxes 2, 4, and 6.
<i>Per diem or mileage allowance <u>up to the Federal rate:</u></i> Adequate accounting and <b>excess</b> returned	No amount reported
<i>Per diem or mileage allowance <u>up to the Federal rate:</u></i> Adequate accounting and return of excess reimbursement both required but <b>excess</b> <u>not</u> returned	The <b>excess</b> amount reported as wages in Boxes 1, 3 and 5. Taxes withheld are reported in Boxes 2, 4, and 6. The <b>amount up to the Federal rate</b> is reported only in Box 12, Code L - it is not reported in Boxes 1, 3, and 5.
<i>Per diem or mileage allowance exceeds the Federal rate:</i> Adequate accounting but <b>excess</b> reimbursement over Federal rate <u>not</u> returned	The <b>excess</b> amount reported as wages in Boxes 1, 3 and 5. The <b>amount up to the Federal rate</b> is reported only in Box 12, Code L - it is not reported in Boxes 1, 3 and 5. Taxes withheld are reported in Boxes 2, 4, and 6.
<b>Under a Nonaccountable Plan</b>	
Either adequate accounting or return of excess, or both, not required by plan	The entire amount reported as wages in Boxes 1, 3 and 5. Taxes withheld are reported in Boxes 2, 4, and 6.
<b>NO REIMBURSEMENT PLAN</b>	The entire amount reported as wages in Boxes 1, 3 and 5. Taxes withheld are reported in Boxes 2, 4, and 6.

## Working Condition Fringe Benefits

Working condition fringe benefits include property or service which, if the employee had paid for, he or she could have deducted the cost as a business expense on his or her individual income tax return. Therefore, if the cost of an item is deductible by an employee as a business expense, it may be excludable from the employee's wages as a working condition fringe benefit if provided by the employer. *IRC §132(d)*

### General Rules for Working Condition Fringe Benefits

- Benefit must relate to employer's business
- Employee would have been entitled to an income tax deduction
- Business use must be substantiated with records
- Certain benefits have additional requirements, i.e., employer-provided vehicles or clothing

### Definition of Employee

All of the following are considered employees for purposes of working condition fringe benefits: *Reg. §1.132-1(b)*

- Current employees
- Partners
- Directors of the employer
- Independent contractors
- Volunteers

Although not employees for most employment tax purposes, independent contractors are treated as employees for this purpose and are therefore eligible to receive nontaxable reimbursements as working condition fringe benefits.

**Note:** Taxable fringe benefits for employees are reportable on Forms W-2 and W-3. Taxable fringe benefits for independent contractors are reportable on Form 1099.

Cash payments or cash equivalents are not working condition fringe benefits, unless they represent reimbursements paid under an accountable plan.

## De Minimis Fringe Benefits

De minimis fringe benefits include property or services provided by an employer for an employee that has small value and accounting for it is unreasonable or administratively impractical. The value of the benefit is determined by the frequency provided to each individual employee, or if this is not administratively practical, by the frequency provided to the whole workforce. *IRC §132(e)*

**Example:** An employer gives employees snacks each day valued at 75 cents. Even though small in amount, the benefit is provided on a regular basis and is, therefore, taxable as a wage.

The IRS has given advice at least once (ILM 200108042) that a benefit of \$100 did not qualify as de minimis. However, this technical advice addresses a specific situation and cannot be relied upon in addressing another specific situation.

### Examples of Excludable De Minimis Fringe Benefits: *Reg. §1.132-6(e)(1)*

Occasional (infrequent), ***not routine***

- Personal use of photocopier (with restrictions)
- Group meals, employee picnics
- Theater or sporting event tickets
- Coffee, doughnuts, or soft drinks
- Flowers or fruit for special circumstances
- Local telephone calls
- Traditional birthday or holiday gifts (not cash) with a low FMV
- Commuting use of employer's car if no more than once per month

### Benefits Not Qualifying as De Minimis Fringe Benefits

- Cash - except for occasional and infrequent meal money to allow overtime work
- Cash equivalent (i.e., savings bond, gift certificate for department store or allowing "cash back")
- Certain transportation passes or costs
- Use of employer's apartment, vacation home, boat
- Commuting use of employer's vehicle more than once a month. *Reg. §1.132-6(d)(3)*

### Definition of Employee for De Minimis Fringe Benefits

Any individual receiving a de minimis fringe benefit is an employee for this purpose *Reg. §1.132-1(b)(4)*

### Cliff Provision

If a benefit does not qualify as a de minimis fringe benefit, the entire benefit is taxable, not just the portion that exceeds the de minimis limits. *Reg. §1.132-6(d)(4)*

## No-Additional-Cost Services

A service provided to employees that does not impose any substantial additional cost may be excludable as a no-additional-cost fringe benefit. A “no-additional-cost service” is a service offered 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 (including foregone revenue) in providing the service to the employee. Examples include excess capacity in airline seating or recreational facilities.

*IRC 132(b)*

No-additional-cost services occur frequently in industries with excess capacity services. Examples include transportation tickets, hotel rooms, entertainment facilities, etc.; however, they may occur with governmental facilities as well (for example, a municipal golf course or recreation center).

For more information on no-additional-cost benefits and restrictions that apply to them, see [Publication 15-B](#). The determination of a reasonable period of time will depend on the facts and circumstances. The Regulations provide timelines as safe harbors for employers. *IRC §132(a)(1)*

## Qualified Employee Discounts

Many public municipalities have park districts that offer a variety of amenities to the public. Examples of such amenities can include swimming pool facilities, fitness and weight room facilities, and public golf courses. In some cases, employees may be able to purchase goods or services from the employer at a lower price than the property or service is offered to the general public. When these amenities are offered to the public for a fee and the same amenities are offered to an employee at no cost, the possibility of a taxable benefit to the employee exists. However, the benefit is excludable if it is a qualified employee discount.

An excludable “qualified employee discount” generally cannot exceed:

- For merchandise or other property, the employer’s gross profit percentage times the price charged to the public for the property. *IR C§132(c)(1)(A)*
- For services, no more than 20% of the price charged to the general public for the service. *IRC §132(c)(1)(B)*

For more information, see Publication 15-B.

## Qualified Transportation Fringe (QTF) Benefits

This section discusses rules that apply to benefits an employer provides to his/her employees for the employee's *personal* transportation, such as commuting to and from work. *IRC §132(f)(1) Reg. § 1.132-9(b)*

### Qualified Transportation Fringe (QTF) benefits include:

- Commuter transportation in a commuter highway vehicle
- Transit passes
- Qualified parking
- Qualified bicycle commuting expenses

Employer-provided QTFs with fair market values (FMV) that do not exceed monthly excludable limits are:

- Exempt from withholding and payment of employment taxes,
- Not reported as taxable wages on the employee's W-2, and
- Not reported as gross income.

The exclusion from income applies only to employees; former employees and independent contractors are not eligible. *IRC §132(f)(5) IRS Notice 94-3; TD 8933; Regs. §1.132-9(b)*

### Valuation

Generally, transportation benefits are valued at FMV; exceptions are as noted below.

### Combined Benefits

The exemption applies whether an employer provides one or a combination of these benefits to employees. The total benefits cannot exceed the statutory dollar limitations, or the excess is taxable as a wage to the employee. Workers may pay for the benefits themselves on a pre-tax basis--see the discussion under "Salary Reduction Agreements," later, for the applicable rules. *IRC §132(f)(4)*

### Cash Reimbursements

Cash reimbursements can be excludable if the employer establishes a bona fide reimbursement plan. This means there must be reasonable procedures to verify reimbursements and the employees must substantiate the expense. See "Transit Passes" for additional requirements. *IRC §132(f)(3)*

### Cash Advances

Cash advances for transportation benefits are not considered reimbursements and are treated as taxable wages.



## **Nondiscrimination Rules**

Nondiscrimination rules do *not* apply to QTFs – these benefits are exempt even if provided exclusively to highly-compensated employees. *Reg. §1.132-8*

## **QTFs and Cafeteria Plans**

QTFs are prohibited benefits under cafeteria plan rules. You cannot include these benefits as part of a cafeteria plan. *Reg. §1.132-1(b)(2)(i)*

## **Commuter Vehicle Transportation**

For a commuter highway vehicle to qualify for an exclusion, the following must apply to the vehicle:

- It is provided by an employer, or by a third party for the employer.
- It is used for travel between employee residence (or parking lot) and the workplace.
- It has seating capacity for at least six adults (excluding the driver).
- Half of the seating capacity (excluding the driver) is occupied by employees.
- 80% of the mileage is used for transporting employees between residences, the workplace and/or parking area. *IRC §132(f)(5); Reg. §1.132-9(b)*

Commuter transportation may include vanpools, and the vehicles may be owned and operated by transit authorities or employees.

## **Dollar Limitations**

The maximum nontaxable benefit in 2009 is \$120 per month. The maximum applies separately to each month. *IRC §132(f); Rev. Proc. 2008-66*

## **Valuation**

Automobile lease valuation, vehicle cents-per-mile rule, or commuting valuation rules (discussed in the “Employer-Provided Vehicle” chapter) may be used in lieu of FMV. If one of these methods is used, the employer must use the same valuation rule to value the use of the commuter vehicle by each employee who shares the use. *Reg. §1.132-9(b), Q&A-21; Reg. §1.61-21(d),(e)&(f)*

## **Substantiation Requirements**

Only *cash reimbursements* by employers for use of a commuter vehicle need to be substantiated with actual proof of the commuter vehicle use by the employee.

## Transit Passes

A transit pass is any pass, token, fare card, voucher, or similar item (including an item exchangeable for fare media) entitling a person to transportation. The pass must be used for transportation on a public or privately-owned mass transit system, or on transportation provided by a person in the business of transporting people in a vehicle, seating at least six adults, excluding the driver.

## Dollar Limitations

Maximum nontaxable value is limited to the combined value of commuter transportation and transit passes per month (\$120 commuter transportation + \$230 parking = \$350 in 2009.)

## Valuation

For transit passes sold at a discount, the discounted price rather than the face amount of the transit pass can be used to figure the exclusion as long as the discount is available to the general public.

*Reg. §1.132-9(b)*

**Example:** 10 tickets cost \$17.50 if purchased separately, but a packet of 10 tickets is available to the public for \$15, or \$1.50 each. Only \$15 counts against the annual maximum.

**Example:** Each month during 2009, the state health department distributes transit passes with a face amount of \$130 to all employees. These same passes can be purchased from the transit system by any individual for \$115. Because the value does not exceed the applicable statutory monthly limit of \$120 for 2009, no portion of the transit pass is includible as compensation.

## Substantiation Requirements

If the employer distributes the transit passes, there are no substantiation requirements. See below for cash reimbursements. *Reg. §1.132-9(b)*

## Cash Reimbursements - Special Rule

Cash reimbursement is nontaxable **only** if no voucher or similar item is readily available for direct distribution to employees.

“Readily available” means the item can be obtained:

1. on terms no less favorable than those available to an individual employee, and
2. without incurring a significant administrative cost *IRC§ 132(f)(3) Reg. §1.132-9(b), Q-16*

**Example:** Maddy buys a transit pass for \$120 each month in 2009. At the end of each month, she presents her used transit pass to her employer and certifies that she purchased and used it during

the month. The employer reimburses her \$120. Lulu also purchases a monthly transit pass for \$120, but presents it to her employer at the beginning of the month and certifies that she purchased it and will use it during the month. Her employer reimburses her at the time she presents the transit pass. In both situations, the employer has established a bona fide reimbursement arrangement for purposes of excluding the \$120 reimbursements from the employee's gross income in 2009.

## **Qualified Parking**

Qualified parking is parking provided to employees on or near the business work premises, or parking on or near a location from which employees commute to work by commuter highway vehicle, mass transit station, or vanpool. *IRC §132(f)(5)(C)*

Maximum nontaxable value is \$230 per month in 2009. *IRC §132(f)(2)(B); Rev. Proc. 2008-66*

## **Qualified Bicycle Commuting Expenses**

Beginning with years after 2008, employees may exclude reimbursements paid by employers for qualified bicycle commuting expenses. The maximum exclusion is \$20 times the number of months the employee uses a bicycle for commuting to work. Allowable expenses include the purchase, maintenance, repair and storage expenses related to commuting. *IRC 132(f)*

The bicycle commuting expense exclusion cannot be claimed for any period in which the exclusion for public transit passes or qualified parking is claimed.

## **Salary Reduction Agreements**

A salary reduction agreement is a way to provide QTF benefit pre-tax to employees, without additional cost to the employer. An employee can choose between receiving a fixed amount of taxable cash or QTF for a specified future period. A QTF salary reduction plan need not be in writing; but the election by the employee must be in writing or another permanent form, such as electronic. *IRC §132(f)(4); Regs. 1.1.32-9 Q&A 11-15*

The election must contain the following:

- Date of the election,
- Amount of compensation to be reduced, and the
- Period for which the election is valid.

## **Limitations**

The salary reduction may not exceed the combined applicable statutory monthly limits for QTFs, i.e., for the calendar year 2009, the limitation is \$350 (\$120 + \$230).

This election may not be revoked after the employee is currently able to receive the cash or after the beginning the period for which the ATF is to be provided. Any unused QTF may not be refunded. However, the unused portion may be carried over to subsequent periods and used to provide QTFs as long as the amount expended does not exceed annual limits.

### **Negative Election**

A negative election is permitted, if the employee receives adequate notice that a salary reduction will be made and is given adequate opportunity to choose to receive cash compensation instead of the QTF. A negative election means that no response is a “Yes,” that is, the employee wants the QTF and does NOT choose the cash.

**Example:** Agency Y maintains a QTF benefit arrangement. Employees of Y are paid twice per month, with the payroll dates being the 10<sup>th</sup> and 25<sup>th</sup> day of the month. Employee Q elects, before the first day of the month, to reduce his compensation in return for QTFs totaling \$250 through the year 2009 (for qualified parking). Because the election was made before he could receive the cash and the election is for a specific period, the arrangement satisfies the requirements for a valid salary reduction.

**Example:** In the above example, if employee Q revoked his election on the 10<sup>th</sup> of the month, it would be effective for the second pay period, since the revocation cannot be effective during a current pay period. It must be for a future period.

### **Effect on Deferred Compensation Plans**

When employees participate in a deferred compensation plan, they are limited to a percentage of their compensation annually that they may contribute. In **computing** what is considered compensation for purposes of the limitation, an employer may exclude certain fringe benefits, including QTFs. *IRC §314(e) IRC §403(b)(3); IRC §414(s)(2)&(3); IRC §415(c)(3); IRC §125*

### **Other Local Transportation Benefits**

Three other local transportation fringe benefits allow employers to provide transportation for commuting to employees that is excludable from wages or taxed at \$1.50 each way:

- Occasional cab fare
- Unusual circumstances
- Unsafe conditions

#### **Occasional Cab Fare (Local Transportation)**

Local transportation fare provided to **any** employee is a nontaxable de minimis fringe benefit if it is **reasonable, occasional** and is provided to permit the employee to work overtime. *Reg. §132-6(d)(2)*

For this purpose, “occasional” means infrequent; not occurring on a regular or routine basis.  
*Reg. §132-6(d)(2)(A)*

“Overtime” involves an extension of the employee’s normal work schedule. *Reg. §132-6(d)(2)(B)*

### **Unusual Circumstances and Unsafe Conditions**

Local transportation for commuting provided to an employee by an employer because of unusual **and** unsafe conditions is taxable to the employee as a wage at a maximum rate of \$1.50 each way. This benefit is not available to individuals considered control employees. *Reg. §132-6(d)(2)(C)(iii)(A)*

**Example:** “Unusual circumstances” includes an employee temporarily working outside his normal work hours or an employee temporarily making a shift change. *IRC §132-6(d)(2)(C)(iii)(B)*

“Unsafe conditions” is determined by a 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. *IRC §132-6(d)(2)(C)(iii) (C)*

### **Unsafe Conditions Only**

Local transportation for commuting provided to an employee by an employer **solely** because of unsafe conditions is taxable to the employee as a wage at a rate of \$1.50 each way. This benefit is available to qualified employees and the employer is required to have a written plan.  
*Reg. §1.61-21(k)*

The exclusion applies for employees covered by the Fair Labor Standards Act (FLSA) of 1938 **and** with compensation not exceeding specified dollar limitations in IRC § 414(q)(1)(C). Employees covered under the FLSA are not exempt from minimum wage and IRS provisions. See Reg. §1.61-21(k)(6) for details.

