AKD Consultants
Adam Dworkin
CPA
188 Whiting Street
Suite 10
Hingham, MA 02043
781-556-5554
Adam@AKDConsultants.com

Offering Employee Benefits

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What is it?

In today's competitive job market, an attractive employee benefit package can be a useful tool to help you recruit new employees and retain those that are crucial to your company's success. In addition, the tax benefits you can receive by offering your employees benefits are twofold: First, the costs of providing employee benefits are sometimes tax deductible as a trade or business expense. Secondly, the value of the benefits that you provide to your employees may be excludable from your employees' gross income, reducing your taxable payroll. A reduction in your taxable payroll decreases your matching payments of Social Security and Medicare taxes, as well as unemployment taxes.

Types of employee benefits

In general

Employee benefits can come in either the form of cash or noncash benefits, also known as fringe benefits. Both types of benefits can help your employees meet needs that otherwise could not be met. In addition, providing your employees with benefits can result in significant tax savings. The IRS allows you to deduct the costs of providing your employees with both cash and noncash benefits if they qualify as a trade or business expense. In addition, certain benefits are excludable from your employees' gross income, reducing your taxable payroll. Finally, if you do provide your employees with benefits, the IRS requires that the value of the benefits be reasonable.

IRS rules for deductibility of benefits

For the IRS to allow you to deduct the cost of benefits that you provide to your employees as a trade or business expense:

- The expense must be an ordinary and necessary expense of your company's trade or business
- You must pay or incur the expense during the tax year in which you deduct the expense
- The expense must be in connection with a trade or business that you conduct

IRS rules for reasonableness

For you to deduct the costs of providing your employees with benefits, the value of the benefits must be reasonable. The IRS considers the following factors when deciding whether or not the benefits that you provide to your employees are reasonable:

- The corporation's size and financial condition (a large company that is financially stable can justify a large increase in compensation, while a small company that is financially unstable cannot)
- The role of the employee (employee's contributions to the success of the company)
- Whether or not you pay the compensation according to a structured program that you apply on a consistent basis
- The employee's compensation in comparison with what similar companies in similar industries pay for similar services
- Whether the company encourages an employee/shareholder, who is able to set his or her own compensation, to disguise nondeductible dividends as compensation

Tip: The IRS considers all of the elements of an employee benefits package (salaries, bonuses, fringe benefits, and retirement benefits) when it determines whether or not the compensation is reasonable.

Health-care reform

Employers are generally not required to offer health insurance coverage, however, under the health-care reform laws enacted in 2010, large employers may be subject to a penalty tax if they either do not offer coverage, or if the employee's contribution to the cost of employer-sponsored coverage exceeds a prescribed limit.

Beginning in 2014, an excise penalty tax will be assessed on an employer who meets all three of the following conditions:

1. The employer qualifies as an applicable large employer. An employer is an applicable large employer with respect to any calendar year if the employer had an average of at least 50 full-time employees during the preceding calendar year.

2. The employer fails to provide adequate health coverage. An employer will be considered to fail to provide adequate coverage if the employer: (a) does not offer coverage for all full-time employees, (b) offers coverage that is unaffordable, or (c) offers coverage that consists of a plan under which the plan's share of the total allowed cost of benefits is less than 60 percent.

3. Any full-time employee is certified to the employer as having purchased health insurance through a state exchange with respect to which a tax credit or cost-sharing reduction is allowed or paid to the employee.

Tip: An employer is not treated as employing more than 50 full-time employees if the employer's workforce exceeds 50 full-time employees for 120 days or fewer during the calendar year and the employees that cause the employer's workforce to exceed 50 full-time employees are seasonal workers.

Tip: In determining whether an employer is an applicable large employer, a full-time employee (for any month, an employee working an average of at least 30 hours or more each week) is counted as one employee and all other employees will be counted on a prorated basis.

