Understanding taxable fringe benefits

Are you and your organization handling them correctly?

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In a world that places greater emphasis on work-life balance, and where salary is only one of the many considerations in job satisfaction, fringe benefits are becoming more important and prevalent than ever. However, that company-owned car has tax consequences to both the provider and recipient.

The IRS has published guidance on whether these benefits should be included in taxable income to the recipient and which are subject to FICA and FUTA. It's important for CPAs and businesses to understand the intricacies of the benefits provided. Some of the basics are broken down in this article.

What is a fringe benefit?

A fringe benefit is a form of pay for the performance of services. Employer-provided cell phones, health insurance, use of company-owned vehicles and even the free coffee in the kitchen are all considered fringe benefits.

Performance of services do not have to be completed specifically by an employee; they can also be performed by an independent contractor or a partner in a company. Two-percent shareholders of an S Corporation are treated as either partners or employees depending on the type of fringe benefit provided. Some fringe benefits are provided tax-free, but others are taxable to the recipient.

The provider is required to include the value of fringe benefits in the recipient's pay. However, the value included in the recipient's pay ought to be reduced by any amounts specifically excluded by law, as well as any amount that the recipient paid for the benefit out of their own pocket. If the recipient is an employee, then taxable fringe benefits are subject to employment and income tax.

Which benefits are taxable?

The law clearly states that all fringe benefits are taxable unless specifically excluded. The list of excludable fringe benefits includes:

- Accident and health benefits
- Achievement awards
- De minimis benefits
- Dependent care assistance
- Educational assistance
- Health savings accounts
- Group-term life insurance
- Meals
- Working condition benefits

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This list is far from exhaustive, but is an example of the types of benefits that can be excluded from taxable income to the recipient. Most of these fringe benefits are excludable only to certain limits, and some may be subject to FICA and FUTA even if they are excluded from income tax withholding. For example, providers can exclude the cost of up to $50,000 of group-term life insurance from the insured recipient's wages. The cost would also be exempt from FICA and FUTA. However, the cost of group-term life insurance over $50,000 would be taxable as wages and subject to FICA, but would be excluded from FUTA and is not subject to income tax withholding. This just goes to show how complicated some of these benefits can be.

The provider of the taxable fringe benefit is required to determine the value of the benefit. In most cases, the provider must use the general valuation rule (GVR). The GVR requires providers to value a taxable fringe benefit by its fair market value (FMV). The FMV of the fringe benefit is the amount that the recipient would pay an independent party in an arm's length transaction while taking into consideration all the facts and circumstances. The facts and circumstances to consider would include the length of the benefit and the location where the benefit was provided.

The FMV is not determined by the deemed worth of the benefit by the provider or recipient, nor is it determined by the actual cost of the benefit. The provider must calculate the value of the benefit by Jan. 31 of the year after the benefit is provided; however, estimates of the value may be used prior to Jan. 31 for withholding purposes and depositing taxes on a timely basis.

Timing of benefits

Providers have the option to determine the withholding, depositing and reporting period of noncash taxable fringe benefits. As long as they are being treated as paid at least annually, the provider can choose to treat the benefit as paid by pay period, quarter, semi-annual or some other basis.

However, if the taxable fringe benefit is paid in cash or some other form of tangible or intangible property, the withholding, depositing and reporting must use the actual period in which the benefit was paid.

Reporting

Providers may report the taxable fringe benefits to employees along with regular wages in a payroll period and figure the taxes as applicable on the total. Because taxable fringe benefits fall under the category of supplemental wages, or wages outside of regular pay, the provider has an option of reporting them separately in a pay period and withholding a flat 25 percent. The percentage is 39.6 if the supplemental wages exceed $1 million during the year.

If the recipient of the taxable fringe benefit is an employee, then the benefit must be reported on Form W-2. Although an estimated value of a fringe benefit is allowed for the purposes of withholding and depositing taxes, the actual value must be reported on Forms 941 (or Form 944) and the W-2.

If the recipient is an independent contractor, the taxable fringe benefit is not subject to employment taxes to the provider, but must be reported on Form 1099-Misc.

If the recipient is a partner, the taxable fringe benefit is not subject to employment taxes to the provider, but must be reported on Schedule K-1 of Form 1065.

Tracking benefits

It's important to identify the fringe benefits and become educated on any consequences of those benefits before providing them to employees or contractors. Providers should use their payroll and tax advisers to assist with reporting and valuation considerations.

A formalized written plan of the benefits provided, the timing of reporting and the method of valuation are important to staying organized and on top of reporting requirements. It's also important to review the status and any changes in benefits periodically throughout the year. Scrambling to calculate benefits only days before a reporting requirement will cause unnecessary stress to all involved.

Providing benefits to employees or others providing services are great ways to improve employee satisfaction, retention and productivity in the workplace. Having satisfied employees can make all the difference in the culture of work and the success of any business. Staying organized and being well-informed are the keys to managing any extra stress and effort that providing benefits will create.

"Before anything else, preparation is the key to success,"
— Alexander Graham Bell ■

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