For this purpose, 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 or use public transportation at the time of day the employee must commute. *Reg. §61-21(j)(5)*

**Example:** Alison is a qualified employee under the requirements for the commuting valuation rule and works as a data-entry clerk for the state revenue department. Her normal hours of work are 11 p.m. to 7 a.m. Public transportation, the only means of transportation available to her is considered unsafe by a reasonable person at the time she is required to commute from home to her workplace. The employer hires a car service to pick her up at her home each evening to transport her to work and to return her to home each morning when she finishes her shift. The amount includible in Alison's income is \$1.50 for the one-way commute from home to work each evening, because public transportation is considered unsafe at that time of day. However, the value of the commute from work to home each morning is includible in Allison's income at FMV since unsafe conditions **do not** exist for this trip.

## Health and Medical Benefits

Under IRC sections 104, 105 and 106, employer-provided health benefits, including reimbursement and insurance, are generally excluded from the income of the employees. This applies to any employer-paid system, whether it is made directly (i.e., self-insured) to the employees or through an insurance provider or a trust. However, if the plan discriminates in favor of highly compensated employees, the amounts paid to those employees is subject to Federal income tax. *IRC § 105(h)*

**Direct reimbursement or payment** - An employer may pay employee or reimburse qualifying medical expenses, without taxable income to the employee. These payments may be made with or without a written plan. This includes payments for specific injuries or illness, but not payments based on work missed (i.e., sick pay).

**Health Reimbursement Arrangement (HRA)** - An HRA is a written plan to provide employer payment or reimbursement for qualifying medical or health benefits. It may provide for the carryover of benefits from year to year, and may specify the types of medical benefits that are covered. An HRA can only be financed by employer contributions, and cannot involve an employee election to participate. For more information, see Publication 969. *IR C§104*

**Employer contributions to health plans** – Contributions to the cost of accident or health insurance, including qualified long-term care insurance. Health insurance paid by an employer is excludable from the income of employees. This includes employer contributions to an Archer MSA account or to a health savings accounts (HSAs). See [Publication 969](#) for more information on these plans. *IRC §105*

**Flexible Spending Arrangement** – Under a written employer plan, the employee may choose to reduce salary and contribute to an account for medical expenses on a pre-tax basis. Amounts in the account may be used to pay for qualifying medical expenses, generally only within that calendar year. Long-term care benefits are not excludable from income tax, but are excludable from social security and Medicare taxes.

Cafeteria plans, including flexible spending arrangements, are benefit plans under which employees can choose from among cash and certain qualified benefits. Benefits provided under a cafeteria plan are subject to social security and Medicare taxes on the same basis as the specific benefits would be if provided outside the plan. If the employee elects qualified benefits, employer contributions are excluded from wages for income tax purposes if the benefits are excludable from gross income under a specific section of the Internal Revenue Code (other than scholarship and fellowship grants under section 117 and employee fringe benefits under section 132).

For more information, see [Publication 15-B](#), [Publication 963](#), and the [Cafeteria Plans Q&A](#) on the FSLG web page. *IR C§125*

## Travel and Transportation Expenses

Reimbursements received by an employee who travels on business outside of the area of his/her tax home may be excludable from wages. In order to determine whether a reimbursement is excludable, you must first understand key travel definitions. This section discusses:

- Travel expenses
- Tax home
- The definition of “away from home”: overnight/sleep or rest rules
- Temporary vs. indefinite travel assignments
- Substantiation methods *IRC §162(a)*
- Reimbursements for travel expenses

### Travel Expenses

Qualifying expenses for travel are excludable if they are incurred for temporary travel on business away from the general area of the employee’s tax home. In order to be excludable as reimbursements, the travel must be temporary and be substantially longer than an ordinary day's work, requiring an overnight stay or substantial sleep or rest. *IRC §162(a)(2)*

Travel expense reimbursements include:

- Costs to travel to and from the business destination
- Transportation costs while at the business destination
- Lodging, meals and incidental expenses
- Cleaning, laundry and other miscellaneous expenses

As stated earlier, there are no tax consequences if the accountable plan rules are met.

**Example:** An employee works for an agency in Detroit, and travels to Denver to conduct business for an entire week. The employee incurs the cost of transportation to and from Denver, as well as lodging and meals while there.

Since the employee is traveling away from his/her tax home on the employer's business for substantially longer than a day, the employee would be considered in travel status.

Reimbursement for substantiated travel expenses incurred by the employee are considered an excludable travel expense.

### Tax Home

Identifying the employee's tax home is critical because the Code only permits an excludable reimbursement for travel expenses incurred while the employee is away from his or her tax home. In most cases, the employee's tax home is the general vicinity of his principal place of

business. The taxpayer may receive excludable travel reimbursements while temporarily away from the tax home in the pursuit of business. Whether the taxpayer's tax home is the employer's business office or the taxpayer's residence, it includes the entire metropolitan area; therefore, the taxpayer is not away from home unless he or she leaves the metropolitan area. *Rev. Rul. 73-529; Rev. Rul. 93-86*

### **One Regular or Main Place of Business**

Generally, the tax home is the employee's regular place of business or official duty station, regardless of where the employee maintains a family home.

**Example:** An employee lives and works in Rochester. The Rochester area is considered the employee's tax home.

**Example:** An employee lives in Rochester, but works permanently in Buffalo. Even though the employee lives in Rochester, Buffalo is considered the employee's tax home.

### **More Than One Regular or Main Place of Business**

If an employee has more than one regular place of business, there is the employee's main place of business. The main place of business is generally determined by the time worked, degree of business activity, and income earned in each location.

**Example:** An hourly employee works in his employer's office in Portland three weeks a month and in a satellite office in Seattle for one week a month. Portland is the employee's tax home.

### **No Regular or Principal Place of Business**

An employee may have a tax home even if he/she does not have a regular or main place of business. If the employee works in the general area of the residence where he/she regularly lives, the general area of that residence is the tax home. *Rev. Rul. 73-529; Rev. Rul. 93-86*

**Example:** A forestry worker has a home in a remote location and works at various forest sites in the general area. His employer does not have an office where the employee works or reports. The general area of his residence may qualify as the employee's tax home.

### **Tax Home Election for State Legislators**

Section 162(h) of the Code provides that a state legislator whose district is more than 50 miles from the capitol building may elect to treat her residence within the legislative district she represents as her tax home. *IRC §162(h)(1)(B) TAM 9127009; Prop Reg 1.162-24*



## Away From Tax Home

In order for a reimbursement of an expense for business travel to be excludable from income, including meals and lodging, a taxpayer must travel "away from home" in the pursuit of business on a temporary basis.

The statutory phrase "away from home" has been interpreted by the U.S. Supreme Court to require a taxpayer to travel overnight, or long enough to require substantial "sleep or rest" (*U.S. v Correll*, 389 U.S. 299, 302-303 (1967)). Thus, merely working overtime or at a great distance from the taxpayer's residence does not create excludable reimbursements for travel expenses if the taxpayer returns home without spending the night or stopping for substantial "sleep or rest". *Rev. Rul. 75-170*; *Rev. Rul. 75-432*

See Meal Allowances, later, for further discussion of the "sleep or rest rule."

Questions concerning the "sleep or rest" rule have been addressed in numerous court cases over the years. Some of the major cases are listed below, and some of them are briefly discussed afterward.

### **Sleep/Rest Not Met - Reimbursements Taxable**

U.S. v Correll, 389 U.S. 299, 302-303(1967)  
Barry v. Commissioner, 27 AFTR 2d 71-334, 435 F2d 1290(CA1 1970)  
Coombs v. Commissioner, 608 F2d 1269, 1276(1979)  
Fife v. Commissioner, 73 T.C. 621(1980)  
Rev.Rul. 68-663, 1968-2 C.B. 71  
Matteson v. Commissioner, T.C. Memo 1974-96  
Unger v. Commissioner, T.C. Memo 1986-64, 51 TCM 455

### **Sleep/Rest Met - Reimbursements Not Taxable**

Williams v. Patterson, 286 F.2d 333 (5th Cir. 1961)  
Rev. Rul. 75-170, 1975-1 CB 60  
Anderson, David, (1952) 18 TC 649  
Weaver, Don, (1953) PH TCM 54001, 12 CCH TCM 1421  
Rev. Rul. 75-168, 1975-1 CB 58  
Johnson, Mose, (1982) TC Memo 1982-2  
Rev. Rul. 75-432, 1975-2 CB 60  
L-1711 - Fed Tax Coord.  
Siragusa v. Commissioner, T.C. Memo 1980-68

### **Court Case 1: Williams v. Patterson**

A railroad conductor regularly rents a hotel room near railroad station where he sleeps and eats during a 5-hour layover during an 18-hour workday. He may deduct his meal and lodging costs because his layover is long enough to obtain sleep or rest and is required by his job to do so.

### **Court Case 2: Barry v. Commissioner**

A consulting engineer works with clients in a three-state area by making one-day trips to each client. She frequently leaves home at 6:30 a.m. and does not return until midnight. During the day, she stops in a rest area and closes her eyes for 20 minutes to refresh herself for the drive. She cannot deduct the cost of her meals on these trips because she is not away from home long enough to obtain substantial sleep or rest.

### **Court Case 3: Unger v. Commissioner**

A truck driver's "safety breaks" which consisted of resting or sleeping at the wheel of the truck for periods ranging from 45 minutes to three and one-half hours, were considered by the courts to be a mere pause from his daily work routine and consequently did not constitute a substantial amount of sleep or rest. Therefore, the truck driver was not considered to be away from home.

**Example:** An employee is required to travel from Milwaukee to Madison to work on a project. She leaves home at 11:00 a.m. on Monday, with plans to return home the same day. She is unable to complete the project on Monday, so she spends the night in Madison. After completing the project the next day, she returns to Milwaukee by 10:30 a.m. Even though the employee had not planned to spend the night and is gone for less than 24 hours she has met the "away from home" rule because she spent the night away from her tax home on business.

**Example:** An employee is required to travel from Dallas to Houston to work for the day. The employee leaves home at 6:30 A.M. and returns that night at 10:00 P.M. On the trip home the employee stops for dinner and rests in the car for two hours. Even though the employee has been away from home for substantially longer than his/her normal work day, the employee is not considered to be in travel status. Courts have ruled that stopping for a meal or a rest in a car does not meet the substantial "sleep or rest" rule.

**Example:** A government agency supplies office equipment to all agencies within the state. An employee drives a tractor-trailer with equipment from the warehouse in Sacramento to an agency in San Diego. After 10 hours the driver stops and rents a room at a rest stop for a 4 hour nap before completing the round trip. Since the driver rented a room in order to sleep, he/she is considered to have met the "sleep and rest" rule. Reimbursements for meals and lodging are not taxable to the employee.

## **Temporary vs. Indefinite Travel Assignments**

Reimbursements of travel expenses for "temporary" assignments away from the tax-home are generally not taxable to the employee. If the assignment is "indefinite," the employee is considered to have moved his/her tax home to the new work location. Reimbursements of expenses for "indefinite" travel are taxable. *Rev. Rul. 93-86; Rev. Rul. 99-7*

All of the facts must be considered to determine whether the travel assignment was intended to be temporary or indefinite. *Rev. Rul. 93-86; Rev. Rul. 93-7*

**Note:** The decision concerning whether an assignment is realistically expected to last less than one year is made when the assignment begins.

### **"Temporary" Travel Assignment**

An assignment is considered temporary if it meets the following conditions:

- Duration at a **single location** realistically expected to last and actually lasts **one year or less**
- Assignment is away from the principal place of work overnight
- Tax home has not changed
- If the employee goes home on days off, the allowable expense is the lesser of (1) travel expenses home, or (2) the cost of staying at temporary assignment

Examples of possible **excludable** travel expenses include meals and lodging at temporary work location.

### **"Indefinite" Travel Assignments**

Reimbursements of expenses for “indefinite” assignments away from the tax home are generally taxable as a wage to the employee. An assignment is considered indefinite if:

- The duration at a single location is realistically expected to last longer than one year or actually lasts one year or longer
- The new assignment location is considered the new tax home *Rev. Rul. 93-86*

Examples of **taxable** travel reimbursements include meals and lodging at indefinite work location.

### **"Temporary" Travel Assignment Becomes "Indefinite"**

If an assignment away from home at a single location is, initially, realistically expected to last one year or less, and then later it is realistically expected to last longer than one year, the assignment is considered temporary *until the date the expectations change*. At that time, the travel is considered "indefinite" and any travel reimbursements from this date on are taxable.

**Example 1:** Joan accepts a 6 month work assignment away from her tax home intending to return to her tax home at the finish of the temporary assignment. The assignment lasts for 6 months and Joan returns to her regular job at her tax home. Joan's reimbursements are excludable because the assignment was intended to last for less than one year and did last less than one year.

**Example 2:** Joan accepts a temporary assignment away from her tax home for 6 months, intending to return to her tax home at the finish of the temporary assignment. After 4 months at the temporary job assignment, Joan agrees to stay for an additional 14 months. Joan is not taxed on employer reimbursements for travel expenses paid or incurred during the first 4

months of her temporary assignment. Joan will be taxed for reimbursements for the additional 14 months because the assignment has now become an **indefinite** assignment. If there had been a reasonable basis at the start of the assignment to believe that it would be extended, then it would have been considered indefinite from the start.

**Example 3:** Joan accepts an assignment away from her tax home for 15 months. After 7 months, the employer cancels the assignment and Joan returns to work at her tax home. Although Joan's assignment lasted for less than one year, it had been realistically **expected** to last for more than one year when the assignment began. Therefore, the assignment was considered "indefinite" and the reimbursements for the 7 months are taxable.

## Reimbursements for Travel Expenses

Many employers reimburse employees for ordinary and necessary business expenses incurred while traveling away from home overnight. In order for these reimbursements to be excludable from wages, the reimbursements must be made under an accountable plan. Alternatively, an employer may reimburse for travel expenses using a per diem allowance method.

*Rev. Proc. 2005-67; Reg. §1.274-5(j)(1)*

A per diem is an allowance per day to pay for lodging, meal and incidental expenses while traveling on business. The amount of the expenses reimbursed under a per diem allowance method will be deemed substantiated without receipts, provided the requirements of the regulations are met.

### Key Requirements for Accountable Plan:

- Business Connection – the travel must be to serve the purposes of the employer.
- Substantiation – Records must substantiate the (1) amount, (2) time and date, (3) place, and (4) business purpose
- Excess reimbursements must be returned within a reasonable time *Reg §1.62-2(c); Reg. §1.274-5T Reg. §1.274-5T(b)(2)*

**Example:** James, who lives and works in Tampa, is required to go to Jacksonville for the week on business. His employer will reimburse him for his lodging and meal expenses. His employer requires him to adequately substantiate the expenses he incurs while on the trip.

If James provides the required substantiation, the reimbursement he receives is not taxable to him. If, however, he fails to provide adequate substantiation, then any reimbursement he receives for the unsubstantiated amount would be taxable to him.

## Federal Per Diem Rate

Federal per diem rates include separate rates for lodging and for meals and incidental expenses (M&IE). These rates apply to employees of the Federal government, and also establish the

maximum amounts for different geographical areas that can be excluded per day for lodging, meals and incidental expenses (M&IE). The rates are revised each year, and are available online as [IRS Publication 1542](#). *Rev. Proc. 2008-59*

**Lodging includes** only the cost of the lodging itself. Room tax and energy surcharges are not considered part of the lodging cost.

**M&IE includes** meals, tips and fees for food and luggage-handling services.

An employer is not required to reduce the M&IE even if meals are provided in-kind to the employee, if the employer reasonably believes that the M&IE will be incurred.

Employers may use lower per diem rates than the Federal rates. The accountable plan rules apply in the same manner in these cases. If a rate higher than the Federal rate is used, the excess is taxable as wages.

