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2020 Year End Reminders: Common Fringe Benefits, Rules for 2% S Corp Shareholders and Changes Under the CARES Act

Summary: As 2020 draws to a close, employers should be reviewing whether they have properly included common fringe benefits in their employee's and (if applicable) 2% S corporation shareholders' taxable wages. This is especially true for 2020, since the CARES Act made a number of changes to the rules relating to traditional fringe benefits.

Fringe benefits are defined as a form of pay for performance of services a company gives to its employees as a benefit and must be included in an employee's pay unless specifically excluded by law. The actual value of the fringe benefits provided must be determined annually before December 31 to allow for the timely withholding and deposit of payroll taxes. Failure to properly report includible fringe benefits to the recipient and the IRS before January 31, 2021, on Form W-2 or Form 1099 may result in lost deductions, as well as tax and civil penalties.

This alert provides information regarding the identification of and tax reporting requirements for several fringe benefits that employers typically offer to their employees. The alert also discusses the special treatment of several fringe benefits that were made available under the CARES Act, which was enacted in March 2020.

Common Employee Frings Benefits

Employer-paid group-term life insurance coverage: Up to $50,000 of group-term life insurance coverage is excluded from tax, and any amount in excess of $50,000 must be included in an employee's taxable income and is subject to Social Security and Medicare taxes (FICA). Even though any amount of coverage exceeding $50,000 is included in taxable wages, withholding of federal income tax (FIT) and state income tax (SIT) is not required. However, employers may withhold at their option. The amount of coverage is to be reported as wages in Boxes 1, 3 and 5 of the employee's Form W-2 and in Box 12 with code "C."As Boomers have aged, their changing preferences have continued to be felt on real estate and construction. Until recently, Boomers comprised a significant cohort of the urban and multifamily rental markets as they threw off the burdens of home ownership in favor of lighter living and to be closer to their children and grandchildren. A side effect of this is a boost to the self-storage facility market as downsizing into smaller living spaces requires external space to house decades of accumulated belongings.

Employee business examples reimbursements and allowances: Any payments of an allowance or the reimbursement of business expenses for which the employee does not provide an adequate accounting (i.e., substantiation with receipts or other records), or for which the employee does not return any excess allowance or reimbursement to the company, are considered to have been provided under a non-accountable plan and are required to be treated as taxable wages for purposes of federal and applicable state and local income tax withholding, employer and employee FICA tax, and federal and state unemployment taxes (FUTA and SUTA).

However, if the employee provides an adequate accounting of the expenses incurred, or is "deemed" to have substantiated the amount of expenses under a per diem arrangement, the reimbursement amounts are excludable from taxable income and wages.

COVID-19 "qualified disaster payments" to employees: Generally, anything of value that an employer provides to an employee is included in the employee's taxable wages, unless an exception applies. Since COVID-19 was declared a national emergency on March 13, 2020, employers can use Internal Revenue Code (IRC) Section 139 to make tax-free, tax-deductible "qualified disaster payments" to employees. These payments can be made on a tax-free basis until the COVID-19 national emergency declaration has been lifted.

Qualified disaster payments are payments made by an employer to an employee that are not reimbursed by insurance and are **reasonably expected** by the employer to:

• Reimburse or pay reasonable and necessary personal, family, living or funeral expenses incurred as a result of a qualified disaster; and

• Reimburse or pay for reasonable and necessary expenses incurred to repair or rehabilitate a personal residence or repair or replace its contents to the extent that the need for such repair, rehabilitation or replacement is attributable to a qualified disaster.

The payments should not include non-essential, luxury or decorative items or services.

With respect to COVID-19, employers can pay for or reimburse expenses (or provide benefits in kind) reasonably believed by the employer to result from the COVID-19 national emergency that are not covered by insurance. For example, employers could pay for, reimburse or provide employees with tax-free payments for over-the-counter medications, hand sanitizers, home disinfectant supplies, child care or tutoring due to school closings, work-from-home expenses (e.g., setting up a home office, increased utilities expense, higher internet costs, using an in-home printer, increased cell phone costs, etc.), increased costs from unreimbursed health-related expenses and increased transportation costs due to work relocation (such as taking a taxi or ride-sharing service from home instead of using public mass transit).