Tip: The number of full-time equivalent employees that must be taken into account for purposes of determining whether the employer exceeds the threshold is equal to the aggregate number of hours worked by non-full-time employees for the month, divided by 120 (or another number as provided by regulations).

Amount of the penalty excise tax--no health-care coverage offered to full time employees

For employers who fail to offer health care coverage to full-time employees, and receive certification that at least one full-time employee has enrolled in health insurance coverage purchased through a state exchange with a premium tax credit or cost-sharing reduction allowed or paid, the penalty excise tax is equal to the number of full-time employees over a 30-employee threshold during the applicable month multiplied by one-twelfth of $2,000:

(Number of full-time employees - 30) x ($2,000/12).

This is true regardless of how many employees are receiving a premium tax credit or cost-sharing reduction.

Amount of the penalty excise tax--health-care coverage offered to full time employees

Employers who offer health care coverage to full-time employees may also face a penalty excise tax for any full-time employee certified as having enrolled in health insurance coverage purchased through a state exchange with a premium tax credit or cost-sharing reduction allowed or paid to such employee. A full-time employee who declines to enroll in an employer's health-care coverage may be eligible for a premium tax credit and cost sharing reductions as a result of joining a state exchange in one of two circumstances:

1. The employer health-care coverage consists of a plan under which the plan's share of the total allowed cost of benefits is less than 60 percent.

2. The employer health-care coverage is considered unaffordable for that employee. Unaffordable is

defined as coverage with a premium required to be paid by the employee that is more than 9.5 percent of the employee's household income.

In this case, the penalty, assessed on a monthly basis, equals one-twelfth of $3,000 for each full-time employee receiving a premium tax credit or cost-sharing subsidy through a state exchange for any month. The penalty tax is, however, capped at an amount equal to the excise penalty tax that would be due if the employer did not offer health-care coverage at all.

Example(s): (From the Joint Committee on Taxation's Technical Explanation of the legislation, JCX-18- 10, March 21,2010) In 2014, Employer A offers health coverage and has 100 full-time employees, 20 of whom receive a tax credit for the year for enrolling in a state exchange offered plan. For each employee receiving a tax credit, the employer owes $3,000, for a total penalty of $60,000. The maximum penalty for this employer is capped at the amount of the penalty that it would have been assessed for a failure to provide coverage, or $140,000 ($2,000 multiplied by 70 ((100-30)). Since the calculated penalty of $60,000 is less than the maximum amount, Employer A pays the $60,000 calculated penalty. This penalty is assessed on a monthly basis.

Other provisions

The 2010 health-care reform laws, which were intended to overhaul the U.S. health-care system, have significant implications for employers who offer health-care benefits and the workers and families covered by those plans. The following provisions became effective in 2010:

- Policies may no longer exclude coverage for children based on pre-existing conditions.
- Dependent coverage must be extended to children up to and including age 26.
- Plans may not impose lifetime dollar limits on coverage benefits, and by 2014, plans are prohibited from placing annual dollar limits on coverage, and plan waiting periods cannot exceed 90 days.
- The creation of a temporary high-risk pool that will provide subsidized premiums to individuals who have been unable to obtain coverage for at least six months due to pre-existing conditions. This program will expire on January 1, 2014, at which time plans are prohibited from excluding applicants due to pre-existing conditions.

In 2011, the laws eliminated coverage of many over-the-counter items under health FSAs and HRAs, and began treating reimbursements for the cost of such items from HSAs as taxable distributions.

Starting in 2014, all new health insurance plans must offer, at a minimum, an essential health benefits package as defined by the Secretary of Health and Human Services, but including the following benefits: (1) ambulatory patient services, (2) emergency services, (3) hospitalization, (4) maternity and newborn care, (5) mental health and substance use disorder services, including behavioral health treatment, (6) prescription drugs (7) rehabilitative and habilitative services and devices, (7) laboratory services, (8) preventive and wellness services and chronic disease management, (9) pediatric services, including oral and vision care. Existing individual and group plans need not meet this coverage mandate.