## Per Diem Allowance Rules

If a per diem allowance is used, employees are deemed to have substantiated the **amount** of expenses equal to the lesser of the Federal per diem rate or the per diem allowance paid by the employer (if less than the IRS rate). *Rev. Proc. 2005-10*

- The per diem must be at or less than Federal rates to be fully excludable. *Rev. Proc. 2008-59*
- “Deemed substantiation” provides an alternative to providing receipts or bills for actual expenses.
- No receipts are required if a per diem allowance is used, but the payments still must meet the other substantiation requirements including time (date), place, and business purpose.
- An employer's substantiation requirements must at a minimum meet the Federal requirements. An employer may have more stringent requirements, such as requiring meal and/or lodging receipts.

**Example:** An employee traveling away from home on business is reimbursed by his employer at the Federal per diem rate for the city in which he spends the night. Because the employee is reimbursed at the Federal per diem rate for the city in which he spends the night, the employee does not have to provide receipts. However, the employee must still provide adequate substantiation verifying the time, place and business purpose of the trip. The employer may require additional substantiation.

## **Miscellaneous Expenses**

Miscellaneous expenses are not considered part of a per diem reimbursement and, therefore, substantiation is required. Employers may require actual receipts or written certification as substantiation depending on their travel policies.

Miscellaneous expenses include cab fares, fax, telephone, copy charges, room taxes, energy surcharges, laundry, cleaning and pressing of clothes, and other business related expenses.

Miscellaneous expenses are not part of M&IE and therefore such reimbursements, in addition to the M&IE allowance, may be excludable from wages. *Rev. Proc. 2007-63*

## **Optional Method for Incidental Expenses Only**

Employer may reimburse employees \$3 per day or partial day if the employee:

- Is traveling away from home on business, and
- Does not pay or incur meal expenses, and
- Is not receiving per diem or M&IE expenses. *Rev. Proc. 2006-41*

## **Travel for Days of Departure and Return**

For both the day travel begins and the day travel ends, the per diem meal allowance is to be prorated by one of two methods:

- Allow  $\frac{3}{4}$  of the per diem meal allowance for each of those days, or
- Use any method that is consistently applied and that is in accordance with reasonable business practice, such as the actual hours away from home on the first and last day. *Rev. Proc. 2006-41*

## **Traveling to More Than One Location**

If the employee is traveling to more than one location in one day, use the per diem rate for the area where stopping for rest or sleep. *Rev. Proc. 2006-41*

## **Per Diem Paid Under a Nonaccountable Plan**

A per diem plan that fails to comply with all accountable plan requirements is considered a nonaccountable plan. *Reg. §1.62-2(a)(4)*

Per diem payments made under a nonaccountable plan are wages subject to Federal income tax, and employer and employee social security and Medicare taxes. The payments are included in wages in boxes 1, 3, and 5 on Form W-2.

**Example:** An employee regularly travels as part of her job requirements. The employer provides her with a monthly per diem allowance based on an estimate of the number of days traveled. The employer does not require the employee to return any of the allowance that exceeds substantiated business expenses.

Because the employer does not require the employee to return excess advances or allowances, the entire amount of the allowance is taxable to the employee as a wage.

## **Other Per Diem Methods**

### **Meals-Only Substantiation Method**

An employer may reimburse the actual lodging expense and use the M&IE per diem allowance plan for the meals and incidentals expense. *Rev. Proc. 2007-63; Pub. 1542*

### **High-Low Substantiation Method of Substantiation**

The high-low substantiation is another deemed substantiation method that may be used in place of the per diem method. The IRS designates key cities or localities as "high-cost" areas. All other localities are considered "low-cost" areas. Use of this method eliminates the need to keep records of the current rate for each city. A single per diem rate is assigned to all high-cost areas and all other areas are assigned another rate. An employer that uses the high-low method for an employee must use the high-low method for that employee for all travel in the continental United States that year, unless an actual expenses method or the meals and incidental expenses method is used. See [Publication 1542](#) for more information and current high-low rates. *Rev. Proc. 2007-63*

## **Transportation Expenses**

Transportation expenses are costs for local business travel that is *not* away from the tax home area overnight and is in the general vicinity of the principal place of business. Transportation expenses must be distinguished from commuting costs, which are not excludable from employee income. Travel expenses are expenses for travel away from your tax home overnight. *IRC 162(a)(2); IRC 62(a)(2)(A); IRC 62(c); Rev. Rul. 99-7*

Reimbursements of expenses for local transportation for "temporary" assignments are generally not taxable to the employee.

### **Transportation expenses may include:**

- Air, train, bus, shuttle and taxi fares in area of tax-home
- Mileage expenses or costs of operating a vehicle

- Tolls and parking fees

**Transportation expenses do not include:**

- Meal and lodging costs
- Commuting to regular or principal place of business

## **Substantiation Methods – Transportation Expenses**

Transportation expenses are subject to the same accountable plan rules for travel expenses, discussed above. They are fully excludable when paid under an accountable plan. The following requirements must be met:

- Business connection
- Substantiation
- Excess returned within a reasonable time *Reg. §1.62-2(c); Reg. §1.274-5T(b)(2)*

To be excludable as transportation expenses, the same tests that are applicable to travel away from home must be met:

- Payments must be made under an accountable plan
- Employee must prove amount, date and time, place and business purpose of expenses
- Employee must keep contemporaneous records such as receipts
- Expenses must not be lavish, but reasonable based on circumstances
- No excludable meal reimbursements can be made unless the employee is away from home overnight. *Reg. 1.62-2; 1.274-5T(b)(2)*

## **Temporary vs. Indefinite Transportation Assignments**

For transportation expenses, it is important to note the distinction between “temporary” and “indefinite” assignments. Reimbursement of transportation expenses for “temporary” assignments in the general area of the tax-home may not be taxable to the employee. Reimbursements of expenses for “indefinite” transportation expenses may be taxable. *ILM 199948019; Rev. Rul. 99-7*

The “temporary” and “indefinite” rules only apply to movement between an employee’s *residence* and a work location, regardless of the distance. The Internal Revenue Service looks at all of the facts to determine whether the travel assignment was truly intended to be temporary.

**Note:** The decision of whether an assignment is realistically expected to last more than one year is made when the assignment begins.



## Temporary Transportation Expenses

The following requirements apply to the excludability of transportation expenses under a temporary assignment:

- Duration at a *single location* is realistically expected to last, and actually lasts, one year or less
- Assignment is away from the main place of work
- Reimbursement cannot be for commuting

Examples of possible excludable transportation reimbursements include mileage and parking.

## Indefinite Transportation Expenses

The following apply to indefinite transportation expenses:

- Duration **at a single location** is realistically expected to last longer than one year
- Assignment location is away from principal place of work
- Taxable transportation expense reimbursements include mileage, parking that exceeds certain transportation fringe benefit limits
- A break of 7 months generally constitutes a new assignment  
*RR 99-7; PLR 200026025; PLR 200025052*

## "Temporary" Transportation Assignments Become "Indefinite"

If initially a local assignment at a single location is realistically expected to last one year or less, and then later it is realistically expected to last longer than one year, the assignment is considered temporary **until** the date the expectations change. At that time, the transportation is considered "indefinite" and any reimbursements from this date are taxable.

**Example:** Tom, a state auditor, is assigned to an audit of another agency that is expected to take, and does take, 18 months to complete. The agency he is auditing is in the same town as his regular place of business. Tom travels daily from his residence to the office of the agency he is auditing and is reimbursed for his mileage by his employer.

Although, the travel is considered "indefinite" since the audit is expected to take more than one year, Tom is not traveling away from his tax home area. The reimbursements for mileage are taxable wages to Tom.

If Tom had traveled from his main place of business rather than from his residence, the reimbursements could be excludable because he was not traveling from his residence, so the "temporary vs. indefinite" rules do not apply.

## Transportation Expenses and Commuting

It is important to distinguish expenses for transportation from commuting. "Commuting" refers to travel between an employee's personal residence and main or regular place of work. Reimbursements of transportation expenses for getting from one workplace to another in the course of the employer's business within the general area of the tax home may be excludable from wages, whereas reimbursements for commuting are not excludable. *Reg. §1.162-2(e)*

The following are examples of excludable business transportation:

1. An employee with one or more regular workplaces drives from her residence to a temporary job site, either within the area of her tax home or outside that area.
2. An employee drives from his regular office (or job location) to a temporary work site.
3. An employee drives from a first job to a second job.
4. An employee drives between temporary job sites.
5. An employee works at two places in one day and drives between work sites whether or not for the same employer.
6. An employee has an office in the home that qualifies as a principal place of business and drives between the home and another work location in the same trade or business.

The following are examples of commuting, for which reimbursements would be taxable and no deduction allowed:

1. An employee drives from his residence to his principal or regular workplace(s) (during or after work hours, whether required or not by employer).
2. An employee drives from her residence to her regular workplace on the weekend because of an urgent meeting convened by her employer.
3. An employee has an office in the home that qualifies as a principal place of business and drives between the home and another work location in a different trade or business.
4. An employee with no regular or main place of business drives between his residence and his first business stop, and last business stops and home.

**Example:** An employee drives from her home in East Lansing to her office in Jackson. In the afternoon she drives to Ann Arbor to deliver papers at a satellite office and returns to her residence. The trip between the employee's home and place of business in Jackson is personal commuting and any reimbursement for this part of the trip is taxable to her as a wage. Assuming the accountable plan rules are met, reimbursement for the travel from her office to the temporary work site in Ann Arbor and the return trip home is excludable.

**Example:** A Fish and Game warden lives in a remote area and does not have a regular place of business. He drives daily to various temporary job locations and is reimbursed for his mileage. Reimbursements for the daily travel between the employee's residence and the first work location, and last work location and home are taxable as wages because the game warden does not have a regular place of business and he is not driving to a work site outside of the general area of his residence. Reimbursements for travel between the work sites are not

taxable. However, if he had a regular place of work, travel between home and the regular workplace would be commuting and reimbursements for this would be taxable.

**Example:** An employee travels from his residence to a temporary work site for the day, driving past his official duty station on the way. Reimbursements for transportation between residence and temporary work site may be excludable as the actual distance traveled. See ILM 199948018.

**Example:** A high-school music teacher is assigned to two schools on a permanent basis. She works at the first school in the morning and drives from the first to the second school in the afternoon. She is reimbursed for her travel between the two locations. The travel is not taxable to the teacher because she is traveling between work sites.

## Moving Expenses

Payments or reimbursements for moving expenses are generally not considered fringe benefits; however, such amounts paid to employees is a common form of supplemental compensation, and therefore is discussed briefly here. For more information, see [Publication 521](#), Moving Expenses.

Moving expenses incurred to change residences, are considered personal expenses and are to be included in wages *unless* the move is directly related to work and the expenses meet the criteria set forth under IRC § 217. Personal expenses are not deductible under IRC § 262.

If the moving expenses qualify under IRC § 217, they may be taken as a deduction on the individual's Federal income tax return. If the expenses are paid or reimbursed by an employer, the moving expense payment can be an excludable fringe benefit to the employee under IRC § 132(g).

### General Rule

A moving expense reimbursement received directly or indirectly from an employer (under an accountable plan) is excludable to the employee if the following tests of IRC §217 are met.

*IRC §82 & §217*

- Individual must be an employee
- Employee must actually incur or pay the expenses
- Expenses are closely related to starting work at the new job location (generally moving expenses incurred within one year from the date you first report to work at the new location qualify)
- Expenses must meet the time and distance tests:

**Time Test:** The employee must work at least 39 weeks full-time in the first year after arriving in the new location.

**Distance test:** The *new* job is at least 50 miles farther from the former home than the old job location was from the former home.

Note: A different time test applies to self-employed persons. See Publication 521.

### Allowable Expenses

Moving Expenses are the reasonable expenses for:

- Moving household goods and personal effects; and,
- The travel costs between the former and the new residence by the shortest and most direct route. *IRC § 217(b)*

## Moving Expense Payments Can Be Direct or Indirect:

Direct payments are made directly to the employee for moving expenses. Indirect payments are made to a third party on behalf of the employee (i.e., a moving and storage company, or an airline, or travel agency). *Reg. §1.82-1(a)(3)*

## Travel Time for Traveling Expenses

An employee can be reimbursed for the cost of transportation and lodging for herself and members of her household while traveling from her former home to her new home. This includes expenses for the day she arrives. An employee can include any lodging expenses she had in the area of her former home within one day after she could not live in her former home (the furniture had been moved). An employee can be reimbursed for traveling expenses for only one trip to her new home for herself and members of her household. However, all family members do not have to travel together or at the same time.

**Begins:** One day after former residence is no longer suitable for occupancy and includes one night lodging at prior residence.

**Ends:** Date the employee secures lodging at the new place of residence  
The qualified expenses are deductible only for the first day the employee arrives at the new location.

**Note:** Any relocation allowances paying for more days than defined above are taxable as wages to the employee.

## Delayed Moving

Expenses are deductible even after through a 12-month period of after arriving; for example, one is waiting for dependents to finish school. *Rev. Rul. 78-200 Reg. §1.217-2(a)(3)*

These rules are further illustrated in [Publication 521](#).

## Meals and Lodging

The fair market value (FMV) of meals or lodging furnished to an employee by an employer may be nontaxable to the employee. If a benefit is deductible by an employee under IRC section 119, it may be excludable from wages. Cash provided for meals is not excludable under this Code section; however, under certain circumstances it can be excluded as a de minimis fringe benefit, discussed earlier. *IRC §119*

### In-Kind Requirement

**"In-Kind"** refers to payments made in something other than cash. Meals or lodging paid in the form of cash equivalent do not qualify for this exclusion.

#### Meals are excludable from wages of the employee if they are provided:

- On the employer's business premises, and
- For the employer's convenience.

#### Lodging is excludable from wages of the employee if it is provided:

- On employer's business premises, and
- For employer's convenience, and
- Required as a condition of employment.

Federal law takes precedence over a state statute or an employment or union contract that indicates that a meal or lodging is taxable or not taxable. The actual facts and circumstances and the requirements of IRC §119 determine the liability for Federal income, social security and Medicare taxes. *IRC §119(b)(1)*

**Example:** An employee of a state institution is required by his employer to reside at the institution in order to be available for duty at all times. Under the applicable state statute, the employee's lodging is regarded as part of the employee's compensation.

Regardless of the state statute, the employee would nevertheless be entitled to exclude the value of such meals and lodging from his wages for Federal tax purposes because the lodging is provided in kind, is on employer's business premises, for the employer's convenience, and is required as a condition of employment. *Reg. §1.119-1(f)*

If an employee has an option to receive additional compensation in place of actual meals or lodging, then the meals and lodging, if chosen, are taxable. *Reg. §1.119-1(e)*

## **“On the Business Premises” of the Employer**

“On the business premises of the employer” means that the meals must be provided either at:

- A place where the employee performs a significant portion of duties, or
- The premises where the employer conducts a significant portion of his or her business.  
*Reg. §1.119-1(c)*

**Example:** Meals are provided at no cost to employees on a state ferry. The meals are not taxable. The ferry qualifies as the employer’s business premises and the employee performs a significant portion of duties there. Meals are furnished for the convenience of the employer since the employer cannot stop the ferry to allow the employees to go to lunch.

## **Meals for the Convenience of the Employer**

Meals are provided for the convenience of the employer if they are provided for a substantial “noncompensatory” nonpay reason. This determination depends on the facts and circumstances.

The following situations illustrate meals furnished for substantial noncompensatory reasons:

- Workers need to be on call for emergencies during the lunch period
- The nature of the business (not merely a preference) requires short lunch periods
- Eating facilities are not available in the area of work
- Meals are furnished to restaurant employees, before, during or after work hours
- Meals are furnished to all employees, if meals are furnished to substantially all the employees are for substantial noncompensatory reasons
- Meals are furnished immediately after working hours because the employee’s duties prevented him or her from obtaining a meal during working hours

Meals provided to improve general morale or goodwill, or to attract prospective employees, are not provided for a substantial noncompensatory reason and are taxable. *Reg. 1.191(a)(2)*

**Example:** Meals are furnished during working hours so that employee is available for emergency calls during the meal; for example, a firefighter. You must have evidence that emergencies occur.

**Example:** Meals are furnished to employees in a remote site because there are insufficient eating facilities in the area, such as a remote logging camp.

**Example:** An employer has pizza delivered to the office at a group meeting because the business requires the meeting be kept short, and there are no alternative facilities in the immediate area.