There is no Form W-2 or 1099 reporting for IRC Section 139 payments.

Employer-paid student loan debt: During 2020, the CARES Act allows employers to pay up to $5,250 of their employees' student loan debt and not treat the payment as taxable wages. However, for these payments to be excluded from taxable wages, they must be made under a tuition assistance plan established under IRC Section 127 and meet the following requirements:

• The tuition plan must be in writing and communicated to the employees with reasonable notice

• Payments cannot discriminate in favor of highly compensated employees, and no more than 5% of the amounts paid can go to shareholders or owners (i.e., those who own more than 5% owners of the company's stock or capital interests on any day of the year)

• Employers cannot give employees a choice between educational assitance and other compensation

• The student loan debt must be for the employee's own education (i.e., student loan debt payments cannot be made towards the education of an employee's child, spouse, etc.)

PTO leave donation: Some employers allow employees to donate unused paid time off (PTO) to other employees who may need it. If handled incorrectly, both the donating employee and the recipient employee may have taxable income. But if the IRS's rules are followed, only the recipient employee will have taxable income. PTO donation programs have increased in 2020 because of COVID-19's widespread effect over where employees work and their decisions to take planned time off or not. Reports indicate that about half of American workers switched to working from home rather than in an office and many have canceled or cut back on vacation plans, doctors' appointments, planned medical procedures, etc. As a result of being home more and fewer planned days off from work, many employees have not used their 2020 accrued PTO.

Employers can set up leave-sharing plans that allow employees to surrender accrued PTO for the benefit of other employees dealing with medical emergencies (including death or other hardships caused by a federally declared "major disaster," including COVID-19). Under long-standing IRS guidance, employees who donate leave to other employees for such hardships through an employer leave-sharing plan may exclude the value of the leave from their income, provided the value is included in the recipient-employee's income. Employees are adversely affected by a major disaster if it has caused severe hardship to the employee (or to a family member) that requires the employee to miss work.

Employers administer the leave-sharing program pursuant to a written plan, which specifies that leave is to be used only for medical emergencies, death of a spouse, child or parent, or hardship due to a major disaster. The plan should set limits on how much leave any employee can donate each year and include a detailed procedure for employees to submit a written request for leave (and such request should describe the specific circumstances that necessitate the leave). Donated leave goes into a commingled pool and donors cannot specify who will receive their donated leave. Recipients can receive donated leave only after exhausting all other PTO. Recipients are paid for the donated leave at their regular rate of compensation. The employer should confirm that all leave transferred under the plan is used for the specified situation. Generally, donated disaster PTO that is not used by the end of the disaster period must be returned pro-rata to the donors who are still employed by the employer.

IRS Notice 2020-46 provides that cash payments that employers make to charities that provide relief to COVID victims in exchange for employees forgoing PTO are not taxable wages for the donor-employees. Donor-employees cannot claim a charitable deduction for the donated leave. Employers may deduct these cash payments as a business expense or as a charitable contribution deduction if the employer otherwise meets those requirements. Recipients should all be charitable organizations, including national, regional and faith-based organizations that are assisting victims of the COVID-19 pandemic.

Value of personal use of a company car: The value of a company car used for personal travel must be treated as additional wages on any frequency chosen by the employer up to and including on an annual basis, unless the employee reimburses the employer for such personal use. FIT withholding on fringe benefit wage additions can be calculated as a combined total with regular wages or generally can be withheld at a flat 22% supplemental wage rate if the employee earns under $1 million.

Alternatively, employers can choose not to withhold FIT if the employee is properly notified by January 31 of the year in which imputed income for personal use of a company car will arise or 30 days after a vehicle is provided and the value is properly reported on a timely filed Form W-2. But employers must withhold FICA taxes on such benefits.