The laws also include an excise tax on so-called "Cadillac plans" (a Cadillac plan is an informal term for any unusually expensive health insurance plan). Starting in 2018, a 40 percent nondeductible excise tax will be levied on all employer-provided health insurance plans costing more than $27,500 for families and $10,200 for individuals (with increased limits for those considered to be in "high risk" professions).

Welfare benefit plans

In general

If you offer your employees an employee benefit plan, it is important for you to determine whether or not the plan qualifies as an Employee Retirement Income Security Act (ERISA) welfare benefit plan. Prior to the enactment of ERISA, the regulation of welfare benefit plans was erratic. As a result, ERISA was enacted to protect the interests of welfare benefit plan participants. The plan will qualify as an ERISA welfare benefit plan if it is a plan, fund, or program that you establish or maintain for the purpose of providing your employees with benefits such as the following: sickness, accident, disability, or life insurance; unemployment benefits; vacation benefits; apprenticeship or other training programs; day-care centers; scholarship funds; prepaid legal services; or holiday and severance pay plans.

> **Tip:** ERISA welfare benefit plans must conform to certain fiduciary, reporting, and disclosure requirements.

> **Tip:** An ERISA welfare benefit plan must be in writing and must name one or more fiduciaries to control the plan's operation and administration. ERISA considers an individual to be a plan fiduciary if the individual exercises discretionary authority or control over plan management and assets, gives investment advice regarding the plan for a fee, or has discretionary authority over the plan's administration.

Welfare benefit plans that are exempt from ERISA

The following types of welfare benefit plans are exempt from ERISA: government plans, church plans, state-mandated plans, plans of the U.S. government that are primarily for the benefit of nonresident aliens, and plans that provide benefits only for a select group of management or highly compensated employees.

Benefits that are not ERISA welfare benefits

ERISA welfare benefit plans do not include benefits such as overtime pay, the maintenance of employee recreation and dining areas, the maintenance of first-aid facilities, and distribution of gifts by an employer to employees on holidays.

IRS tax treatment of ERISA welfare benefit plans

The IRS allows you to deduct a limited portion of the cost of a welfare benefit plan. Assuming that you use the cash method of accounting and have established a qualified asset account (the account that holds the funds set aside by the business to provide for the benefits), you can deduct the fund's qualified cost. To arrive at the qualified cost, you use the following method:

Qualified cost (the amount the business provides for benefits)	=	Qualified direct cost (the total cost, including administrative expenses, that the business would deduct for benefits provided during the tax year if the business had provided benefits directly to the employee)	+	Additions made to the qualified asset account for the year

> **Tip:** If you pay more than the fund's qualified cost, you can carry the excess over to the next tax year.

> **Tip:** The process by which you calculate your deduction is extremely complicated and requires an intimate understanding of IRS tax rules. This discussion is intended to provide you with only a general understanding of the subject matter. For more information, consult additional resources.

Welfare benefit funds

Welfare benefit funds are methods of funding an employee welfare benefit plan. A welfare benefit fund allows you to prefund a plan by making deposits into the fund and using those deposits to purchase the welfare benefits at a later date. There are two types of welfare benefit funds: the welfare benefit trust, also known as a taxable trust, and the voluntary employees' beneficiary association (VEBA) trust, also known as a nontaxable trust. VEBAs and welfare benefit trusts are organizations that you establish to hold funds to pay benefits under an employee benefit plan. While income from the VEBA can be tax exempt, income from a welfare benefit trust is taxable. In certain situations, the IRS allows you to deduct contributions you make to a VEBA or welfare benefit trust in the year the benefits are paid out to your employees.

