

IRS EXPLAINS TAX TREATMENT OF EMPLOYER-PROVIDED CELL PHONES

On September 14, 2011, the Internal Revenue Service ("IRS") released new, taxpayer friendly guidance concerning the tax treatment of employer-provided cell phones. This guidance allows employers to provide cell phones to their employees, either directly or through reimbursement of employees' cell phone expenses, on a tax-free basis without burdensome recordkeeping requirements so long as certain criteria are met. In light of this development, employers should review their cell phone policies and practices and evaluate whether changes should be made to make use of the new guidance.

BACKGROUND

The IRS guidance became necessary last fall when the Small Business Jobs Act of 2010 amended the Internal Revenue Code to remove cell phones from the definition of "listed property" for tax years beginning after December 31, 2009. Prior to this date, federal tax law required that employer-provided cell phones be subject to the strict substantiation requirements associated with listed property in order for their business use to be excluded from employees' income. This change in federal tax law was widely praised by the business community because it reduced the recordkeeping burden associated with substantiating business use. However, the Act did not change the requirement that only the value of substantiated business use of employer-provided cell phones could be excluded from employees' income. Thus, questions remained regarding what constituted adequate substantiation (i.e., proof) of business use and whether the value of personal use of employer-provided cell phones should be treated as taxable income to employees.

IRS GUIDANCE

The IRS answered these questions in IRS Notice 2011-72, which can be found here: <http://www.irs.gov/pub/irs-drop/n-11-72.pdf>

In summary, the Notice provides that the IRS will consider all use of an employer-provided cell phone as a non-taxable fringe benefit so long as the cell phone is provided primarily for noncompensatory business reasons, as further explained below:

- *Definition of Cell Phone.* The Notice explains that the term "cell phone" includes cellular telephones or other similar telecommunications equipment. Presumably, this includes smart phones such as iPhones and Blackberry devices.
- *Substantiation of Business Use Not Required.* The Notice essentially eliminates the need for employers and/or employees to substantiate the business use of employer-provided cell phones. Instead, employers now can simply show that they provided a cell phone primarily for noncompensatory business reasons. The Notice also explains that any personal use of an employer-provided cell phone will be considered a de minimis fringe benefit, which is non-taxable, so long as the cell phone was provided primarily for noncompensatory business reasons.
- *Noncompensatory Business Reasons.* To be considered a noncompensatory business reason (or purpose), there must be a substantial reason relating to the employer's business for providing an employee with a cell phone. Examples of valid noncompensatory business reasons include:
 - The employer's need to contact the employee at all times for work-related emergencies;
 - The employer's requirement that the employee be available to speak with clients at times when the employee is away from the office; or
 - The employee's need to speak with clients located in other time zones at times outside of the employee's normal work day.

The IRS also specifically identified the following as examples that would not be considered valid noncompensatory business reasons:

- A cell phone provided as a means of providing additional compensation to an employee;

- A cell phone provided to promote the morale or good will of an employee; or
- A cell phone provided to attract a prospective employee.

The use of the word "primarily" in the Notice emphasizes that a noncompensatory business reason must be the principal reason for providing a cell phone to an employee. It also signals that other benefits, such as improved employee morale, are likely allowable so long as they are secondary to the noncompensatory business reason(s).

4. *Reimbursement Arrangements Will Be Allowed.* In conjunction with the Notice, the IRS issued an internal memorandum to its field examination operations to provide interim guidance to IRS auditors regarding employers who reimburse their employees for the costs of an employee's personal cell phone. The memorandum (found at: <http://www.irs.gov/pub/foia/ig/sbse/sbse-04-0911-083.pdf>) directs IRS auditors to analyze reimbursements of employees' cell phone expenses in a manner that is similar to the approach described in the Notice. Specifically, employers will be allowed to reimburse an employee's cell phone expenses if the applicable employer has substantial business reasons, other than providing compensation to the employee, for requiring the employee's use of personal cell phones in connection with the employer's trade or business. The following requirements must also be satisfied for favorable tax treatment:


- The employee must maintain the type of cell phone coverage that is reasonably related to the needs of the employer's business;
- The reimbursement must be reasonably calculated so as not to exceed expenses the employee actually incurred in maintaining the cell phone; and
- The reimbursement for business use of the employee's personal cell phone must not be a substitute for a portion of the employee's regular wages.

While the release of this memorandum is helpful to employers who utilize reimbursement arrangements for cell phones, such employers should exercise caution when relying on the memorandum because of its characterization as "interim guidance." This label appears to indicate that the IRS may issue additional guidance. Although it is unlikely that the IRS would retroactively change its position on reimbursement arrangements, employers should continue to monitor this topic for any additional developments.

CONCLUSION

Most, if not all, employers that currently provide cell phones to their employees, either directly or through reimbursement of employees' cell phone expenses, will likely want to follow the guidance provided in the Notice. As employers move forward with compliance with the provisions of the Notice, there are several considerations to keep in mind:

- Employers will need to evaluate which employees should be provided with a cell phone and whether each person fits the noncompensatory business reason requirement.
- The Notice is effective beginning January 1, 2010. Thus, for those employers who have been treating the value of cell phones as a taxable benefit, they may want to consider whether any action should be taken for 2010 and/or for 2011 to reverse this tax treatment.
- To the extent employers have a policy or procedure addressing the provision of cell phones, such employers will need to review and revise those documents to be consistent with the changes they plan to make in order to comply with the provisions of the Notice.

Should you need assistance with your organization's evaluation of employer-provided cell phones and the Notice, please contact Calvin R. Chambers at (317) 977-1459  or cchambers@hallrender.com or your regular Hall Render attorney.