For administrative convenience, an employer can calculate the value of personal use of a company vehicle for the current year based on the 12-month period beginning November 1 of the prior year and ending October 31 of the current year (or any other 12-month period ending in November or December) if the employee is properly notified no earlier than the employee's last paycheck of the current year and no later than the date the Forms W-2 are distributed. Once this valuation period is elected, the same accounting period generally must be used for all subsequent years with respect to the same automobile and employee.

Many companies have moved away from providing company cars in lieu of making a cash payment to reimburse the employee for the business use of his or her personal vehicle. Car allowances paid in cash without any substantiation of business use are fully taxable and subject to FICA, FUTA, FIT and SIT withholdings.

Due to COVID-19 restrictions, some employees who use company cars may have experienced an unexpected shift in the percentage of business versus personal use of that vehicle in 2020. As a result, some employees may have significantly higher imputed income because the company car was not used as much for business during 2020. For example, if the company car was parked at the employee's home (even if unused), the employee had personal use of the car for the period of time that the car was not used for business. This may come as a surprise to many employers and employees. The IRS has not yet published any relief that would change the normal imputed income inclusion rules for these circumstances.

Value of personal use of company aircraft: This fringe benefit (unless reimbursed by the employee to the extent permitted under FAA rules) is subject to FICA, FUTA, FITW and SITW. The value calculated is based on the Standard Industry Fare Level formula provided by the IRS. Expenses related to personal entertainment use by officers, directors and 10%-or-greater owners that exceed the value treated as compensation to key employees are nondeductible corporate expenses.

Reports indicate that both personal and business use of company aircraft has increased in 2020 because of COVID-19, so employers may need to address that issue for 2020, even if they have not encountered it in past years.

Benefits that exceed the de minimis exclusion: De minimis benefit amounts can be excluded when the benefit is of so little value (taking into account the frequency) that accounting for it would be unreasonable or administratively impractical. A common misconception is that if a fringe benefit is less than $25, it is automatically considered a de minimis benefit. However, there is no statutory authority for this position. If a fringe benefit does not qualify as de minimis, generally the entire amount of the benefit is subject to income and employment taxes (FICA, FUTA, FITW and SITW). Season tickets to sporting or theater events, use of an employer's residence, apartment, boat or vacation home, and country club or athletic facility memberships do not qualify as de minimis benefits. De minimis benefits have never included cash, gift cards or certificates or cash-equivalent items, regardless of their amount. Gift cards or certificates that cannot be converted to cash and that are otherwise a de minimis fringe benefit that is redeemable for only specific merchandise such as ham, turkey or another item of similar nominal value, might be excludable from income. However, gift cards or certificates that are redeemable for a wide variety of items are deemed to be cash equivalents. Any portion of a gift card or certificate that is considered a cash equivalent should be included in the employees' Forms W-2 and subject to income and employment taxes as detailed above.

While snacks and meals provided to employees can meet the de minimis requirements, they often do not. Still, most employer-provided meals are excluded from the employees' taxable income under the accountable plan rules for working condition fringe benefits. The employer's deduction for these meals and entertainment is limited to 50% of food and beverage expense excludable under the de minimis fringe benefit rule and quiet business meals with customers and clients. Food or beverage expenses related to employee recreation, such as holiday parties or annual picnics, are fully deductible when provided primarily for the benefit of rank and file employees. Entertainment expenses, even with a business purpose, are not deductible.

Caution: We have seen the IRS take an aggressive position on examination, where the agent proposes that the company expenditure for on-site food and beverages regularly furnished to employees should be treated as employee compensation because it is too frequent or extravagant to be excludible as a working condition or de minimis fringe benefit.

Value of employee achievement awards, gifts and prizes: This fringe benefit is subject to FICA, FUTA, FITW and SITW. In general, employee achievement awards, gifts and prizes that do not specifically qualify for exclusion are only deductible for the employer up to $25 per person per year, unless the excess is included as taxable compensation for the recipient. Any gifts in excess of $25 per person per year to employees in the form of tangible or intangible property are taxable wage income for employees. There are two exceptions to the general rule: (i) achievement awards for length of service or safety and (ii) certain non-cash achievement awards, such as a gold watch at retirement or nominal birthday gifts, which fall within the exclusion for de minimis benefits.