Cafeteria plans

In general

A cafeteria plan allows employees to choose from an array of benefits and customize a benefits package that is based on their individual needs. Employees can purchase benefits from the plan by using either a flexible spending account or a dollar amount that you previously allocated to them. The IRS may allow you to deduct contributions that you make to a cafeteria plan, depending on the types of benefits you provide under the plan. Furthermore, cafeteria plan benefits are not includable in your employees' gross income as wages, reducing your taxable payroll. A reduction in your taxable payroll results in a decrease in your payment of Social Security, Medicare, and federal unemployment taxes.

> **Tip:** The health-care reform laws passed in 2010 included a provision creating " SIMPLE cafeteria plans " for small businesses, effective for years beginning in 2011. Simple cafeteria plans are treated as meeting nondiscrimination requirements applicable to cafeteria plans if they meet certain minimum eligibility, participation and contribution requirements. This safe harbor also covers nondiscrimination requirements applicable to certain benefits offered under the cafeteria plan, including group term life insurance, coverage under a self-insured group health plan, and benefits under a dependent-care assistance program.

Methods of funding cafeteria plans

There are numerous ways to fund your cafeteria plan. A flexible spending account (discussion to follow) allows your employees to contribute pretax dollars to an account that may later be used to reimburse them for qualified expenses. A premium-only cafeteria plan allows you to pay for a certain amount of your employees' health coverage while your employees pay the remaining difference with pretax dollars through a salary reduction program. An add-on cafeteria plan provides basic low-level benefits to your employees and allows them to supplement or add to those benefits. Under an opt-up/opt-down cafeteria plan, you provide both high- and low-level benefits and allow your employees to either decrease or increase their level of benefits. A core plus option plan allows employees to supplement their benefits beyond the core benefits that you provide to them under the plan. Under a modular cafeteria plan, you combine certain benefits into packages and allow your employees to choose the benefit package that suits their particular needs. Under a full-flex cafeteria plan, you place a price on benefits and then give your employees a certain number of credits with which to purchase the benefits.

Flexible spending accounts

A flexible spending account (FSA) allows your employees to contribute pretax dollars to an account that may later be used to reimburse them for qualified expenses. Since contributions are made before taxes, employees save Social Security taxes, federal income tax, and, in most cases, state and local income taxes on the money they put into the account. Your employees' pretax contributions lower your gross payroll, resulting in a decrease in your matching payments of Social Security and Medicare taxes, as well as unemployment taxes.

> **Caution:** The health-care reform laws passed in 2010 set the limit on how much employees can set aside for FSAs. In 2013, the law limits the accounts to $2,500 (employers may also set their own lower limits) if the FSA is part of a cafeteria plan. FSAs can be used to pay for doctor's bills, prescription medicine, and certain other qualified medical expenses.

Health reimbursement arrangements

A health reimbursement arrangement (HRA) is an arrangement that allows employees to pay for medical costs using a pool of employer-provided funds (employees cannot make contributions). The HRA reimburses employees for qualified medical expenses, up to a maximum amount per coverage period. Reimbursements received by employees are not taxable income. Employees may carry over unused funds from year to year.

> **Tip:** Many employers who establish HRAs require high-deductible coverage to help fund the account.

> **Caution:** HRAs can be used to pay for doctor's bills, prescription medicine, and certain other qualified

medical expenses.

Health savings accounts

A health savings account (HSA) is a tax-favored vehicle where the funds are earmarked for medical expenses. An HSA must be combined with a high-deductible plan. Amounts contributed to the HSA belong to the employee and are completely portable, remaining with the employee if they switch jobs, become unemployed, or retire. Amounts left in the individual's account at his or her death may be bequeathed to a spouse or other beneficiary. Contributions made by employees may be either pretax if offered through a cafeteria plan or tax deductible (even if the employee does not itemize). Contributions you make are tax deductible in the year they are made as a business expense.

Caution: Beginning in 2011, tax-free HSA dollars could no longer be used to purchase most over-the-counter items not prescribed by a doctor. Also effective January 1, 2011, the tax on HSA distributions that are not used for qualified medical expenses increased to 20 percent from 10 percent.

