IRS Resolves Tax Impact of Employer-Provided Cell Phones

The federal income tax implications of providing cell phones to employees for business (and some personal) use has now been fully resolved. The issue has been a source of widespread frustration for years, with industry groups criticizing the IRS’s treatment as outdated and out of sync with the widespread use and considerably reduced costs of cell phone technology today. But the IRS put the debate to bed recently by releasing two documents — on employer-provided cell phones and employer reimbursements for the business use of employees’ personal cell phones — that provide favorable relief to employers and employees alike.

Background

All employer-provided fringe benefits are includable in an employee’s taxable income as wages unless a specific exception applies. Working condition fringe benefits — property or services provided to an employee by the employer that would be deductible as “ordinary and necessary” business expenses if incurred by the employee — are excludable from an employee’s gross income if any required record-keeping or substantiation is satisfied. Under prior law, business use of employer-provided cell phones was deductible to the employer and excludable from an employee’s income as a working condition fringe only if the business use of the cell phones was substantiated under the particularly burdensome rules that applied to “listed property” as imposed by Internal Revenue Code Sections 274(d) and 280F. If these rules were not met, the value of all business use and personal use of an employer-provided cell phone was includable in an employee’s taxable wage income, and subject to FICA, Medicare tax and income tax withholding.

The Small Business Jobs Act of 2010 (SBJA) removed cell phones from the definition of “listed property” — meaning that, effective Jan. 1, 2010, cell phones were no longer subject to the stricter substantiation requirements of Code Section 274(d). Employees were no longer required to maintain detailed records of usage of employer-provided cell phones, making it easier for employers to deduct — and employees to exclude — the cost of the business use of cell phones. Instead, reasonable allocations and estimates of business use (excludable) and personal use (still generally considered taxable) could be made, consistent with the general substantiation requirements required under Code Section 162.
SBJA did not put an end to the drama, however. A hint as to what taxpayers needed (and possibly what Congress wanted) appeared in the Joint Committee on Taxation’s report on the SBJA, where it was noted that the delisting of cell phones did not affect the IRS’s authority to determine the appropriate characterization of cell phones as a working condition fringe benefit or whether personal use of cell phones that are provided primarily for business purposes qualify as a de minimis fringe benefit (similar to occasional personal use of office copiers). Nevertheless, this would require further action by the IRS that was a long time coming. In other words, even after SBJA, personal use of employer-provided cell phones still could be considered taxable to employees despite the relaxed substantiation rules.

Finally, the IRS has taken the hint and, in two documents released Sept. 14, provided employers and employees with that long-sought relief.

New IRS Guidance on Employer-Provided Cell Phones

In Notice 2011-72, the IRS concluded that, when an employer provides an employee with a cell phone primarily for noncompensatory business reasons, the IRS will treat the employee’s use of the cell phone for business reasons as a working condition fringe benefit under Code Section 132(d), and will automatically consider the substantiation requirements that would have been imposed under Code Section 162 to be satisfied. Equally important, to the extent that the employee uses the cell phone for personal reasons, the IRS will consider such usage to be a de minimis fringe benefit under Code Section 132(e). The bottom line is that, in such cases, no portion of an employee’s use will be considered taxable.

The key threshold for the above favorable treatment, is that the employer must have provided the cell phone primarily for noncompensatory business reasons. The IRS has explained that such circumstances may exist where, for example:

> The employer needs to contact the employee at all times for work-related emergencies;

> The employer requires the employee to be available to clients when outside the office; or

> The employee needs to speak with clients located in other time zones before or after the employee’s normal work day.

Conversely, the “noncompensatory business reasons” standard will not be met where an employer provides a cell phone merely to promote employee morale or goodwill, as a recruiting inducement or as a means to compensate or reward an employee for past or future services.
Companion Guidance on Employer Reimbursement for Business Use of Employees’ Personal Cell Phones

In a welcome effort to cover all bases, the IRS Small Business/Self-Employed Division concurrently issued an internal memorandum providing guidance to auditors in cases where employers do not provide employees with cell phones, but instead reimburse employees for the use of their personal cell phones for business-related purposes. The IRS instructed examiners to apply the same considerations set forth in Notice 2011-72, focusing on whether the employer has substantial noncompensatory business reasons for requiring employees to use their personal cell phones for business purposes and reimbursing them for that business-related usage. The IRS stated that, in such cases, the employer's reimbursement to the employee should not be considered taxable to the employee, provided that:

> The employee maintains the type of cell phone coverage that is reasonably related to the employer’s business needs;

> The reimbursement is reasonably calculated to not exceed the employee's actual expenses of maintaining the cell phone; and

> The reimbursement is not a substitute for any portion of the employee’s regular wages.

The new provisions are effective for tax years beginning after Dec. 31, 2009.

For further information on the tax treatment of cell phones or other fringe benefits, please contact T.J. Sullivan at (202) 230-5157 or TJSullivan@dbr.com, or Linda Moroney at (414) 221-6057 or Linda.Moroney@dbr.com, or any member of the Business Tax Team.

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