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IRS Cell Phone Guidance Clears the Air

The IRS recently issued Notice 2011-72 and a Memorandum for All Field Examination Operations, which provide a road-map for employers to avoid taxing employee on cell phone expenses. Following the de-listing of cell phones as "listed property" from Code section 274(d) last year, there has continued to be some uncertainty on the proper tax treatment of employer-provided cell phones (and reimbursements of cell phone costs) (see <http://www.groom.com/resources-542.html>). This guidance, summarized below, clarifies the proper tax treatment and is retroactively effective for cell phone use after December 31, 2009.

Notice 2011-72

The Notice provides the value of the business use of an employer-provided cell phone is excludable from the employee's income as a working condition fringe under Code section 132(d), provided that the cell phone is provided "primarily for noncompensatory business reasons." Importantly, the substantiation requirements under Code section 162 are deemed to be satisfied.

In addition, the Notice provides that the value of any personal use of a cell phone provided by the employer primarily for noncompensatory business purposes is excludable from gross income as a de minimis fringe benefit under Code section 132(e).

A cell phone will be considered primarily for noncompensatory business reasons if there are substantial reasons relating to the employer's business, other than providing compensation to the employee, for providing the employee with a cell phone, including:

(1) employer's need to contact the employee at all times for work-related emergencies, (2) employer's requirement that the employee be available to speak with clients at times when the employee is away from the office, and (3) employee's need to speak with clients located on other time zones outside the employee's normal work day.

In contrast, a cell phone will be considered provided for a compensatory business reason (and thus taxable) if it is provided (1) to promote the morale or good will of the employee, (2) to attract a prospective employee, or (3) as a means of furnishing additional compensation to the employee. The Notice also cautions that its guidance is limited to cell phones and not any other property (e.g. laptops).

Examination Memo

The Examination Memo addresses the treatment of reimbursements received by employees from employers for the business use of an employee's personal cell phone. Following Notice 2011-72, such reimbursements will not be taxable, provided that:

1. for "substantial" noncompensatory business reasons, the employee is required to maintain and use their personal cell phones for business purposes (see above for noncompensatory business reasons),
2. the type of coverage is reasonably related to the needs of the employer's business (i.e., not an international or satellite coverage plan for local clients),
3. the reimbursement is reasonably calculated so as not to exceed expenses the employee actually incurred in maintaining the cell phone (i.e., not unusual or excessive expenses), and
4. the reimbursement must not be a substitute for a portion of the employee's regular wages.

For example, an employer's reimbursement of the full cost of the employee's basic coverage plan that charges a flat-rate per month for a certain number of minutes of domestic calls should not result in taxable income, provided the reimbursement is for substantial noncompensatory reasons. However, if there is a pattern of reimbursements that deviates significantly from the normal course of cell phone use in the employer's business (e.g., an employee received reimbursements for cell phone use of \$100/quarter in quarters 1 through 3, but receives a reimbursement of \$500 in quarter 4), it will be examined more closely.

Action Steps

Accordingly, as long as the cell phone is provided "primarily for noncompensatory business reasons," there is no longer a requirement to track or substantiate the calls – the entire use of the phone is non-taxable to the employee (i.e., not reported on the W-2 as wages), and the employer should be entitled to the full deduction for the cost of the cell phone (and related data plans). Therefore, we recommend that employers review their cell phone policies and adjust their imputed income approach accordingly. As this Notice and Examination Memo are effective for 2010, consideration should also be given for corrected returns (e.g., W-2c, 941-X) to the extent any imputed income was imposed on the W-2/941 for personal use.

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