Cash compensation

Although cash compensation is not traditionally thought of as an employee benefit, it plays a major role in your employee's overall benefits package. Most employee benefits are valued according to their cash equivalency, and many benefit plans have contribution schedules that are based on your employee's rate of pay. In addition, cash compensation appeals to many employers since it is easier to administer than traditional employee benefits. While the IRS reasonableness requirement applies to both the cash and noncash compensation in your employee's benefits package, it most frequently comes up when the IRS suspects the disguising of dividends, which are not deductible and must be included in your employees' gross income, as cash compensation. As a result, if the IRS sees a significant increase in an employee's cash compensation, you will have to show that the increase was reasonable. If the IRS denies a compensation deduction, it may recharacterize the payments as dividends.

Example(s): Acme Corp., a financially unstable company with 10 employees, pays $100,000 to an administrative assistant. Acme then treats the $100,000 as deductible compensation for tax purposes. The IRS will most likely determine that the $100,000 that Acme paid to the administrative assistant was not reasonable and therefore disallow the compensation deduction, treating it as a nondeductible dividend.

Caution: In addition to declaring that an employee's compensation is unreasonable, the IRS may issue negligence penalties for what it sees as excess deductions. The possibility of negligence penalties leads many corporations to enter into payback agreements with their employees. Payback agreements generally require an employee to pay back any excess cash compensation to the corporation if the IRS disallows a deduction for compensation. However, it is important to note that the IRS often sees these types of agreements as indicators that the company intended to reward the employee with unreasonable cash compensation.

Tip: Cash compensation benefits mainly arise in the context of regular or C corporations.

Tip: Certain publicly held corporations are subject to additional limitations for compensation in excess of $1 million.

Tip: For more information on IRS rules regarding cash compensation, see Section 162 of the Internal Revenue Code.

Tip: In general, the American Taxpayer Relief Act of 2012 permanently extended the preferential income tax treatment of qualified dividends and capital gains. Dividends are now taxed at a maximum rate of 20%. Because of the reduced tax rate for dividends, employees who are also shareholders may prefer dividends to wages, depending on their tax bracket. Dividends have the further advantage, for both the employee and the employer, of being free from payroll taxes.

Noncash/fringe benefits

Noncash benefits, also known as fringe benefits, can include the use of a company car, a country club membership, dependent care assistance, health insurance, and even tickets to sporting events. Unless the fringe benefit that you provide to your employee falls within certain exceptions, you must include the value of the fringe benefit in your employee's gross income as wages. You can determine the value of the fringe benefit by using either the general valuation rule or one of the special valuation rules. While you cannot deduct the value of the fringe benefits that you provide to your employees, you can deduct the costs of providing your employees with the fringe benefits as a trade or business expense.

General valuation rule and special valuation rules

General valuation rule

Under the general valuation rule, you must include in your employee's wages any amount over the fair market value (FMV) of a fringe benefit when it is more than:

- Any amount the employee paid for the benefit
- Any amount the law excludes from income

The FMV of a fringe benefit is the amount your employee would have to pay a third party to buy or lease the fringe benefit.

> **Tip:** When you provide your employee with a company car, the FMV of the car is the amount your employee would have to pay a third party to lease the same or a similar car in the same or similar circumstances.