**Example:** Meals are furnished by a bank that experiences highest customer demand during the lunch hour and therefore establishes a short meal period to meet this need, not to allow the employee to leave earlier.

### **Meals *Not* Provided for the Convenience of Employer**

Meals provided before or after working hours are not for the convenience of employer, unless:

- Provided for a restaurant or cafeteria employee, or
- Duties prevent the employee from taking a meal until immediately after working hours  
*Reg. §1.119-1(a)(2)*

Meals provided with a charge may or may not be considered for the "convenience of the employer." If there is a mandatory charge or deduction from the employee's pay required for meals, this amount is not included in gross income to the employee. *IRC §119(b)(3)*

### **De Minimis Meals**

Infrequent meals of minimal value may be excludable as a de minimis fringe benefit, regardless of the tests above. See the discussion of de minimis fringe benefits, earlier.

### **Lodging**

Whether lodging is provided for substantial non-pay ("noncompensatory") reason depends on the facts and circumstances. *Reg. §1.119-1(b)*

Lodging provided to a state governor is considered to be for the convenience of the employer.  
*Rev. Rul. 75-540*

Rent subsidized living quarters provided to state legislators do not satisfy the convenience of the employer or condition of employment tests where the legislator is not required to accept them. However, there is an election that a legislator may make to have his/her personal residence treated as his or her tax home and then the value of the lodging may be excludable as a qualified travel expense. (See the discussion of travel expense reimbursements earlier.) *IRC §162(h)(1)(B); TAM 9127009*

**Example:** A full-time executive works for a city but lives in another community. The city provides a rented apartment locally to help defray the executive's personal commuting costs. The requirements for lodging to be excluded from income have not been met. The lodging is not on the business premises of the employer, and therefore, does not qualify for an exclusion.



## Lodging Required as Condition of Employment

Lodging is required as a condition of employment when the employer requires the employee to live on the premises to be able to perform their job duties, such as firefighters or apartment managers. For the exclusion to apply, the employee must be required to accept lodging. Where lodging is provided as a condition of employment, meals, if provided, may qualify as excludable. *Reg. §1.119-1(a)*

**Example:** An employee at a prison is given the choice of residing at the institution free of charge, or of residing elsewhere and receiving a cash allowance in addition to his regular salary. If he elects to reside at the prison, the value of the lodging is taxable as a wage to the employee because he is not required as a condition of employment to reside on the premises.

## Lodging for Educational Institutions

Qualified campus lodging furnished to employees is not taxable to an employee as a wage, if:

- Lodging is located on or near the campus, and
- The employee pays rent for the taxable year of at least 5% of appraised lodging value, or
- Rent charged to the employee is comparable to rent charged by the institution to students or non-employees. *IRC §119(d)*

### Taxable Campus Lodging

**If the employee pays no rent:** The lesser of 5% of the appraised value or the comparable rent is included in income as wages.

**If the employee pays rent that is less than the 5% of appraised value or comparable rent:** The difference between what is actually paid and the lesser of 5% of the appraised value or the comparable rent is a wage is included in wages.

The benefit applies to employees of institution and their spouse and dependents.

## Meals or Lodging Furnished With a Charge

If an employer charges an employee a fixed amount for a meal or lodging, whether or not taken by the employee, the employee's regular *taxable wage* is reduced by the amount of the charge. If *not* provided for the convenience of the employer, the FMV of meal or lodging is then added to the wage. Generally, the FMV of the meal will be the amount charged for the meal by the employer. *IRC §119(a)(2); IRC §119(b)(3)*

### Optional Meal

If an employer provides a meal which an employee may choose whether to purchase, the employee's taxable wages are *not* reduced by the amount the employee pays for the meal. If the meal is not for the convenience of the employer, the FMV of the meal less any amount charged by the employer is included in the employee's wages. *IRC§119(b)(3)*

## **Meals While Traveling**

As discussed earlier, employers often reimburse employees for meals while traveling away from home overnight or while attending meetings or entertaining customers. These meals generally fall under the rules for travel and transportation expenses, discussed earlier. The taxability of these reimbursements or allowances depends on whether there is a valid business reason for the meals and whether the expenses are substantiated. Reimbursements or allowances must first meet the accountable plan rules in order to be excludable.

### **Overnight Travel**

In general, meals are subject to the same rules as other expenses when they occur under the conditions of travel expenses, discussed earlier. The overnight rule, discussed earlier, and the accountable plan rules apply. In order for travel meal reimbursements to be excludable from wages, employees must be traveling away from their tax home on their employer's business. As with other travel-related expenses, the general area of work, not the employees' residence, determines the tax home.

Traveling "away from home" means:

1. Employee must be traveling away from the general tax home area substantially longer than an ordinary day's work, and
2. Employee needs to obtain substantial sleep or rest to meet the demands of the work while away from home. *IRC §162(a)(2) Rev. Rul. 75-170 Rev. Rul. 75-432*

### **Meals Away From Tax Home But Not Overnight**

Generally, these meals are taxable as wages to the employee because travel must be away from home overnight to be excludable.

**Example:** An employee is required to travel from Topeka to Wichita to work for the day. The employer agrees to pay for the employee's meals while in Wichita. The employee leaves home at 7:00 a.m. and returns home at 9:00 p.m. Before the employee returns in the evening, the employee takes a nap in his car for an hour.

Although the employee is away from his tax home for substantially longer than a normal work day and even stops for rest, the employee is not considered to be away from home overnight. The rest is not be considered substantial. Any meal money that the employee receives is taxable as wages.

For more information, refer to the earlier section on Travel and Transportation Expenses.

## Meals as Entertainment

Reimbursements or allowances provided to employees for meals in the course of entertaining customers may be excludable if the expenses are ordinary and necessary, and meet either a ***Directly Related Test*** or an ***Associated Entertainment Test***.

**Directly-Related Test** – Entertainment-related meal reimbursements meet the directly-related test and may be excludable from wages if:

- The main purpose of the combined business and meal is the active conduct of business,
- Business is actually conducted during the meal period, and
- There is more than a general expectation of deriving income or some other specific business benefit at some future time.

All of the facts must be considered, including the nature of the business transacted and the reasons for conducting business during the meal. If the meal takes place in a clear business setting and is for your business or work, the expenses are considered directly related to your business or work. *Reg. §1.274-2(c) and (d)*

### Examples of Directly-Related Meals or Entertainment

- Meals at a hospitality room sponsored by an employer at a convention.
- Entertainment of civic leaders at the opening of a new city hall.

**Associated Test** - Entertainment-related meal reimbursements meet the associated test and are excludable if the entertainment is:

- Associated with the active conduct of the employer's business, and
- Directly before or after a substantial business discussion.

Generally, an expense is associated with the active conduct of a business, if there is a *clear business reason* for incurring the expense. The purpose may be to get new business or to encourage the continuation of an existing relationship. These activities need not occur in a clear business setting.

Whether a business discussion is substantial depends on the facts of each case. A business discussion will not be considered substantial unless you can show that you actively engaged in the discussion, meeting, negotiation, or other business transaction to get income or some other specific business benefit. You must be able to show that the business discussion was substantial in relation to the meal. *Reg. §1.274-2(c) and (d)*

## Trade or Professional Association Meetings

Reimbursements for meal expenses directly related to and necessary for attending business meetings or conventions of certain exempt organizations are excludable from wages if the expenses of your attendance are related to your trade or business. These organizations include chambers of commerce, business leagues and trade or professional associations. *Reg. §1.274-2(d)(3)*

**Example:** A manager regularly buys lunch for all of the employees in her group after monthly group meetings in an effort to boost morale. The manager and the employees are reimbursed by the employer. This does not meet either the directly-related test or the associated test and is not a qualified business meal. The value of the meal is considered taxable to the employees.

**Example:** A government official attends a meeting as a representative of his agency. The meeting is followed by a dinner for which the official is reimbursed by this agency. The meal reimbursement meets the associated business test, and therefore qualifies as an excludable business meal.

## De Minimis Exclusion for Occasional Meal Reimbursements

Regularly-provided meal money does not qualify for the exclusion for de minimis fringe benefits provided by an employer. Occasional meal money can meet an exception and be excludable, if the following three conditions are met:

- **Occasional Basis** - Meal is reasonable in value, and is not provided regularly or frequently, **and**
- **Provided for Overtime Work** - Overtime work necessitates an extension of the employee's normal work schedule, **and**
- **Enables Overtime Work** - Provided to enable the employee to work overtime. Meals provided on the employer's premises that are consumed during the overtime period, or meal money expended for meals consumed during that period, satisfy this condition. *Reg. §1.132-6(d)(2)*

If meal reimbursements are provided as part of a company policy or union contract, they are not excludable as de minimis benefits, because the benefit is required and is not occasional. The employer would normally have the opportunity to set up the administrative procedures for reporting the benefit, so accounting for it does not meet the "administratively impracticable" standard for de minimis benefits.

Meal money calculated on the basis of number of hours worked (for example, \$5.00 per hour for each hour worked over 8 hours) is never excludable as a de minimis fringe benefit. *Reg. §1.132-6(d)(2)*

### **Example: Nontaxable de minimis meal benefit**

A commuter ferry breaks down and engineers are required to work overtime to make repairs. After working 8 hours, the engineers break for dinner because they will be working for an additional 3 hours. The supervisor gives each employee \$10.00 for a meal. The meal is not taxable to the engineers because it was provided to permit them to work overtime in a situation that is not routine.

### **Example: Taxable de minimis meal benefits**

An employer has a policy of reimbursing employees for breakfast or dinner when they are required to work an extra hour before or after their normal work schedule. The reimbursements are taxable because the employer has a policy which indicates payments are routinely made. In addition, the meal reimbursement does not enable the employee to work overtime, but is an incentive to do so.

## **Substantiating Employee Meal Expense Reimbursements**

Meal expense reimbursement/allowance must meet the accountable plan rules in order to be excludable from wages. An employer may reimburse employees using an actual expense or per diem method.

Reimbursements for allowable business travel meals **while traveling away from home overnight** may be substantiated using either an actual expense method or a per diem method.

Meals **while not traveling**, such as meals with meetings or overtime meals, must be substantiated using the actual expense method.

If an employee chooses not to be reimbursed for expenses, the employee cannot claim the expenses on his/her personal tax return *P.W. Havener, 23 TCM 539*.

## Use of Employee-Owned Vehicle

Government employees often use their personal automobiles for official use. If reimbursements are made under an accountable plan, they are excludable from the employee's income. Otherwise, they may be taxable as wages. In most cases, an employer can opt to reimburse the employee a mileage allowance in lieu of actual automobile expenses.

### Standard Federal Mileage Rates

As of January 1, 2009, the standard mileage rate is 55 cents per mile. The rate for the current year can be found on [www.irs.gov](http://www.irs.gov) or in [Publication 553](#).

Reimbursements for allowable business travel are excludable from the wages of the employee, if made at or less than the standard Federal mileage rate. *Reg§1.274(g)(2)(iii); Reg. § 1.274-5*

Reimbursements for ***non-business travel***, including commuting, are always taxable even if paid at or below the Federal mileage rate and are to be included in regular wages and subject to all income and employment taxes.

***Personal commuting*** between the residence and the principal place of business is considered non-business travel or personal use.

### Employer Reimbursements in Excess of Federal Mileage Rate

Reimbursements in excess of the Federal mileage rate are taxable as a regular wages to the employee. When there is an excess reimbursement, both the nontaxable and taxable amounts are reported on Form W-2:

<i>Reimbursements <u>up to</u> Federal Mileage Rate (<b>when there are excess Reimbursements</b>)</i>	<i>W-2, Box 12 - Code L</i>
<i>Reimbursements <u>in Excess</u> of Federal Mileage Rate: (Taxable)</i>	<i>W-2, Box 1, 3, and 5*</i>

*\*Subject to withholding reported in Boxes 2, 4 and 6.*

### Employer Reimbursement Paid at or Less Than the Federal Rate

If an employer reimburses an employee's business mileage under an accountable plan, at or below the Federal mileage rate, and the employee substantiates the business miles, then:

- The reimbursement is not taxable to the employee.
- No income tax is withheld.
- No reporting is required on Form W-2.

## **Employee Deduction**

If an employer reimbursement is less than the Federal rate, employees who itemize deductions on their personal returns can deduct the difference between the Federal mileage rate and the employer reimbursement, using Schedule A and attaching Form 2106.

## **Substantiation Requirements**

The employee is required to provide substantiation to the employer. Substantiation rules require the employee to record the date, business purpose, and place of each trip. *Reg. §1.274-5T(c)(1)-(2); Reg. §1.274-5A(f)(3)*

Mileage should be recorded "at or near the time" incurred. Monthly expense reports generally qualify as "at or near the time." *Reg. §1.274-5T(c)(2)(ii)*

**Example:** In 2009, a state agency paid automobile mileage reimbursements at the Federal rate of 55 cents per mile to employees for business use of their personal vehicles. The employees verified their expenses on monthly expense reports. Because the reimbursement does not exceed the Federal mileage rate and the business use has been verified, the reimbursements are not included in employee wages. No reporting is required on Form W-2.

## **Rule If Not Requesting Reimbursement from Employer**

If employees choose not to be reimbursed for business mileage, they cannot claim the expenses on their personal tax returns. *P.V. Havener, 23 TCM 539*

## Employer-Provided Vehicle

If an employer provides a vehicle which is used exclusively for business purposes (except for allowable de minimis use, discussed later) there are no tax consequences or reporting. Business use does not include commuting (except as discussed later). Records should be maintained to substantiate that all vehicle use was for business.

### Employer Vehicle Used for Both Business and Personal Use

If an employer-provided vehicle is used for both business and personal purposes, substantiated (see Substantiation Requirements, below) business use is not taxable to the employee. Personal use is taxable to the employee as wages. The employer can opt to include all use as wages; however, the employee can pay the employer for personal use rather than having it treated as wages. *Reg. § 1.61-21(c)*

### What is Personal Use?

The following are examples of taxable personal use of an employer-provided vehicle:

- Commuting between residence and work station.
- Vacation, weekend use, or use by spouse or dependents.
- The employee goes into his office on the weekend. This is personal commuting, regardless of whether it is required by the employer. *Reg. § 1.162-2(e)*

### Examples of De Minimis Nontaxable Personal Use

- Small personal detour while on business, such as driving to lunch while out of the office on business.
- Infrequent (not more than one day per month) commuting in employer vehicle. This does not mean that an employee can receive excludable reimbursements for commuting 12 days a year. The rule is available to cover infrequent, occasional situations. *Reg. § 1.132-6(d)(3)*

**Example:** An employee uses a motor pool vehicle for a business meeting. The employer requires that motor pool vehicles be returned at the end of the business day, but the employee is delayed and the motor pool is closed when the employee arrives back at the office. The employee takes the vehicle home and returns it the next morning.

Assuming that this is an infrequent occurrence for that employee (generally happening no more than once a month) the commuting value of the trip would be considered a nontaxable de minimis fringe benefit. If not an infrequent occurrence, the commuting would be taxable to the employee.

### Substantiation Requirements



Separate records for business and personal mileage are required. *IRC 274(d)*

**If records are not provided by the employee,** the value of **all** use of the automobile is wages to the employee, and the employee can then take itemized deductions for any substantiated business use on Form 1040, Schedule A. *Reg. §1.132-5(b)*

**If records are provided by the employee to the employer, only** the personal use of the automobile is wages to the employee.

Exceptions to the recordkeeping requirements apply in certain situations discussed latter in this chapter.

## Valuing Personal Use of Employer-Provided Vehicle

Personal use of an employer's vehicle is taxable wages to the employee. The following procedure should be used to determine how much to include in wages on the employee's Form W-2. *Reg. §1.162-2(d)*

**Step 1:** Compute personal use based on miles driven **Example:**  
2,000 personal miles/10,000 total *miles* = 20% *Personal use*

**Step 2:** Apply valuation rule - General Valuation Rule or one of three special automobile valuation rules

## General Valuation Rule

### Computation:

1. Determine what employee would pay to lease auto ( FMV\*).
2. Multiply FMV by % of personal use (computed in Step 1).  
Example: Cost to lease car (FMV) for 1 yr. plus value  
of fuel provided \$ 4,000
3. Multiply by 20% personal use 20%  
Include in wage of employee \$ 800

\* FMV (fair market value) - the amount an employee would have to pay to a third party in an arms-length transaction. *Reg. § 1.61-21(b)(4)*

## Three Special Automobile Valuation Rules

- **Automobile Lease Valuation Rule** *Reg. §1.61-21(d)*
- **Vehicle Cents-Per-Mile Rule** *Reg. §1.61-21(e)*
- **Commuting Rule** *Reg. §1.61-21(f)*

### **General requirements for using these special valuations:**

- Employer and employee must timely report personal use as wages.
- Generally, the rules are applied on a vehicle-by-vehicle basis.
- Employer may use different rules for different vehicles.