For a length of service or safety award to be considered excludible, there must be a meaningful presentation of the award, the employee being recognized for the award must have at least five years of service and the award cannot have been granted to the same employee in any of the prior four years. The exclusion applies only for awards of tangible personal property and is not available for awards of cash, gift cards or certificates, or equivalent items. The exclusion for employee achievement awards is limited to $400 per employee for nonqualified plans (unwritten and discriminatory plans) or up to $1,600 per employee for qualified plans (written and nondiscriminatory plans).

Job-related moving expenses paid by employer: Moving expenses incurred during 2020 must be included in the employee's taxable compensation, unless the employee is an active duty member of the U.S. Armed Forces and is moving to a permanent change of station. The exclusion from employee income is scheduled to be reinstated January 1, 2026. Employers can still pay (and obtain a deduction for paying) employee moving expenses, but such amounts are now taxable wages paid to the employee.

Value of qualified transportation fringe benefits: Employers cannot deduct expenses incurred in providing any transportation fringe benefits to employees. Tax-free transportation fringe benefits may still be provided to employees, but the employer will not get a deduction for providing such tax-free benefits. The payroll tax treatment of employee parking, van pool and mass transit benefits remains unchanged.

Qualified commuting and parking amounts provided to the employee by the employer in excess of the monthly statutory limits are subject to FICA, FUTA, FITW and SITW. For 2020, the statutory limits are $270 per month for qualified parking and $270 for transit passes and van pooling. An employee can be provided both benefits for a total of $540 per month, tax-free, with the excess included in Form W-2. Amounts exceeding the limits cannot be excluded as de minimis fringe benefits.

Bicycle commuting benefits incurred on or after January 1, 2018, are included in taxable wages subject to FIT, FITW, FITA and FUTA. Because these benefits are taxed to the employee as regular compensation, the benefits are deductible by the employer.

The value of any de minimis transportation benefit provided to an employee can be excluded from Form W-2. For example, an occasional taxi fare home for an employee working overtime or departing a business function such as a holiday party may be provided tax-free.

Please note that some local jurisdictions require mass transit options. For instance, the District of Columbia requires employers with 20 or more employees to offer qualified transit benefits. While D.C. employers are not necessarily required to subsidize the cost of their employees' commuting expenses under the new law, they are required to provide an arrangement for employees to make a pre-tax election to take full advantage of the maximum statutory limits for transit, commuter highway or bicycling benefits.

San Francisco and New York City have adopted similar laws in an attempt to promote the use of available mass transit options and to reduce automobile-related traffic and pollution. Employers should confirm that they are in compliance with local requirements regarding mass transit options for each employee location.

Value of noncompensatory cell phones (and other devices): The value of the business use of an employer-provided cell phone (and other communications devices) provided primarily for noncompensatory business reasons is excludable from an employee's income as a working condition fringe benefit. Personal use of an employer-provided cell phone, given to the employee primarily for noncompensatory business reasons, is excludable from the employee's income as a de minimis fringe benefit. Employers provide a cell phone primarily for noncompensatory business purposes if there are substantial business reasons for providing the phone. Examples of substantial business reasons include the employer's need to contact the employee at any time for work-related emergencies, the requirement that the employee be available to speak with clients at times when the employee is away from the office and the need to speak with clients located in other time zones at times outside the employee's normal workday.

Employers cannot exclude from an employee's wages the value of a cell phone provided to promote the goodwill of an employee, to attract a prospective employee or as a means of providing additional compensation to an employee.

Special rules for taxing certain employee fringe benefits to 2% S corporation shareholders

Certain otherwise excludable fringe benefit items are required to be included as taxable wages when provided to a 2% shareholder of an S corporation. A 2% shareholder is any person who owns, directly or indirectly, on any day during the taxable year, more than 2% of the outstanding stock or stock possessing more than 2% of the total combined voting power of the corporation. These fringe benefits are generally excluded from the income of other employees but are taxable to 2% S corporation shareholders similar to partners. If these fringe benefits are not included in the shareholder's Form W-2, they are not deductible for tax purposes by the S corporation. The disallowed deduction creates a mismatch of benefits and expenses among shareholders, with some shareholders paying more tax than if the fringe benefits had been properly reported on Form W-2.

