TAX NOTE

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TOPIC

EMPLOYEE BENEFIT TAXATION

Generally, all payments that employers make to employees, including benefits, are considered wages and are subject to federal and state income tax and Social Security/Medicare (FICA) and unemployment (FUTA) tax unless federal or state law specifically exempts the payment from taxation.

Non-cash employee benefits are taxed according to their fair market value. Some special valuation rules apply to certain benefits, such as excess life insurance.

This Benefit Taxation Chart describes some common non-wage employer benefits and payments and the tax rules that apply to them.

ABOUT

Lewis Law Office, LLC provides legal advice to public, non-profit and private entities and emerging businesses on tax, ERISA, employee benefits, employment and commercial law.

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Achievement Awards

Items of tangible property (e.g., fleece jacket) awarded for length of service or safety achievement. Per 2017 Tax Cuts Act, excludible tangible property does not include cash, gift cards, vacations, meals, theater or sports tickets or shares of stock. These items are subject to income, FICA and FUTA tax.

If the employer has a qualified award benefit plan – a written plan that does not discriminate in favor of highly compensated employees and requires the award to be made as part of a meaningful ceremony, the tax exemption limit is $1,600 per employee per year. Non-qualified plan awards have a tax-exempt limit of $400 per employee per year. Awards in excess of the tax exemption limit are subject to income, FICA and FUTA tax on the difference.

Details – Length of service awards cannot be awarded more often than every five years and may not be awarded during the first five years of employment. Safety awards cannot be awarded to more than 10% of the eligible employee group each year and manager, supervisor, professional or administrative employees are not eligible.

Awards and Prizes

Awards for scientific, charitable or artistic achievements

The award is taxable and subject to income, FICA and FUTA tax if it is granted to an employee for an achievement connected with employment. Awards to nonemployees are not included in the nonemployee's gross income if the award recipient did not enter a contest for the award, the recipient is not required to perform services in the future, and the recipient donates the award to a government or charitable organization.

Back Pay

Back pay awards by courts, administrative agencies and settlement agreements are wages subject to income, FICA and FUTA tax. They are taxable in the year paid at the rates in the year paid, and not the year earned. Back pay can be reported electronically at www.socialsecurity.gov/bso.htm.

Benefit Plans – Employer Contributions

Employer contributions toward group term life insurance (up to $50,000 in coverage), pension, retirement income plans, accidental death and dismemberment (AD&D) insurance, disability insurance, health and medical insurance, and worker's compensation insurance are exempt from employment tax as long as the plans are qualified under the Internal Revenue Code and do not discriminate in favor of highly compensated employees.

The value of group term life insurance above $50,000 is subject to FICA. Employer contributions toward other forms of life insurance (not group term – whole life, cash value, split dollar) are taxable as wages.

Benefit Plans – Employee Contributions

Employee contributions toward insurance and other benefits are treated like other payroll deductions and subject to income, FICA and FUTA withholding. Employee contributions made through a salary deferral agreement to a 403(b) plan are considered employer contributions when within the contribution limits. The salary deferred contributions are not subject to income tax withholding but FICA and FUTA apply. Also, Roth contributions to a 403(b) plan are taxed as wages.

Bonuses

Bonuses paid by an employer to employees are taxable wages. An exception is noncash holiday gifts of minimal monetary value (the holiday turkey) which are not taxable.

Business Expense Reimbursements

Employer payments, advances or reimbursements of employee's business-related expenses are not taxable wages if they are paid under an "accountable plan" and are paid separately from wages. An accountable plan requires employees to substantiate their expenses within a reasonable period of time and to return any excess value above the amount expended. Payments and reimbursements made under a nonaccountable plan are taxable.