Special valuation rules

Special valuation rules include the annual lease value rule, the vehicle cents-per-mile rule, the commuting rule, and the employer-operated eating facility rule. You can use the special valuation rules only if one of the following conditions is met:

- You treat the value of the benefit as wages for reporting purposes by the due date of the return for the tax year that you provide the benefit
- Your employee includes the value of the benefit in income by the due date of the return for the year the employee receives the benefit
- Your employee is not a control employee
- You demonstrate a good faith effort to treat the benefit correctly for reporting purposes

Section 132 benefits

In general

While you must include the value of most fringe benefits in your employee's gross income, there are certain noncash/fringe benefits that the IRS specifically allows you to exclude from your employee's wages. These fringe benefits are found in Section 132 of the Internal Revenue Code and include:

- No-additional-cost service
- Qualified employee discount
- Working condition fringe

- De minimis (minimal) fringe
- Qualified transportation fringe
- Qualified moving expense reimbursement
- Certain athletic facilities

Tip: Each of the Section 132 benefits is subject to its own rules and requirements. See Section 132 of the Internal Revenue Code for more information.

Caution: The exclusion is not allowed if another tax rule provides for the tax treatment of the fringe benefit (e.g., dependent care assistance and tuition reductions).

Tip: Certain nondiscrimination rules apply to no-additional-cost service and qualified employee discount fringe benefits.

No-additional-cost service

No-additional-cost service is when you provide your employee with a service at no additional cost to yourself. No-additional-cost services are usually found in excess capacity services, such as airlines, trains, buses, and cruises.

For example, an airline allows its employees to fly free on those planes that have empty seats. The airline is providing a no-additional-cost fringe benefit to its employees. By allowing its employees to fly free of charge on planes with empty seats, the airline provides its employees with a service that they sell to the general public, at no additional cost to the airline. The no-additional-cost service you provide to your employee is not includable in his or her income if you do not incur any substantial costs to provide that service to your employee. Also, you can claim a tax deduction for the cost of providing the service to your employees.

Qualified employee discount

A qualified employee discount is when you give your employee a price reduction on the same goods or services that you offer to your customers.

Tip: The no-additional-cost service and qualified employee discount benefits that you provide to your employees must be for goods or services that you offer for sale to your customers in the ordinary course of the same line of business in which the employee who receives the goods or services performs substantial services.

Working condition fringe

Working condition fringe benefits include any property or service that you provide to your employee where if the employee paid for the property or service, he or she could deduct it as a business expense. You can claim a business deduction for the cost you incur providing the property or service. A working condition fringe benefit can include benefits such as a company car or educational assistance.

De minimis (minimal) fringe

A de minimis fringe benefit includes any property or service that you provide to an employee that has so small a value that it would be unreasonable or administratively impractical to account for it. De minimis fringe benefits include use of a secretary to type a personal letter, occasional personal use of a copying machine, and occasional tickets to entertainment events. You can deduct the cost of a de minimis fringe benefit if the benefit is ordinary and necessary to your business.

Example(s): Acme Corp. allows its employees to use the photocopy machine for personal use. Acme estimates that the photocopy machines are used for company business 90 percent of the time and that employees use the photocopy machines for personal use 10 percent of the time. Since the employees' personal use of the photocopy machines is minimal, it would qualify as a de minimis fringe benefit.

Qualified transportation benefits

Qualified transportation benefits for employees include transportation in a commuter vehicle, a transit pass, or qualified parking. Qualified transportation benefits are, within certain limits, excludable from your employees' gross income. The value of a qualified transportation benefit is based on the benefit's FMV.

Qualified moving expense reimbursement

Qualified moving expense reimbursements are amounts that you give to your employee, directly or indirectly, as a payment for, or a reimbursement of, expenses that would be deductible as moving expenses if your employee paid or incurred them. Deductible moving expenses include the moving of household goods and personal effects from the former home to the new home, and traveling from the former home to the new home.

> **Tip:** There is no dollar limit on the exclusion for qualified moving expense reimbursements. However, the expenses must be reasonable and substantiated.

Athletic facilities

Athletic facilities include any on-premises gym or other facility that you provide to your employees. The exclusion does not apply if you make access to the athletic facility available to the general public.

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AKD Consultants
Adam Dworkin
CPA
188 Whiting Street
Suite 10
Hingham, MA 02043
781-556-5554
Adam@AKDConsultants.com

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