### **Automobile Lease Valuation Rule**

Compute the value for purposes of the lease valuation rule as follows:

1. Determine the fair market value (FMV) of vehicle on first day made available to employee.
2. Use the table in Reg. §1.61-21(d)(iii) or Pub. 15-B to compute the annual lease value;
3. Multiply the annual lease value by the percentage of personal use computed in Step 1.
4. If fuel is provided, add 5.5¢ per mile driven by the employee to the table lease value.

Maintenance and insurance costs are included. *Reg. §1.61-21(d)*

**Note:** The employer's cost, including tax, title, etc. may be used to determine the FMV. See the Regulations for information on the valuation of leased vehicles.  
*Reg. §1.61-21(d)(5)*

**Example:** Joe, an employee of Agency XYZ, uses an agency-provided car. In 2009, Joe drives the car 20,000 miles, of which 4,000 were personal miles or 20% ( $4,000/20,000 = 20\%$ ). The FMV of the car is \$14,500 for an Annual Lease Value of \$4,100. Personal use is valued at \$820: ( $\$4,100 \times 20\%$ ) plus \$220 ( $5.5¢ \times 4,000$  miles) for fuel costs. \$1,040 ( $\$820 + \$220$ ) is included in Joe's wages.

### **Recalculation of Value after 4-Year Lease Term**

Once computed, the Annual Lease Value remains in effect until 12/31 of the 4th full calendar year after the rule is first applied. *Reg. §1.61-21(d)(2)*

**Example:** Joe is assigned an agency-provided car on 2/17/08. The agency uses the same \$4,100 annual lease valuation until 12/31/12. After the 4<sup>th</sup> full year, or if the vehicle is transferred to another employee, the value may be recalculated (unless the purpose of the transfer is only to reduce the tax).

## Daily Lease Value

This method is required if the vehicle is available for less than 30 days. Figure the daily lease value by multiplying the annual lease value by a fraction, using four times the number of days of availability as the numerator, and 365 as the denominator.

However, you can apply a prorated annual lease value for a period of continuous availability of less than 30 days by treating the automobile as if it had been available for 30 days. Use a prorated annual lease value if it would result in a lower valuation than applying the daily lease value to the shorter period of availability.

*Reg. §1.61-21(d)(4)*

## Fleet Average Value

If the employer has 20 or more cars used for business and personal use by employees, a "fleet-average value" may be used to calculate the annual lease valuation. For 2009, each vehicle must be valued at less than \$19,900. (For trucks, the amount is also \$19,900.) *Reg. §1.61-21(d)(5)(v); Rev. Proc. 2009-12*

## Vehicle Cents-Per-Mile Rule

To use the vehicle cents-per-mile rule, the vehicle must meet one of the following tests:

- It is regularly used (50% or more each year) in the employer's business, or is
- Generally used each workday to transport at least three employees to and from work, in an employer sponsored commuting vehicle pool, or is
- Driven by employees at least 10,000 miles per year.

## Continued Usage Rule

You must continue using the cents-per-mile rule for the vehicle unless the vehicle no longer meets the requirements, except that an employer may change to the commuting valuation rule.

## Limitation on Value

For 2009, the cents-per-mile valuation rule cannot be used for cars with FMV exceeding \$15,000 (2009) The amount for trucks is \$15,200. Note: This amount is revised annually. *Rev. Proc. 2009-12; Rev. Reg. §1.61-21(e)(1); Reg. 1.280F*

## Computation

Multiply the standard mileage rate by number of personal miles driven. If fuel is not provided, the standard mileage rate can be reduced by up to 5.5 cents (55 cents – 5.5 cents = 49.5 cents in 2009). *Reg. §1.61-21(e)*

**Example:** Joe drives his agency-provided car for 2,000 personal miles in 2009. The amount included as a wage is \$1,100 (55 cents x 2,000 personal miles) or if no fuel is provided it would be \$980 (49.5 cents x 2000 miles).

## Commuting Valuation Rule

Personal use for commuting can be valued at \$1.50 each way if:

- The vehicle is owned or leased by the employer;
- The vehicle is provided to the employee for business use; and
- The employer requires the employee to commute in the vehicle for a valid non-compensatory business reasons
- Employer has a written policy prohibiting personal use other than commuting, and
- Employee does not use the vehicle for other than de minimis personal use

If more than one employee commutes in the vehicle, the \$1.50 each-way rule applies to each employee. *Reg. §1.61-21(f)*

**Note:** The employer must *require* the employee to use the vehicle for a *business* purpose; it cannot be voluntary on the employee's part.

**Example:** A transportation employee, who is on call 24 hours a day to respond to road emergencies, is required by his employer to commute in a vehicle outfitted with communications or other equipment the employee would need if called out at night.

## Commuting Rule Not Available for “Control Employee”

Personal use of a vehicle by a "control employee" cannot be valued using the commuting valuation rule (\$1.50 rule). A control employee in a governmental organization is either an:

1. Elected official, or an
2. Employee whose compensation is at least as great as a Federal government employee at Executive Level V (2009 - \$143,500) *Reg. §1.61-21(f)(6) ; EO 12/19/08*

Instead of the above definition of control employee, the employer may treat all employees who are “highly compensated” (Generally, for 2009, those exceeding \$110,000 compensation) as their only control employees. *IR 2008-18; Reg. 1.132-8(f)*

**Example:** An agency in a rural area does not have secure parking and has had a history of vandalism to its vehicles. The employer requires employees using the vehicles for the day on business to take the vehicles home overnight. The trip home and to the office the next day is considered taxable personal commuting. The commuting may be valued at \$1.50 each way since the employee had a valid noncompensatory business reason for commuting in the employer's

vehicle. If this was an unusual situation for the employee, that is, generally occurring no more than once a month, the commuting could be considered a nontaxable de minimis fringe benefit.

**Example:** An agency requires an employee to take home a van to carry displays and equipment to a trade show the next day. In this situation, the commuting could be valued at \$1.50 for the trip from the office to home since the agency is requiring the employee to use a specific vehicle for valid business reasons (assuming the other rules listed above are met). If this was an unusual situation for the employee, that is, generally occurring no more than once a month, the commuting could be considered a nontaxable de minimis fringe benefit.

## Qualified Nonpersonal Use Vehicle

Use of a qualified Nonpersonal use vehicle, including commuting, is excludable to the employee; and recordkeeping and substantiation by the employee are not required by the IRS. *Reg. § 1.274-5T(k); Reg. § 1.132-5(h)*

## Qualified Nonpersonal Use Vehicle

A qualified nonpersonal use vehicle is any vehicle that the employee is not likely to use more than minimally for personal purposes because of its design. Qualified nonpersonal use vehicles generally include all of the following vehicles.

- Clearly marked police and fire vehicles\*
- Unmarked vehicles used by law enforcement officers if the use is officially authorized\*
- Qualified specialized utility repair truck\*
- An ambulance or hearse used for its specific purpose
- Any vehicle designed to carry cargo with a loaded gross vehicle weight over 14,000 pounds
- Delivery trucks with seating for the driver only, or the driver plus a folding jump seat
- A passenger bus with a capacity of at least 20 passengers used for its specific purpose
- Construction or specially designed work vehicles, (i.e., bucket trucks, dump trucks, cement mixers, forklifts, garbage trucks)
- School buses
- Tractors, combines and other special-purpose farm vehicles. *Reg. § 1.274-(k)(2)*

\* These vehicles are discussed in greater detail below.

## Clearly Marked Police, Fire, or Public Safety Officer Vehicles

A clearly marked police, fire, or public safety officer vehicle qualifies only if the following apply:

- Employee must always be on call.
- Employee must be required by the employer to use the vehicle for commuting.
- Employer must prohibit personal use (other than commuting) for travel outside of the officer or firefighter's jurisdiction. *Reg. § 1.274-5T(k)(3); Prop. Reg. 106897-08*

A police, fire, or public safety officer vehicle is clearly marked if, through painted insignia or words, it is readily apparent that the vehicle is a police, fire, or public safety officer vehicle. A marking on a license plate is not a clear marking for this purpose.

### **Unmarked Law Enforcement Vehicles**

Unmarked law enforcement vehicles are qualified nonpersonal use vehicles only if the following apply:

- The employer must officially authorize personal use
- Personal use must be incident to use for law-enforcement purposes; i.e., no vacation use.
- The employer must be a governmental unit responsible for prevention or investigation of crime.

The vehicle must be used by a full-time **law enforcement** officer; i.e. officer authorized to carry firearms, execute warrants, and make arrests. The officer must regularly carry firearms, except when it is not possible to do so because of the requirements of undercover work. *Reg. § 1.274-5T(k)(6)*

### **Qualified Specialized Utility Repair Truck**

The following tests must be met for a specialized utility repair truck to qualify as a qualified nonpersonal use vehicle:

- The truck (not van or pickup) is designed to carry tools, equipment, etc.
- The truck has permanent interior construction, including shelves and racks.
- The employer must require employee to commute for emergency call-outs to restore or maintain power services, i.e., gas, water, sewer. *Reg. § 1.274-5T(k)(5)*

**Vans and pickup trucks** do not qualify as qualified nonpersonal use vehicles unless specifically modified to be unlikely to have more than minimal personal use. For a van or pickup truck with a loaded gross vehicle weight of 14,000 pounds or less, the vehicle must be clearly marked with permanently affixed decals, special painting, or other advertising associated with the trade, business, or function and:

**Vans** must have a seat for the driver only (or the driver and one other person) and either of the following items:

- Permanent shelving that fills most of the cargo area, or

- An open cargo area, and the van always carries merchandise, material, or equipment used in your trade, business, or function. *Rev. Rul. 86-97PLR 200236022*

**Pickup trucks** must meet either of the following requirements:

1. Equipped with **at least one** of the following items:
  - a. A hydraulic lift gate.
  - b. Permanent tanks or drums.
  - c. Permanent side boards or panels that materially raise the level of the sides of the truck bed.
2. Used primarily to transport a particular type of load (other than over the public highways) in a construction, manufacturing, processing, arming, mining, drilling, timbering, or other similar operation for which it was specially designed or significantly modified.

## **Safe Harbor Substantiation Rules**

Employees using employer vehicles are **not** required to keep detailed records of vehicle use if all of the following tests are met:

**For vehicles not used for personal purposes:**

- Vehicle is owned or leased by the employer
- Vehicle is provided to the employee for use in the employer's business
- When not in use, the vehicle is kept on employer's premises (i.e., motor pool cars)
- No employee using the vehicle lives at the employer's business premises
- Employer has a written policy prohibiting personal use, except de minimis use, such as driving to lunch while away from the office
- Employer believes the vehicle is not used for any personal use (other than de minimis) *Reg. §1.132-(5)(e) and (f); Reg. § 1.274-6T(a)(2)*

**For vehicles not used for personal purposes other than commuting (\$1.50 each way), the following conditions must apply:**

- For bona fide noncompensatory reasons, the employer requires the employee to commute to and/or from work in the vehicle
- Vehicle is owned or leased by the employer
- Vehicle is provided to the employee for business use
- Employer requires the employee to commute in the vehicle for valid business reasons
- Employer has a written policy prohibiting personal use other than commuting  
Employee does not use the vehicle for personal use  
*Reg. § 1.274-6T(a)(3)*

## **Written Policy Statements**

Employer must maintain a written policy statement that implements a policy restricting personal use of employer-provided vehicles. The Conference Report to P.L. 99-44, Contemporaneous Recordkeeping Requirements Repeal, states that a resolution of a city council, or a provision of state law, or the state constitution qualifies as a written policy statement for the safe harbor provisions.

## **Employer Monitoring Required**

Although detailed recordkeeping is not required, the employer must have some way to prove that the vehicles are being used in accordance with the rules. For example, internal controls such as requiring employees using motor pools to sign the vehicle out, and signed statements by the employees agreeing to no personal use, or (if applicable) no personal use other than commuting.

**Example:** An employer has a motor pool with vehicles that employees use on a daily basis, returning them at the end of the day. The employer does not have a written policy concerning personal use of the vehicle. The employees using the vehicles are not required to keep a record of use of the vehicles. The employer does not have a written policy in effect and therefore, does not meet the safe harbor substantiation rules. Since the employees do not keep records of use of the vehicles and the employer does not have a written policy prohibiting personal use, the value of the use is considered wages.

**Example:** If the employer maintained a written policy prohibiting personal use of the vehicles and met all the safe harbor conditions of the regulations, none of the value of the use is taxable as a wage to the employees. If safe harbor substantiation rules are in effect, employees are not required to keep records of the use of the qualified vehicles.



## Independent Contractor Expenses

Generally, the treatment of reimbursements paid to independent contractors is similar to that for employees. However, different withholding and reporting requirements apply.

### Reimbursements for Travel, Transportation and Other Out-of-Pocket Expenses

In general, all compensation for services for an independent contractor must be reported on Form 1099-MISC when the amount (excluding reimbursements under an accountable plan) is \$600 or more in a calendar year. The amounts are not subject to income or employment tax withholding.

**Note:** New withholding requirements are scheduled to go into effect in January 2011 on payments made by governmental entities to contractors for goods and services. For more information, see the [FSLG web site](#).

If the individual is considered an independent contractor and does not properly account to the payer for reimbursed expenses, then any advances or reimbursements are to be included on a Form 1099-MISC along with the compensation for their services. *Reg. §1.274-5T(h)(2)*

### Substantiation Requirements

[Publication 463](#) provides information regarding records, substantiation and reporting requirements for independent contractors, such as vendors.

Independent contractors are treated in the same manner as are employees for purposes of working condition fringe benefits. See Working Condition Fringe Benefits, earlier.

## Board and Commission Members

Some of the independent contractor rules and reporting requirements may also apply for board or commission members. Board or commission members may be employees or independent contractors. Officers, employees and elected officials of states and their political subdivisions and instrumentalities are employees for purposes of Federal income tax withholding. But for FICA (social security and Medicare) purposes, the common-law rules apply to determine whether an individual is an employee.

If you are not sure of the status of a board or commission member, it may be necessary to consult the statutes or ordinances establishing a position to determine whether that position is a public office. In the case of school boards, the statutes or ordinances likely provide ample evidence that the school board members are public officials. Public officials are usually subject to a degree of control that is characteristic of an employer-employee relationship. Elected officials should generally be classified as employees while appointed officials may be either employees or

independent contractors. See [Publication 963](#) and ILM 200113024 for a discussion of the issue.  
*ILM 200113024*

## **Worker as Employee or Independent Contractor**

If a worker is an employee, but is working outside of his or her regular employment or job duties with the employer, then for that work the individual could be an independent contractor.

**Example:** An employee of the department of utilities has been awarded a consulting project for another state agency. Assuming that the other state agency has not retained the right to control the contractor in the details and means of completing the project, the worker would be considered an independent contractor for the consulting services and an employee for his position with the department.

**Example:** An independent contractor is hired to perform specific services for a set fee, plus out of pocket expenses. If the contractor provides adequate substantiation for the out-of-pocket expenses, they will not be reported, either as income on Form 1099 or on the contractor's individual income tax return. The contractor is not permitted to deduct the expenses if they are reimbursed by the payer. If the contractor is not reimbursed, adequate substantiation of the expenses should be retained to claim expenses on the contractor's individual income tax return.