Cafeteria Plans

A cafeteria plan allows participants to choose between a tax-qualified benefit and cash. Former employees, including retirees, may participate but the plan cannot be designed for former employees. A cafeteria plan can include AD&D and health insurance, group term life insurance, dependent care assistance, adoption assistance, elective contributions to a cash 0r deferred 403(b) plan and paid time off accruals. If the employee chooses to participate in a nontaxable benefit plan, the value of the employee's participation is tax-exempt. If the employee chooses cash, the cash payments are subject to withholding, FICA and FUTA.

FICA and FUTA apply to employee elective contributions to the 403(b) plan. If the cafeteria plan favors highly compensated employees, the highly compensated employees and key participants are subject to withholding on their cafeteria plan benefits.

Holiday Gifts

Gifts from employers to employees generally are considered compensation and treated as taxable wages. Noncash gifts of low value (holiday ham) are considered de minimis and are not subject to employment tax. Any gift certificate or card that can be converted to cash of any amount is not exempt from employment tax.

Company Car

An employee's personal use of the employer's vehicle is includible in the employee's gross income unless it can be excluded as a de minimis use. The employer can decide whether to withhold tax or report the fair market value of the use on the employee's Form W-2. Valuation of the fair market value of the use can be done using the annual lease valuation or a cents per personal mile approach. Documentation of the personal miles is required.

Consultant Fees

A consultant will generally be considered an independent contractor if the terms and conditions of the consultant's contract satisfy the independent contractor test. Fees paid to consultants are not wages and should be reported on a Form 1099.

Deceased Employee Wages

Wages, salary or paid time off accruals paid to the estate or beneficiary in the same calendar year as the employee's death are exempt from federal income tax withholding but subject to Social Security and FUTA tax. The employee's death does not remove the obligation to withhold and pay employment tax.

Dependent Care Assistance Program

Up to $5,000 per year can be excluded from wages for the cost of dependent care assistance under a qualified dependent care assistance program. The qualified program must be described in a written plan document that is separate from any other benefit plan. The plan cannot discriminate in favor of highly compensated employees. The plan does not have to be funded.

Employer-Provided Meals

Meals provided and paid for by the employer may be tax-exempt if provided for the "convenience of the employer." This requirement is met when more than one-half of the employees receive on premise meals. An example is hospital employees who must stay in the hospital to respond to emergencies. The convenience of the employer criteria may also be met when the employment location is remote or the meal period is too brief to expect employees to get the meal somewhere else.

Educational Assistance

Up to $5,250 can be excluded annually from an employee's income for employer-provided contribution toward the cost of the employee's undergraduate or graduate studies. The educational assistance benefit must be described in a separate written plan document. Meals, lodging and transportation cannot be reimbursed under this benefit. The education can, but is not required to be, job-related.

Job-related educational expenses are reimbursed as a non-taxable working condition fringe benefit. Job-related means the educational course helps the employee maintain current job skills or develop new skills relating to the employee's job duties for that employer.

Employer-Provided Cell Phones

The value of an employee's use of a cell phone can be excluded from the employee's income as a working condition fringe benefit when the phone is provided and used for the employer's business. The value of the employee's personal use of an employer-provided cell phone is generally excludible as a de minimis fringe benefit.

Equipment and Tools

An employee who is hired with the understanding that s/he will use the employee's tools or truck in the employer's service is typically paid a stipend in addition to the employee's wages for the use or rental of the equipment. Payments made under an accountable plan are not taxed to the employee because the cost of using the equipment is an ordinary business expense for the employer.

An equipment allowance paid under a non-accountable plan is fully taxable as wages.

Financial Counseling

The value of employer-paid individual financial counseling or financial planning is includible in the employee's gross income and subject to all employment tax.

Flexible Spending Arrangement (FSA)

An FSA is an employer-sponsored benefit that allows the employee to make a tax-exempt salary reduction contribution to an earmarked account to pay for reimbursements of qualified medical or dependent care expenses. Qualified medical care must be for the employee, employee's spouse or dependents. Qualified medical expenses include the cost of transportation to/from medical care. The 2019 maximum employee tax-exempt contribution limit is $2,700.