Health, dental, vision, hospital and accident (AD&D) and qualified long-term care (LTC) insurance premiums paid under a corporate plan: These fringe benefits are subject to FITW and SITW but not to FICA or FUTA. The amounts include premiums paid by the S corporation on behalf of a 2% shareholder, as well as amounts reimbursed by the S corporation for premiums paid directly by the shareholder. If the shareholder partially reimburses the S corporation for the premiums using post-tax payroll deductions, the net amount of premiums must be included in the shareholder's compensation. Pre-tax payroll deductions cannot be used by 2% shareholders to reimburse premiums paid by the S corporation. However, 2% shareholders can deduct the premiums using the self-employed health insurance deduction their personal federal income tax return (i.e., on Form 1040).

Cafeteria plans: A 2% shareholder is not eligible to participate in a cafeteria plan created under IRC Section 125, nor can the shareholders' spouse, child, grandchild or parent participate. If a 2% shareholder (or any other ineligible participant, such as a partner or nonemployee director) is allowed to participate in a cafeteria plan, the cafeteria plan will lose its tax-qualified status, and the benefits provided will, therefore, be taxable to all participating employees, nullifying any pretax salary reduction elections to obtain any benefits offered under the plan.

Employer contributions to health savings accounts and other tax-favored health plans: This fringe benefit is subject to FITW and SITW but not FICA or FUTA. If the shareholder partially reimburses the S corporation for the health plan contribution, using post-tax payroll deductions, the net amount of the contribution must be included in the shareholder's compensation. Pre-tax payroll deductions cannot be used by 2% shareholders to reimburse plan contributions paid by the S corporation. However, 2% owners can take a corresponding self-employed deduction for the cost of their health savings account contributions on their Form 1040.

Short-term and long-term disability premiums: For 2% shareholders of an S corporation, employer-paid short- and long-term disability premiums are subject to FITW and SITW, but not to FICA or FUTA. Because the disability insurance premiums are paid with after-tax dollars, any disability insurance proceeds generally would be tax-free.

Group-term life insurance coverage: Group-term life insurance premiums should be included in Boxes 1, 3 and 5 of a 2% shareholder's Form W-2. The entire premium paid on behalf of a 2% shareholder under a group-term life insurance policy is treated as taxable, not just the premium for coverage in excess of $50,000. Although the value is taxable income to the 2% shareholder, the cost of the insurance coverage (i.e., the greater of the cost of the premiums or the Table I rates) is only subject to FICA tax withholding. The cost of the insurance coverage is not subject to FUTA, FITW or SITW. It should be noted that any life insurance coverage for which the corporation is both the owner and beneficiary (e.g., key man life insurance) does not meet the definition of group-term life insurance and, therefore, there is no income inclusion in the shareholder's Form W-2.

Other taxable fringe benefits: Employee achievement awards, qualified transportation fringe benefits, qualified adoption assistance, qualified moving expense reimbursements, personal use of employer-provided property or services, and meals and lodging furnished for the convenience of the employer must be included as compensation when made available to 2% shareholders of an S corporation. All of the above fringe benefits are subject to FICA, FUTA, FITW and SITW.

Nontaxable fringe benefits: The following fringe benefits are not includible in the compensation of 2% shareholders of an S corporation:

- Qualified retirement plan contributions
- Qualified educational assistance up to $5,250 (but tax-free benefits are not available if more than 5% of the educational assistance benefits are provided to 2% S corporation shareholders, their spouses or dependents)
- Qualified depedent care assistance up to $5,000 (but tax-free benefits are not available if more than 25% of benefits paid during the year are provided to individuals who own more than 5%)
- Qualified retirement planning services
- No-additional-cost services
- Qualified employee discounts
- Working condition fringe benefits
- De minimis fringe benefits
- On-premises athletic facilities