## **Misclassification of Workers**

If you classify a worker as an independent contractor and have no reasonable basis for doing so, you may be held liable for employment taxes for that worker. This may be for more than one tax year and could also include the taxes on fringe benefits that should have been provided, i.e., health insurance, deferred compensation, etc. See [Publication 963](#) for more information. *IRC §3509*

## Equipment and Allowances

This section discusses some common situations involving employee use of equipment and supplies, or allowances provided by an employer to pay for them. As with ordinary and necessary business expenses, allowances paid or reimbursed by an employer on behalf of an employee are excludable to the employee, if payments meet the rules of an accountable plan. *IRC §162*

In summary, the accountable plan requirements are:

- Business connection
- Substantiation of amount, date and time, place, and business purpose
- Excess returned within a reasonable time *Reg. §1.62-2(c)(1)Reg. §1.274-5T; Reg. §1.274-5T(b)(2)*

Under the business connection requirement, the expenses must qualify as a business expense to the employer and as a deduction on the employee's Form 1040 as an employee business expense, if the employer did not reimburse the expense.

## Work Clothes and Uniform Allowances and Reimbursements

Clothing or uniforms are excluded from wages of an employee if they are:

- Specifically required as a condition of employment, and
- Are not worn or adaptable to general usage as ordinary clothing.

The accountable plan rules must be met for reimbursements or clothing allowances. *IRC §162; Reg. §1.62-2(c)(1)*

**Note:** If the clothing qualifies as excludable, then the cleaning costs are also excludable.

**Example:** Periodic allowance payments are made to employees for the purchase and maintenance of specific articles of *employer required* uniforms. The allowances are not taxable to the employees provided the uniforms are not adaptable to general usage, and, in fact, are not worn for general usage. In addition, the employees must substantiate the expenses. If the employer does not require substantiation, the allowance is taxable as wages to the employees when paid.

**Example:** An agency is required to reimburse certain employees for shoes under a union contract. The shoes are not safety shoes. If the shoes are not safety shoes and are adaptable for general wear, the reimbursements are included as wages to the employees even if the employer is required to make the payment.

**Example:** A premium per working hour (sometimes called a “tool allowance”) is paid for employees who provide their own tools. Premium pay does not meet the accountable plan rules and, therefore, is additional compensation includible in income and fully taxable as wages. The employees retain ownership and control of their tools and there is no accountability to the employer. The employees are not required to substantiate the cost of each of their tools. The premium is not specifically related to the employees’ expenses. Reimbursements based on the hours worked cannot meet the accountable plan requirements. The employees may be entitled to claim an employee business expense deduction on their personal 1040 tax returns (Form 2106 and Schedule A.)

## Safety Equipment

Safety equipment is excludable from employee wages if the equipment helps the employee to perform his/her job in a safer environment. To be excludable, it is not necessary that the equipment be required by the employer. However, the accountable plan rules must be met for reimbursements for safety equipment. *IRC § 162; Reg. §1.62-2(c)(1)*

Common examples include hardhat, anti-glare screen for computer, safety shoes.

**Example:** Paying employees on an annual basis for part of the cost of safety equipment not required by employer. The payments may be excludable even though the safety equipment is not required by the employer. If the equipment helps the employee perform his/her job in a safer environment, it may qualify as an employee business expense. If the expenses are substantiated, the reimbursement would be excludable to the employee.

## Mileage Allowances

Mileage allowances should be treated under the rules for automobile expense reimbursements discussed earlier.

**Example:** An employer provides an employee with a car or mileage allowance and no substantiation is required. The car allowance is fully taxable as wages to the employee since the business use has not been substantiated. The accountable plan rules have not been met.

## Cell Phones/Electronic Devices

Employers often provide employees with certain electronic and telecommunication equipment for use outside of the employer's premises in the performance of their duties. These items (and other items listed in *IRC § 280F*) are considered "listed property." Because the nature of the property lends itself to personal use, strict substantiation requirements are in place. Employees are required to account for business and personal use. *IRC § 274(d); IRC § 280F(d)(4); IRC § 132(d)*

**Examples:** Cell phones, automobiles, computers, internet provider allowances

**"Listed Property"** *IRC § 280F(d)(4)*

- Business use is excludable from the wages of the employee as a working condition fringe benefit.
- Personal use is included in the wages of the employee.
- If substantiation requirements are not met, all use is included in the wages of the employee.

**Substantiation Requirements**

Records of business and personal use must be kept by the employee in order to determine whether the value of any of the use is included in the employee's wages. *IRC § 274(d)*

**Example:** An employer provides an employee with a cell phone and pays the monthly charges. The employer requires the employee to highlight personal calls on the monthly bill. The employer includes the direct charges for personal use and a pro rata share of monthly fees and services in the wages of the employee. The business use is not taxable to the employee.

**Cell Phone Use**

Because they are considered "listed property," cell phones are subject to the special substantiation rules. Employees are required to keep records of business and personal calls. The value of personal use, any use that is not documented as business use, and reimbursement for *personal* usage should be included as wages to the employee. If records of business and personal use are not kept, the value of all use is included in the wages of the employee.

## Other Types of Compensation

Any compensation for services, including fees, bonuses, commissions, taxable fringe benefits, and similar items are taxable as "wages" or regular pay. All income is taxable unless it is specifically excluded by the Internal Revenue Code. *IRC § 61*

Some types of payments are considered 'supplemental' wages and are subject to specific withholding rules. Supplemental wages are compensation paid in addition to the employee's regular wages.

### Types of Taxable Supplemental Compensation

- Performance bonuses
- Signing, recruiting, or relocation bonus
- Awards for outstanding service or performance
- Back pay
- Severance pay - payments to terminate employment
- Amount paid for administrative leave
- Recognition payments for exceptional work and performance
- Certain legal settlements and/or damages related to employment.
- Grossing up wages to pay for the employee's share of taxes.

*Reg. §1.61-2; Reg. § 1.3401(a)-1(b)(6); RR 86-14*

## Supplemental Wages – Income Tax Withholding Options

Special rules apply to withholding on supplemental wages, including some fringe benefits. Supplemental wages are compensation paid to employees in addition to regular wages, such as bonuses, severance pay, awards, back pay, payments for non-deductible moving expenses, etc. *Reg. §31.3402(g)-1*

In general, there are two methods of withholding on supplemental wages:

**Optional** – Apply flat rate withholding (currently 25%) to the supplemental wages. There are two requirements to use the optional method:

- The employer must have withheld income tax from regular wages paid to the employee during the same or previous year, and
- The supplemental wages must be either (a) not paid concurrently with regular wages, or (b) separately stated on the payroll records of the employer.

**Aggregate** – Include the supplemental wages with the regular wages for the pay period, and

withhold according to the tables used for regular wages. If the supplemental wages are paid concurrently with regular pay, they must be aggregated with the regular pay for that payroll period.

**Note:** Special rules apply to employees whose supplemental wages exceed \$1 million for the year. Payments that exceed \$1 million and the part of any payment that brings the total over \$1 million must be withheld on at the highest rate of tax for that year (currently 35%).

## **Employee Tax Paid by Employer**

If an employer pays the employee's share of payroll taxes without deducting it from the employee's pay, the tax paid on behalf of the employee generates additional income to the employee. The tax on the additional income leads to a "pyramiding" effect of tax liability. See [Publication 15-A](#) for information on calculating wages in this "gross-up" situation. (This procedure does not apply to FICA taxes for household and agricultural workers.) *Rev. Rul. 86-14*

## Awards and Prizes

Generally, the value of an award or prize given by an employer is taxable to an employee as a wage, included on the Form W-2, and subject to Federal income tax withholding, social security and Medicare. *IRC 74; IRC 3121(a)(20)*

If the employer pays the employee's share of taxes on an award, these amounts are additional wages to the employee (except for agricultural and domestic services) and are subject to all payroll taxes, as discussed above.

### Nontaxable Awards

There are three types of noncash awards that may be excluded from income. Each category has specific requirements that have to be met in order to be excludable. These categories are:

- Certain prizes or awards transferred to charities
- De minimis awards and prizes
- Certain employee achievement awards

Any other awards, such as recognition rewards (unless qualifying de minimis fringe benefits), are taxable. A worksheet to compute the taxability of an award to an employee is provided in [Publication 535](#), Business Expenses.

The three categories are discussed in detail below.

### Nontaxable Prizes or Awards Given to Charities

Certain prizes and awards given for charitable, scientific, artistic or educational achievement are not taxable to the recipient if transferred to a charitable organization. *IRC §74(b)*

**Examples:** Nobel Peace Prize and Pulitzer Prize for Journalism

### Requirements for Exclusion

- Award is for achievement
- Recipient is selected without entering any contest
- No substantial future services are required
- Recipient transfers the award to a charitable (IRC §170(c)) organization prior to receiving the benefit



**Example:** A college instructor is chosen as teacher of the year by a national education association. He is awarded \$1,000, which he directs the education association to transfer to a college scholarship fund at the institution where he teaches before accepting it. The award is not taxable to the college instructor.

## Nontaxable De Minimis Awards and Prizes

A prize or award that is not cash or cash equivalent, of *nominal value* and is provided *infrequently* is excludable from an employee's wages. Prizes or awards that are given frequently to an employee do not qualify as an excludable de minimis award, even if each award is small in value. *IRC §132(e)*

### Examples of Excludable De Minimis Awards

- Nominal gifts for birthdays, holidays
- Holiday turkey and hams
- Flowers, plaques, coffee mugs for special occasions
- Gold watch on retirement
- Parking for employee of the month, if value is less than QTFB limit

**Nominal** for this purpose means small in value, relative to the value of total compensation. There is no set dollar amount in the law for nominal prizes or awards. A \$25 limit is imposed on business gifts. The IRS has given advice at least once that a benefit of \$100 did not qualify as de minimis. *ILM 200108042*

**Cash equivalent** means readily convertible to cash, such as a savings bond or gift certificate.

**Example:** An employer provides dinner at an annual awards banquet for employees. The regulations specifically mention that occasional group meals are considered nontaxable fringe benefits. *Reg. §1.132-6(e)(1)*

## Cliff Provision

If an employer provides an award that exceeds either the value or frequency limitations for de minimis fringes, the entire award is included in the employee's wages, not just the portion that exceeds the de minimis limits. *Reg. §1.132-6(d)(4)*

## Employee Achievement Awards

An employee achievement award is an item of tangible personal property for **length-of-service or safety**. (Cash awards are always taxable.) In order to be excludable from wages, special requirements and dollar limitations must be met. A qualifying award:

- Must be a given for length-of-service or safety
- Cannot be a disguised wage
- Must be awarded as part of a meaningful presentation
- Must be an item of tangible personal property (Cannot be cash, cash equivalent, vacations, meals, lodging, theater or sports tickets, stocks, bonds.)
- Must meet other special requirements and limitations, discussed below. *Reg. §1.274-8(c)*

**Note:** Taxable if cash or cash equivalent, or if over certain dollar limits

### Length-of-Service Awards

An award will not qualify as a length-of-service award if either of the following applies.

- The employee received the award during his or her first 5 years of employment.
- The employee received another length-of-service award (other than one of very small value) during the same year or in any of the prior 4 years.

**Note:** A traditional retirement award is an exception to the 5-year rule. *Reg. §1.274-8(d)(2)*

### Safety Achievement Awards

An award will not qualify as a safety achievement award if either of the following applies.

1. It is given to a manager, administrator, clerical employee, or other professional employee.
2. During the tax year, more than 10% of the employees, excluding those listed in (1), have already received a safety achievement award (other than one of very small value). Eligible employees must have worked full-time for a minimum of one year prior to the award. *Reg. § 1.274-8(d)(3)*

**Example:** If an agency has 50 eligible employees and 6 receive safety awards, the 6<sup>th</sup> award is taxable because 10% of the eligible employees have already received it.

## Qualified Plan Award

An award is a qualified plan award if it is:

- Made under an established written plan, and
- Does not discriminate in favor of highly paid employees, and if
- The **average cost** of **all** employee achievement awards (both qualified and nonqualified awards for length of service and safety) made by the employer during a single year does not exceed \$400. Awards of \$50 or less are not included in computing the average.  
*Reg. § 1.274-8(c)(5); IRC §414(q)(1); Reg. §1.274-8(c)(5)*

Generally, if an award is taxable to an employee, it is valued at the fair market value (FMV). The taxable amount of an award to an employee depends on whether the award is made under a qualified or nonqualified plan, whether the cost of the award to the employer exceeds the dollar limitations, and the FMV of the award. *IRC § 274(j)(2)*

**Example:** In 2009, an agency presents employee length of service awards to 6 employees for a total cost to the employer of \$1,800. The average cost of all awards is \$300 (\$1,800/6). Since the average cost of all awards does not exceed \$400, the awards are considered qualified plan awards provided there is a written plan that does not discriminate in favor of highly paid employees.

## Nonqualified Plan Awards

A nonqualified plan award is one **not** made under a qualified plan. Nonqualified awards can discriminate in favor of highly paid employees. *Reg. §1.274-8(c)(5)(ii)*

Regardless of the cost of an award or its FMV, the following awards are taxable as wages to an employee:

- Cash or cash equivalent awards, such as savings bonds or general merchandise gift certificates.
- Recognition awards, cash or non-cash, for job performance unless they are qualifying de minimis fringe benefits
- Awards for outstanding customer service, employee of the month, highest productivity
- Achievement awards, cash or non-cash, that do not meet the requirements for excludable treatment
- Awards for length of service or safety achievement that do not meet certain specific requirements and limitations.
- Non-cash prizes (unless de minimis) won by employees from random drawings at employer sponsored events. *Reg. §1.274-2(c)(4)*

## Dollar Limitation

The maximum amount of excludable awards to a single employee during a calendar year is limited to:

- \$400 for awards made under a nonqualified plan, or
- \$1600 in total for awards made under both qualified and nonqualified plans

**Example:** An employer only makes awards to employees that are non-cash qualifying length-of-service or safety awards. In order to avoid the extensive recordkeeping and tracking required for determining the taxability of awards, the employer has a policy of not making awards that exceed \$400 per employee annually. In this situation, none of the awards would be taxable to the employees.

**Example:** An employee receives two employee achievement awards during the year. The cost and FMV of the awards were the same.

	Cost and FMV
Nonqualified plan award of a watch	\$ 400
Qualified plan award of a stereo	<u>1,350</u>
Total awards	\$1,750
Less: Annual limitation	<u>(1,600)</u>
Taxable portion of awards	<u>\$ 150</u>

### Cost Exceeds Dollar Limitations - Excess Deduction Award

Generally, if an award is taxable to an employee, it is valued at the fair market value (FMV). If the cost to an employer for an award exceeds the plan dollar limitations, either \$400 (non-qualified plan) or \$1,600 (qualified plan), then the amount included in wages is the *greater* of:

1. The part of the employer's cost that is more than the plan dollar limitation (but not more than the FMV), or
2. The amount by which the FMV exceeds the amount of the plan dollar limitation. *Reg. §1.74-2(b)*

### Example 1: Excess Deduction Award

An employer pays \$520 for golf clubs given to an employee as a nonqualified plan employee achievement award. The fair market value of the award (golf clubs) at the time it is given to the employee is \$750.

	<u>Cost</u>	<u>FMV</u>
Award	\$520	\$750
Less: Limitation	<u>400</u>	<u>400</u>

Excess over limitation	<u>\$120</u>	<u>\$350</u>
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The employee is taxed on \$350, the greater of the cost less the limitation or the FMV less the limitation. If the award had been a qualified plan award, the employee would not have been taxed on any of the value of the award.

### **Example 2: Excess Deduction Award**

An employer pays \$395 for golf clubs given to an employee as a nonqualified plan employee achievement award. The fair market value of the clubs at the time the award is given to the employee is \$450.

	<u>Cost</u>	<u>FMV</u>
Award	\$395	\$450
less: Limitation	<u>400</u>	<u>400</u>
Excess over limitation	<u>\$ 0</u>	<u>\$ 50</u>

Since the employer's cost of the award does not exceed the \$400 limitation for nonqualified awards, the employee is not taxed on the value of the award. *Reg.. §1.74-2(b)*

### **Awards Funded by Third Party**

If funds for awards or prizes are provided by an outside party, the award is taxable in the same way as if provided directly by the employer. If the funds are turned over to the employer to select and distribute the awards, the employer is responsible for all applicable payroll taxes and withholding. *IRC §3402(d)*

**Example:** A bank provides funds to a state agency to support a special performance award program. The agency chooses the recipients and distributes the awards. The value of the awards are additional compensation to these employees and reportable on their Forms W-2, subject to payroll taxes and withholding. This answer would be the same even if the outside party were a nonprofit organization or an educational foundation.