Fringe Benefits

Certain employer-provided benefits are tax exempt or tax-preferred under federal law. These tax-exempt/preferred benefits include qualified pension and retirement plans, group term life insurance, AD&D and health benefits and dependent care assistance.

Any fringe benefit that is not specifically excluded from taxation by a federal law is taxable. Taxable fringe benefits include the employee's personal use of a company car, employer-provided meals and snacks and employer-provided transportation for commuting purposes (e.g., paying for an Uber). Withholding on taxable fringe benefits must occur at least annually.

No additional cost services are services the employer provides as part of its business. These fringe benefits are not taxable to the employee.

Qualified employee discounts are not taxable to the employee if applied to merchandise or services offered to employees for their own use at a cost less than what is charged to nonemployee customers.

Working condition fringe benefits are property or services that the employee could deduct as a business expense if the employee paid for them. Business-related travel, professional publication subscriptions and professional licenses or memberships are some examples. These expenses are not taxable to the employee.

De minimis fringe benefits are property or services whose value is so small and difficult to track that accounting for the benefit is unreasonable. Examples include occasional, sporadic personal use of the employer's copy machine, occasional parties or picnics. The value of these items is not taxable to the employee. There is no cash minimum. A high volume of low-cost items may be taxable if provided frequently enough.

Gifts

Gifts of cash and certificates redeemable for cash equivalence and noncash items with more than a nominal value are taxable to the employee. There is no minimum excludible amount for cash or cash equivalents (gift cards).

Health Insurance

Employer contributions to the cost of health insurance premiums or medical expenses are not taxable to employees to a certain limit. The health insurance benefits are also excludible from employee income.

A self-insured medical plan must be written and tested to ensure the plan does not discriminate in favor or highly compensated employees. Excess benefits paid to highly compensated employees will be taxable to the employee.

Jury Duty Pay

The employer payment of the difference between a jury duty stipend and the employee's normal wage is taxable. The jury fee is subject to FICA and FUTA but not income tax withholding.

Leave - Paid Time Off

Paid leave time is included in employee taxable wages. Leave is not taxed until it is actually paid. Accruals that are carried over are not taxable until paid. Cash-out leave conversions are taxable when the leave is credited to the employee. Leave that is contributed to the employee's post-employment benefit (OPEB) is not taxed if it is used to pay an OPEB benefit that is otherwise tax-exempt (I.e., post-employment health plan premiums).

Meals and Lodging

Meals that are provided during working hours for the employer's convenience, on the employer's premises, are tax-exempt. The meals must be provided for a substantial business reason that is not otherwise compensated – for example, being on site to respond to emergencies for emergency personnel. At the convenience of the employer means that more than half of the employees receive a meal in kind. Any arrangement where the employee can choose cash or a meal would make the meal value taxable to the employee.

Food service workers can receive a meal immediately before or after their shift without being taxed on the meal value. Coffee and doughnuts or other occasional food is generally de minimis; however, occasional food that is provided on a regular basis may become taxable to the employee. An example would be sandwiches available at all times in the employee kitchen.

Similar rules apply to employer-provided housing on the employer's premises.

Pensions and Retirement Plan Contributions

Employer contributions to pensions, qualified retirement plans and tax-sheltered annuities are tax-exempt. Employee contributions to a qualified 401(k) or 403(b) plan up to annual contribution limits are income tax-exempt but are subject to FICA and FUTA. Employer matching contributions to a qualified plan are tax-exempt.

Wellness Programs and Incentives

Some wellness program incentives are tax-exempt and some are not. Cash and cash-equivalents (E.g., gift cards) are taxable no matter what the amount is and are payments or reimbursements for gym or health club memberships and fees. Non-taxable wellness incentives may include the employer's contribution to the employee FSA, HRA or HSA, access to employer athletic facilities on the employer's premises and gift cards that are coded so that they can be used only for tax exempt medical expenses (e.g., discount coupon for blood pressure screening).