In the case where the outside party selects and distributes the award directly to an agency employee without any direction or decision making from agency personnel, then the award is income to the recipient and must be reported. The outside party would be required to furnish a Form 1099-MISC to the recipient if the amount is \$600 or more in a calendar year.

**Example:** A television set, donated by a business to a state agency, is awarded through a random drawing to an employee. The fair market value of the television would be considered taxable wages to the employee. Prizes in a random drawing of employees are considered wages. A television set is not considered a de minimis benefit.

If an agency pays the taxes on an award, the tax paid on behalf of the employee is taxable under the “grossing up” procedure discussed earlier. The additional payment for the taxes is a taxable item and must be included on the employee’s Form W-2 in the year the payment was made. See section 7 of Publication 15-A, Rev. Proc. 81-48 and Rev. Rul. 86-14.

**Example:** Special duck prints donated by artists are given away as awards to employees. For purposes of determining the taxable value, the FMV can be determined by an appraisal, by establishing the sales price of similar prints by the artist, or by any other reasonable method. The taxability of the value of the prints to the employees depends on the type of award, dollar limitations and other specific requirements.

## Professional Licenses and Dues

An employer may reimburse employees for the cost of their professional licenses and professional organization dues. If these amounts are directly related to the employee's job they may be excludable from income.

Once an employee has completed the education or experience required for a professional license, the expenses necessary to maintain a license or status are considered ordinary and necessary business expenses. If the employer pays these expenses (under an accountable plan), and the professional license is related to the position the employee holds with the employer, the value of the benefit is not taxable to the employee.

If paid by **an individual**, the fees are deductible as a business expense on the individual's Federal income tax return. *IRC §162 Reg. §1.62-1T(e)*

If paid or reimbursed by **an employer for an employee**, the fees are a working condition fringe benefit. If paid under an **accountable plan**, they are excludable from the income of the employee. If paid under a **nonaccountable plan**, they are included in the income of the employee and is subject to Federal income tax, social security, and Medicare taxes.

*IRC § 132(d); Reg. §1.132-5(a)(1)(v); IRC §62(a)(2)(A); Reg. §1.62-2(c)(2); IRC § 62(c)(1)&(2); Reg. §1.62-2(c)(3)*

**Example:** An employer pays the professional dues for an employee who is a financial officer to a national association of finance officers. If the accountable plan rules are met, this is an excludable reimbursement to the employee.

**Example.** A state agency requires an employee to be a notary. The employee submits the paid receipt to the agency and the agency reimburses the employee for the annual fee to maintain this professional license. The reimbursement is not taxable to the employee because it is an ordinary and necessary business expense per IRC Section 162 and paid by the employer under an accountable plan.

**Example.** A state agency pays the annual CPA license fee for the chief game warden each year. The warden does not use his CPA expertise on the job for the agency. Because the game warden does not use his CPA expertise in his capacity as game warden with this state agency, the reimbursement to the game warden is a taxable reimbursement to him and is subject to Federal income and employment taxes.

## Business and Professional Organizations

Clubs organized for business purposes only, such as business leagues, professional organizations, and trade associations, are not considered entertainment or recreational organizations. If related to the employer's business, payment or reimbursement of dues is excludable to the employee when the employee is performing duties for the employer that are related to the professional organization's focus or mission. Examples of these organizations include bar and accounting associations; AICPA, state association of CPAs,

school business officers, or public service organizations, i.e., Kiwanis and Rotary Clubs  
*Reg. §1.274-2(a)(2)(iii)(b); Reg. §1.274-2(b)-2*

### **Entertainment and Recreational Organizations**

Club dues and memberships are not allowed as business deductions. If an employer provides these benefits to an employee, they are taxable to the employee and subject to withholding for income tax, social security and Medicare.

The payment of club dues by the employer is a taxable fringe benefit. No business deduction is allowed for club dues. If an employer pays or reimburses an employee for club dues, the amount is taxable to the employee and subject to income tax withholding, social security and Medicare taxes. *IRC §274(a)(3)*



## Volunteers

Volunteers perform significant services for many governmental entities. The entities may provide the volunteers with various reimbursements, stipends, or other payments. The use of the term “volunteer” generally has no significance in applying the tax law; the general rules apply to any compensation received. However, reimbursements made under the accountable plan rules for employees, discussed earlier, are excludable from income. In addition, volunteers may be able to deduct business-related expenses against compensation they receive.

As with employees generally, the treatment of the payments for Federal payroll purposes depends on whether the volunteer is an employee or non-employee and the form of payment. The same tests that are used for other workers apply to workers who are considered volunteers. The discussion below illustrates how the common-law rules may apply to volunteers.

### Right To Control

A volunteer is an employee under common law if an entity has the right to direct and control the volunteer's performance, not only as to the results to be accomplished, but also as to the methods by which the results are accomplished. It is the *right* to control, even if the entity does not exercise the right, that is important. Many factors in an employment relationship have to be considered before a decision can be made as to whether the entity has the right to direct and control.

If an entity does not retain the right to direct and control the details and means of performing the work, the volunteer worker is not an employee.

### Evidence of the Right To Control

In determining whether an entity retains the right to control a worker, the IRS generally looks at facts that fall into three main categories of evidence: behavioral control; financial control; and relationship of the parties. The facts considered in these categories include whether the agency provides training or instructions, whether the worker can earn a profit or incur a loss, whether benefits are provided and other factors. Not every evidential factor applies in every situation and the degree of importance varies depending on circumstances.

**Example:** An agency is required to build a watershed in a state forest. Volunteers who are experienced in forestry work have offered their services. The agency asks the volunteers to build the watershed in accordance with environmental laws to the best of their abilities and experience. The agency does not provide other instructions or supervision.

**Example:** The circumstances are the same as above, except that an agency employee oversees the project. The agency gives instructions, provides the tools and materials, and sets the hours of operation. In this case, the volunteers are common-law employees.

### **Volunteer Firefighters**

Generally, “volunteer” firefighters are employees of the fire department or district for which they perform services. The usual common-law tests apply to determine their employment status. For example, the relationship between the firefighter and the fire department will generally indicate that the department provides training and direction in how the work will be performed and provides the equipment to perform the work.

Many jurisdictions provide some kind of compensation to volunteer firefighters, or emergency responders, other than payments designated as wages. For instance, volunteer firefighters in some cases receive no amounts designated as salaries, but receive amounts intended to reimburse them for expenses. They may also receive other cash or in-kind benefits, including reductions in property or other local taxes that may be includible in gross income for Federal tax purposes. They may receive no regular payment, but receive a certain amount of reimbursement per call. None of these payments are automatically excluded from income. Volunteer firefighters who are employees can receive tax-free reimbursements for their expenses provided the accountable plan rules are met; any reimbursements that are provided without an accountable plan are includible in income (but see the special exclusion, discussed next).

### **Exclusion for Members of Volunteer Emergency Response Organizations**

In general, any benefit, including a property tax reduction, made because of services performed by a common-law employee, is treated in the same way as payments to any other government employees. However, legislation enacted late in 2007 created two exclusions from income for members of “qualified volunteer emergency response organizations”:

- Any reduction or rebate of tax imposed by a state or local government can be excluded from gross income.
- Payments of up to \$30 for each month of service made on account of service by such volunteers can be excluded from income.

The amounts excludable from gross income are also excluded from social security and Medicare taxes for employees. For individuals considered self-employed, the amounts excludable are also excluded from self-employment tax.

The excludable amount is determined after any reimbursements that are excludable under the accountable plan rules have been considered. These exclusions are available for years after 2007 and before 2011. For more information, see [www.irs.gov](http://www.irs.gov). PL 110-142

### **Payments under Domestic Volunteer Service Act (Title II and III)**

Payments for supportive services or reimbursements of out-of-pocket expenses of volunteers under Title II and III of the Domestic Volunteer Service Act are not wages or compensation and no withholding or reporting is required by the payer. *Rev.Rul. 74-322*

### **Liability Insurance for Volunteers**

Liability insurance provided for volunteers by an entity qualifies as a tax-free working condition fringe benefit. *Reg. 1.132-5(r)(3)*

Programs under Title II and III include:

- Retired Senior Volunteer Program (RSVP),
- Foster Grandparent program and other older volunteer programs,
- Service Corps of Retired Executives (SCORE),
- Active Corps of Executives (ACE)

### **Reporting Payments to Volunteers**

If a volunteer meets the definition of an employee, the reporting rules are the same as for other employees. Therefore:

- Stipends and other payments for services are wages.
- Reimbursements paid under an accountable plan are not taxable and not reportable.
- Reimbursements **not** paid under an accountable plan are taxable and reportable on Form W-2 as wages subject to withholding.
- Wages in the form of stipends, taxable reimbursements, or other payments are subject to withholding and reportable on Form W-2, unless the wages are not normally subject to social security or Medicare taxes under Section 218 of the Social Security Act.

If the volunteer does not meet the definition of an employee, no reporting is necessary if the only payments are reimbursements for substantiated expenses. However, if the reimbursements are greater than the expenses, the excess is gross income (unless some other exclusion applies, such as the special exclusion for members of emergency response organizations, discussed above), and is reportable on Form 1099-MISC. *Rev. Rul. 80-99; Rev. Rul. 67-30*

## Educational Reimbursements and Allowances

An employer may pay, or reimburse an employee for, educational expenses. Whether or not the cost or value of the course is excludable from wages to the employee depends on several factors. There are three sections of the Internal Revenue Code (IRC) that permit the payments or reimbursements to be excludable from wages under certain circumstances:

### For all employers:

IRC 132(d) - (Working Condition Fringe) - Educational reimbursements  
IRC 127 - Qualified Educational Assistance Program

### For certain other employers:

IRC 117 – Qualified Scholarships  
IRC 117(d) – Qualified Tuition Reductions

An educational payment that is not exempt from tax under one Code section may be exempt under a different Code section. Excludable treatment of an educational benefit under IRC §132(d) (working condition fringe benefit) applies only if benefits under any other Code sections do not apply. A chart at the end of this chapter will help in determining whether specific payments or reimbursements for education expenses are excludable.

This section summarizes the various education provisions. For more information, see [Publication 970](#), Tax Benefits for Education.

## Working Condition Fringe Benefit – Educational Reimbursements

**Job-related** educational expenses are excluded from an employee's income as a "working condition" fringe benefit. This is an excludable benefit of property or service provided by an employer to an employee that, if the employee had paid for it, could have been deducted by him or her as an unreimbursed employee business expense on Form 1040. The exclusion is generally available for any form of educational instruction or training that improves or develops the job-related capabilities of an employee. *IRC §132(d); Reg. § 1.162-5*

For governmental employers, benefits are applicable to current employees or independent contractors.

For educational reimbursement to qualify as a working condition fringe benefit, the education must be job-related. It is not required to have a written plan or dollar limitations, and the employer may discriminate in favor of highly-compensated employees.  
*IRC §132(d); Reg. §1.132-1(f)(1)*

## **Job-Related**

Educational course must be job-related, and either (a) maintain or improve job skills, or (b) be expressly required by the employer or by law.

Examples of qualifying (excludable) courses include a masters degree required to be obtained in five years or employee is fired; or salary is lower without a masters degree. *IRC §132(d); Reg. §1.162-5(a)(1)*

### **Educational course must not:**

- Be needed to meet the minimum educational requirements of the current job, or
- Qualify the employee for a new trade or business. *Reg. §1.162-5(b)(2); Reg. §1.162-5(b)(3)*

## **Substantiation Requirements for Cash Payments to Employees**

If an employee receives cash, the employer must require the employee to:

- Use the amount for payment of education expenses that qualify as a working condition fringe benefit,
- Verify that the payment was actually used for such expenses, and
- Return to the employer any unused portion of the payment. *Reg. §1.132-5(a)(v)*

## **"Employee" for Purposes of Working Condition Fringe Benefits Only**

- Current employees
- Independent Contractors
- Directors and Partners
- Volunteers *Reg §1.132-5(r) Reg §1.132-1(b)*

## **Qualifying Educational Expenses**

- Tuition, books, supplies, equipment *Reg. §1.162-6*
- Certain travel and transportation costs *Reg. §1.162-5(d)*
- Graduate or undergraduate level courses *Reg. §1.162-5(a)*

## **Courses Qualifying Employee for New Trade or Business**

Generally, education courses that qualify an employee for a new position or specialty within his/her existing trade or business are not considered as qualifying an employee for a new trade or business. Examples of excludable courses that qualify employees for a new position rather than a new trade or business include:

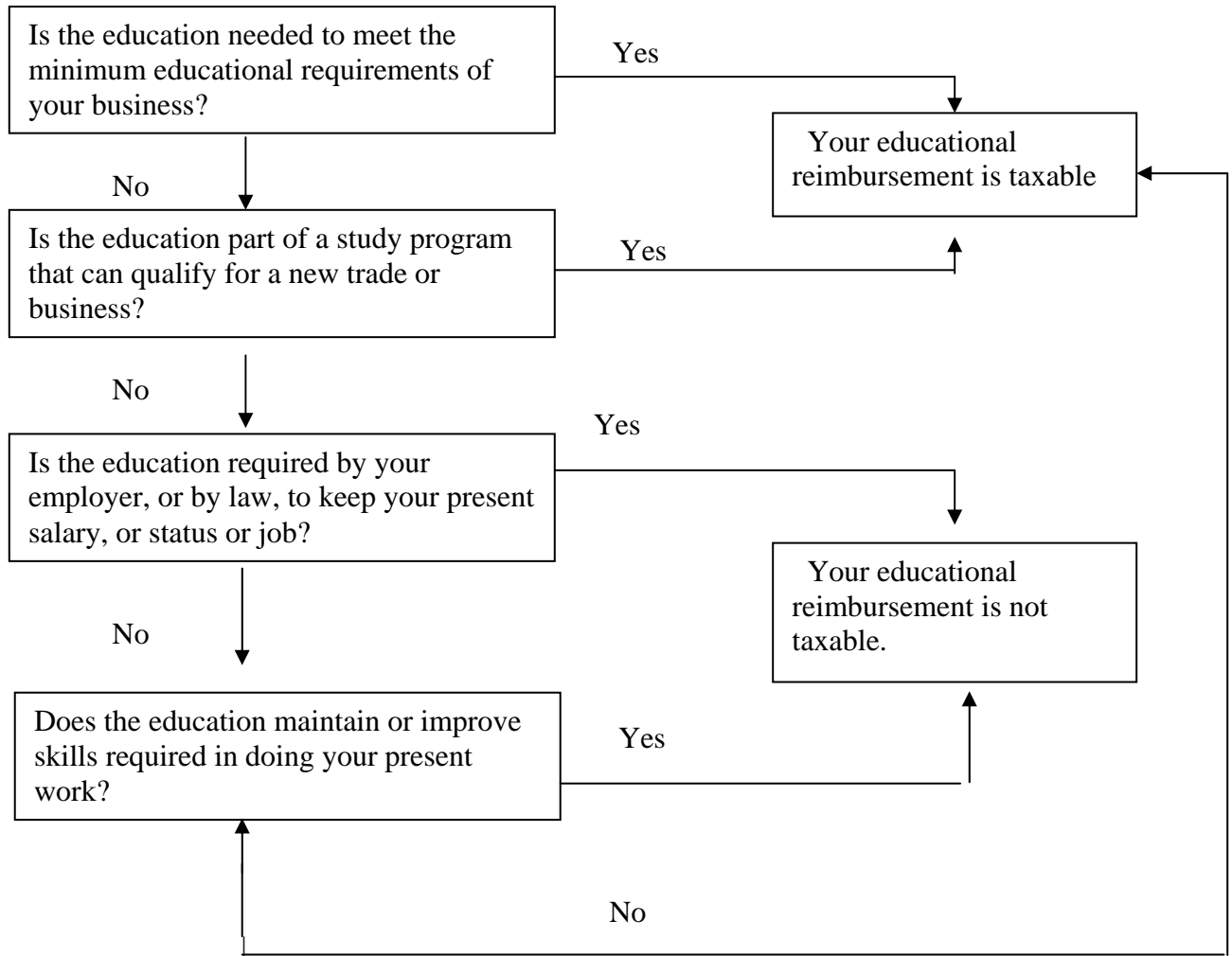
- Elementary school teacher to principal
- Elementary school teacher to physics teacher

- Doctor developing new specialty  
*Reg. § 1.162-5(b)(3)*

Often, courses needed for acquiring a license or certificate, are considered taxable courses leading to a new trade or business. Examples include:

- Accountant to CPA
- CPA to lawyer
- Mechanic to engineer

### Working Condition Educational Fringe Benefit -General Guide



**Example 1:** Veronica is a computer processor at a state agency. The agency pays for her to take a graduate computer course at STU University to enhance her current job skills. The class is excludable as a working condition fringe benefit because it is job-related and maintains or improves Veronica's skills, and it does not prepare her for a new trade or business.

**Example 2:** Due to a teacher shortage, Doug, who has 80 hours of college credits, is given a position as a teacher although the job requirements are for 120 hours of credits. Doug is reimbursed by his employer to complete the 40 credits at night school while he is teaching. The reimbursement is not excludable as a working condition fringe benefit because, the reimbursement for earning the 40 credit hours is taxable to Doug since the courses are needed to meet the minimum requirements of his present job. (This amount may be excludable under another Code sections, i.e., section 127. See the next section.)

**Example 3.** Peter, a fiscal technician hired into an Accountant I position, does not have all of the accounting credits he needs for the job. He signs up and takes all of the courses required for the position. The courses will improve his job performance, but the primary purpose of taking them is to acquire the minimum requirements for the position. The reimbursement for Peter's classes is not excludable under IRC Section 132(d) because the education is needed to meet the minimum educational requirements of his position. (This may be excludable under one of the other Code sections, i.e. Section 127. See the next section.)

## Qualified Educational Assistance Plans

Amounts paid or expenses incurred by an employer for educational assistance for an employee are excludable from the wages of the employee, if certain requirements are met. Education may be for undergraduate or graduate level courses. The education is not required to be job-related. *IRC §127*

**The following requirements apply for a qualified educational assistance plan:**

- Employer must have a written plan *Notice 97-60*
- A dollar limitation of \$5,250 per calendar year for all employers combined *IRC §127(a)(2)*
- The plan must not discriminate in favor of highly compensated employees (for 2009, earning \$110,000 or more) *IRC §127(b)(2); IR 2008-118*

## Eligible Employees

These include current and/or laid off employees, employees retired or on disability, and certain self-employed individuals. Spouses or dependents of employees are not eligible. *Reg. §1.127-2(h)*

## Educational Expenses

**Covers:** Tuition, books, supplies, equipment necessary for class

**Does not cover:** Tools or supplies which employee may keep after the course is completed; education involving sports, games, hobbies unless job-related meals, lodging, or transportation *IRC §127(c)(1)*

**Example 1.** Karen is a secretary at a state agency. She wishes to take an undergraduate psychology class at MNO Community College. The state agency has a written educational assistance plan. The state agency pays \$250 for the tuition to the community college for the course. Karen has no taxable income because the requirements for an educational assistance plan have been met under IRC 127.



**Example 2.** Joe, a janitor at a state agency, wants to take a math class leading towards his bachelor degree. The state agency has a qualified educational assistance plan and reimburses Joe \$300 for the course after he verifies the cost. Joe does not have taxable wages from this reimbursement. The fact that he is taking a course leading toward an undergraduate degree is not relevant for qualified educational assistance programs under IRC 127.

**Example 3.** Tom is a recreation specialist for the Division of Parks and Recreation. His employer pays for him to take courses toward a license as a soccer referee. If the employer has a qualified plan, Tom does not have taxable income even though the courses he is taking are sports-related. The courses have a reasonable relationship to the business of the employer and this provides an exception to the rule that sports, games and hobby classes are not permitted under educational assistance programs.

## Qualified Tuition Reduction

Free or reduced tuition for employees of educational institutions may be excludable to employees. The term “qualified tuition reduction” means a tax-free reduction in tuition provided by an eligible educational institution. Whether a tuition reduction is a qualified tuition reduction, and therefore excludable from income, depends on whether it is for education below or at the graduate level. The qualified tuition reduction must not represent payment for services.

The exclusion under section 117 is available in addition to tuition reductions that may qualify under sections 127 or 132. *IRC §117(d)(1)*

### Requirements for Tuition Reduction To Be Excludable (Nontaxable):

- Must be for employee of educational institution
- The employee must be involved in educational function
- Benefit must be available to employees on a non-discriminatory basis
- Generally, education must be below graduate level

**Note:** If employee is a graduate student performing teaching or research activities for the educational institution, he/she may take excludable graduate courses. The courses must be taken at the school where the employee is working. *IRC §117(d); §170(b)(1)(A)(ii)*

### For purposes of a Qualified Tuition Reduction, an employee may be a:

- Current employee or spouse
- Former employee retired or left on disability
- Spouse, widow or widower of deceased employee
- Spouse, widow or widower of employee retired or left on disability

- Dependent child of employee
- Child of employee, under age 25, with both parents deceased *IRC § 117(d)(2)(A)*  
*IRC § 132(h)*

**An “educational organization” for this purpose must:**

- Maintain a faculty and curriculum, and
- Normally have a regularly enrolled student body on site. *IRC§170(b)(1)(A)(ii)*

**Nondiscrimination Restriction:**

Generally, a qualified tuition reduction cannot discriminate in favor of highly-compensated employees (for 2009, employees with total compensation exceeding \$110,000 *IRC §414(q)(1)(B)(i); Reg. §1.132-8(f); IR-2008-118*

**Qualified Tuition Reductions and IRC 132:**

If the tax treatment of an educational expense is expressly provided for in a specific Code section, then it is not covered by IRC 132 (except for 132(e)-de minimis fringe benefits). Because section 117(d) applies specifically to tuition reductions, the exclusions under section 132, such as no-additional-cost benefits, or working condition fringe benefits do not apply to *free or discounted tuition* provided to employees of an educational institution. *Reg. §1.132-1(f)(1)*

If the amounts *paid* by the employer for education relating to the employee’s trade or business as an employee of the employer (in other words, there is no tuition reduction or free classes) is such that, if the employee had paid for the education, the amount paid could be deducted on Form 1040, the costs of the education may be eligible for exclusion as a working condition fringe under 132. *FSA 200231016*

**Example 1.** Carl works for ABC Community College, a division of the State University, as a physics teacher. His two children attend the State University undergraduate program at a reduced tuition. This situation meets the requirements for qualified tuition reduction and does not result in any taxable income for Carl.

**Example 2.** Same facts as in the above example, but in addition to reduced tuition, Carl’s children are receiving free room and board. The tuition reduction remains excludable but the value of the free room and board will be taxed as wages for Carl.

**Education Below the Graduate Level**

Qualified tuition reductions for education below the graduate level (including primary and secondary school) are tax free if provided to the following individuals who are treated as employees.

1. A current employee of the eligible educational institution
2. A former employee who retired or left on disability
3. A widow or widower of an individual who died while an employee
4. A widow or widower of a former employee who retired or left on disability
5. A dependent child or spouse of any person listed in (1) through (4), above *IRC 117*

### **Officers, Owners, and Highly Compensated Employees**

Qualified tuition reductions apply to officers, owners, or highly compensated employees only if benefits are available to employees on a nondiscriminatory basis. This means that the tuition reduction benefits must be available on substantially the same basis to each member of a group of employees. The group must be defined under a reasonable classification set up by the employer. The classification must not discriminate in favor of owners, officers, or highly compensated employees.

### **Graduate Education**

Tuition reductions for graduate education are considered “qualified” and are tax free if they are provided by an eligible educational institution to a graduate student who performs teaching or research activities for that institution. All other tuition reductions for graduate education are taxable.

### **Tuition Waiver for State Employees**

Certain state laws permit state colleges and universities to waive all or a portion of tuition, services and activities fees for state employees employed half-time or more in the following classifications for permanent employees:

- Classified and exempt paraprofessional employees of technical colleges,
- Faculty, counselors, librarians, and exempt professional and administrative employees at institutions of higher education. *IRC §117(d), 127, and 132(d)*

If the waiver or reduction does not meet the requirements for a qualified tuition waiver, it may still qualify for an exclusion as an educational assistance plan or as a working condition fringe benefit, discussed earlier.

## Scholarships and Fellowships

Individuals pursuing a course of study or research often receive awards or funds to pay for their educational costs in the form of scholarships, fellowships, stipends, or grants. Regardless of the name given the fund or award, the taxability depends on whether the provisions of IRC § 117 are met.

**The amount is excludable if it is a "qualified" scholarship, and the recipient is a candidate for degree at a qualified educational organization** *IRC §117(a)*

**The amount is taxable if it represents:**

- Payment is for past, present or future services, OR
- Payments fund study or research primarily for benefit of the grantor.

For the scholarship to be nontaxable, no services can be required of the student in order to receive the scholarship or grant either presently or in the future.

### Definitions

#### Qualified Scholarship or Fellowship

Scholarship or fellowship to the extent the amounts are used for qualified tuition and related expenses This includes fees, books, supplies, and equipment required for a class. Does not include travel, meals or lodging. *IRC §117(b)*

#### Educational Institution

- Organization exists for an educational purpose, and maintains a regular faculty and curriculum, and
- Has a regularly enrolled body of students on site. *IRC §170(b)(1)(A)(ii)*

#### Candidate for Degree

A candidate for degree is a:

- Primary or secondary school student, or
- Undergraduate or graduate student pursuing studies or conducting research toward a degree at a college or university
- Non-degree candidate, if a full- or part-time student at an accredited educational institution *Reg. §1.117-6(b)(4)*

**Example 1:** Jeff, a professor of anthropology, is awarded a fellowship by the college which allows him to devote 100% of his time to a research project of his own choice. The fellowship is designed to award faculty for present or past services. The fellowship is taxable wages to Jeff.

**Example 2:** Tracy is granted a stipend by the city of Riverdale to attend a paramedic training program. She is required to accept employment with the grantor at the conclusion of the training. The stipend is taxable wages to Tracy.

**Example 3:** Mona is an advanced medical degree candidate at a university. She receives a fellowship grant of \$2,000 per month for performing surgery in a residency program at the university's hospital and a one-time payment of \$3,000 for independent research. The \$3,000 for research is excludable from income. The \$2,000 per month grant to perform surgery represents payment for services and is taxable as wages.

## Comparison of Code Sections Covering Educational Assistance

The following table is for quick reference. For full information, see the text, Internal Revenue Code sections or [Publication 570](#).

Feature	§127 Qualified Educational Assistance	§132(d) Working Condition Fringe	§117(d) Qualified Tuition Reimbursement
Written Plan Required	Yes	No	No
Undergraduate Courses Covered	Yes	Yes	Yes
Graduate Courses Covered	Yes	Yes	No*
Must Be Job Related	No	Yes	No
Courses Qualifying Employee for New Trade or Business Covered	Yes	No	Yes
Courses Needed to Meet Minimum Job Requirements Covered	Yes	No	Yes
Can Discriminate in Favor of Highly Compensated Employees	No	Yes	No
Dollar Limitation	Yes-\$5,250	No	No
Expiration date	None	None	None
<b>Employee Includes:</b>			
Current Employees	Yes	Yes	Yes
Family Members	No	No	Yes
Laid-Off Employees	Yes	No	No
Employees Retired or on Disability	Yes	No	Yes
Independent Contractors	No	Yes	No
<b>Educational Expenses Covered:</b>			
Tuition, Books, Supplies, Equipment	Yes	Yes	Tuition Only
Tools or Supplies, for class use only	No	No	No
Education Involving Sports, Games, Hobbies	No**	No**	Yes
Meals, Lodging or Transportation	No	Yes	No

\* See text for exceptions

\*\* Yes, if specifically job related

**Note:** These are general rules. For details, refer to the text and Publication 970.



In many circumstances, citizens make contributions of money or property to governmental entities. An income tax deduction for this contribution is allowed for the individual only if the contribution is made to, or for the use of, a qualified organization. A state or local government agency is a qualified organization; it is exempt from income tax by statute (IRC Section 115) and is considered an exempt organization for purposes of receiving donations or grants under IRC Section 170(c)(1). *Reg. §1.170A-9(d)*

A contribution is fully deductible only if made to or for the use of a qualified organization, and is voluntary and is made without getting or expecting to get anything of tangible value. If anything of tangible value is received in return, its value must be subtracted from the amount deductible as a charitable contribution. *IRC §170 (c)(2)(C)*

The Internal Revenue Code lists in [Publication 557](#) the types of organizations that are considered to be qualified organizations for purposes of receiving charitable contributions.

A donor can give a contribution to a state for charitable or public purposes and have a full deduction for up to the individual income tax limitation (50% of adjusted gross income). *IRC § 170(a); IRC §170(c)(1)*

Most familiar charitable organizations are exempt under IRC 501(c)(3).

### **Substantiation Requirements**

Contributions of \$250 or more must be acknowledged in writing by the governmental agency receiving the donation in order for the donor to claim a deduction. *IRC §170(f)(8); Reg. §1.170-13*

Written acknowledgment to the donor must include:

- Cash received, and a
- Description of property received but not the value, and the
- Value of any goods/services, if any, provided to the donor in exchange for the contribution.

There is no preferred format as long as the acknowledgment is in writing. (Treasury Decision 8690, Dec. 13, 1996)

**Note:** The donor should not include the fair market value of any donated property in the acknowledgement. The recipient is responsible for establishing the value. Depending on the type of property and the donor's tax situation, different IRS rules apply for property valuation. [Publication 561](#) provides information about determining fair market value. *Reg. § 1.170A-13(f)(1)*

### **Office of Federal, State and Local Governments (FSLG)**

**Web site:** [www.irs.gov/govts](http://www.irs.gov/govts) - provides information on many topics related to tax issues for public employers, recent developments, the FSLG Newsletter  
**Customer Account Services - (877) 829-5500** (for governmental entities)

Assistance with determination letters, deposits, 941s, penalties

### **Other IRS Contacts**

IRS Taxpayer Information - (800) 829-1040

IRS Taxpayer Information (TDD) - (800) 829-4059

IRS Taxpayer Advocate - (877) 777-4778

(For assistance with long-standing tax issues)

IRS Forms Ordering - (800) 829-3676

IRS Forms Ordering (TDD) - (800) 829-4059

Fax Ordering - (703) 368-9694

**IRS Information Returns (W-2, 1099) Assistance**

Toll Free (866) 455-7438 (8:30 am - 4:30 pm Eastern Time)

E-mail your inquiries to: [mccirp@irs.gov](mailto:mccirp@irs.gov)

**International Tax Issues** - (215) 516-2000 (6:00 am – 2:00 am EST) (Not toll-free)

### **Federal Per Diem Rates**

Federal rates can be found in the current IRS Publication 1542. or on the General Services Administration [website](http://www.gsa.gov).

For High Cost Locations – Non Continental USA and Foreign Locations:

<http://www.state.gov/www/perdiems/index.html> – U.S. Secretary of State – Per Diem Rates



# INDEX

## Links to IRS Publications

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<a href="#"><u>15-A</u></a>	Employer's Supplemental Tax Guide
<a href="#"><u>15-B</u></a>	Employer's Tax Guide to Fringe Benefits
<a href="#"><u>463</u></a>	Travel, Entertainment, Gift, and Car Expense
<a href="#"><u>521</u></a>	Moving Expenses
<a href="#"><u>525</u></a>	Taxable and Nontaxable Income
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<a href="#"><u>970</u></a>	Tax Benefits for Higher Education
<a href="#"><u>1542</u></a>	Per Diem Rates

New revisions of the publications are generally available after the first of the year.

Forms and publications may also be ordered by calling 1-800-829-3676.

### **Legend for Reading the Citations in this Guide**

<b>CITATION SOURCE</b>	<b>EXAMPLE</b>
IRS Code	IRC §132(a)(1)
Treasury Regulation	Reg. §1.162-2(a)(2)
Treasury Proposed Regulation	Prop. Reg. 106897-08
Revenue Procedure	Rev. Proc. 2007-1
Publication	Pub. 15-B
Revenue Ruling	Rev. Rul. 2006-36
Notice	Notice 98-03
Announcements	Ann. 85-113
Internal Letter Memorandum	ILM 200113024
Field Service Advice	FSA 200132035
IRS News Release	IR 2007-171
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Tax Court Memorandum	1986-64, 51 TCM 455

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