

Chapter 23

REVIEW OF FRINGE BENEFITS AND BUSINESS DEDUCTIONS

Fringe benefits and tax deductions are areas which you will discuss with your accountant and attorney in detail. For this reason, the tax code sections have been included as a tool to assist your advisors. Although the tax code provisions change over time, the code section numbers typically remain unchanged.

Fringe Benefits

Although the limited liability available to a C corporation's or professional C corporation's, shareholder(s) is generally regarded as a major non-tax advantage in choosing the corporate form of doing business, for federal income tax purposes, C corporations have traditionally offered both owners and employees a greater number of tax-favored fringe benefits than other entities. This is changing, however. For fringe benefits, the cost of tax benefits are tax-deductible to the practice and the values of the benefits are tax-free to the employee, provided that appropriate documentation is prepared. For a comparison of fringe benefit plans, Figure 23-1 has been included.

Accident and Health Plans

Amounts paid by C corporations for accident and health plans are deductible under IRC Section 162 and such amounts are not includable in the income of the employees, including owners, under IRC Sections 105 and 106. Non-C corporation practice owners can deduct 60% of health insurance premium costs through 2001, 70% in 2002 and 100% in 2003 and thereafter. IRC Section 162(l).

Unlike self-insured medical plans, there are no non-discrimination tests which presently apply to medical benefits fully provided through accident and health insurance policies. Therefore, these benefits may be offered to employees on a "selective" or "discriminatory" basis by employers.

A self-insured medical plan must satisfy certain "non-discrimination" rules under IRC Section 105 to be completely tax free, e.g., 70% of eligible employees working more than 25 hours per week. The 25 hours per week is typically a "small group" health coverage requirement imposed by many states. IRC Section 105(h) provides for 25 to 35 hours depending upon the customary hours worked for full-time status in the business in question. A medical plan is self-insured unless reimbursement is provided under an individual group policy of accident or health insurance issued by a licensed insurance company or under an arrangement resembling a prepaid health care plan that is regulated under state or federal law in a manner similar to the regulation of insurance companies. IRC Reg. 1.105-11(b)(i).

Self-insured medical plans are considered discriminatory if they favor highly compensated individuals with regards to either eligibility or benefits or if they discriminate in operation. However, routine medical diagnostic procedures, including physical examinations, are an exception to these regulations. IRC Reg. 1.105-11(g).

Under the 1988 Technical and Miscellaneous Review Act, COBRA, employers with 20 or more employees are generally required to provide terminated employees, their spouses and dependents, if covered under a group health plan, an opportunity to continue to receive such coverage that would otherwise be terminated, subject to the payment of premiums. IRC Section 4980(B). State laws usually require continuation coverage for employers with fewer than 20 employees and take the place of COBRA for small employers.

Long-Term Care Plans

Long-term care insurance is now treated as a deductible medical expense under IRC Section 213(d) and the premiums are deductible subject to limits under IRC Section 7702B. In other words, long-term care insurance is now treated like hospitalization insurance premiums for purposes of deductibility.

Disability Income Plans

Disability income plans are intended to protect employees against the risk that their ability to earn a living will be interrupted or terminated by a disability. Costs for disability insurance are deductible by C corporations under IRC Section 162. In general, if a disability income plan is implemented so that premium payments are included in the income of the employee, the benefits paid under such a plan are not taxable. If premiums are not includable, then the benefits are taxable. However, a more aggressive position regarding reimbursements of disability income premiums by the corporation is set forth in Letter Ruling 8027088. Premiums for disability income insurance are not deductible by sole proprietors, partners or more than a 2% S corporation shareholders.

Group Term-Life Insurance

IRC Section 162 provides a deduction for a C corporation's payment of premiums on group term life insurance for its employees. IRC Section 79 excludes the first \$50,000.00 of coverage from income of an employee. Premiums in excess of the \$50,000 coverage are taxable based on IRS tables. Premiums are not deductible by sole proprietorships, partnerships or more than 2% S corporation shareholders.

Dependent Care Assistance Plans

Pursuant to a separate written plan under IRC Section 129, employees can receive tax free dependent care assistance up to \$5,000.00 annually, \$2,500 for married individuals filing separate returns. Qualified individuals for dependent care assistance are dependent children under thirteen (13) years of age and spouses or dependents who are no longer capable of taking care of themselves, regardless of age. IRC Section 21(b).

Unlike some other fringe benefits, dependent care assistance programs are not limited only to C corporations, but are available to sole proprietorships, partners and more than 2% S corporation shareholders.

Achievement Award Plans

In general, gross income of an employee includes amounts received as prizes and awards. However, there is an exception for employee achievement awards under IRC Section 274(j) and 74(c), provided that the cost to the employer does not exceed the amount deductible by the employer.

A deduction is available to the employer under IRC Section 274(j) only for the cost of an employee achievement award made to the employee which: (i) if not a "qualified plan award", does not exceed \$400 when added to the cost of all other employee achievement awards made to the employee during the taxable year which are not "qualified plan awards"; or (ii) if a "qualified plan award", does not exceed \$1,600 when added to the cost of all other employee achievement awards during the taxable year, including employee achievement awards which are not "qualified plan awards". IRC Section 274(j)(2)(A),(B).

An "employee achievement award" must be tangible personal property which is awarded as part of a "meaningful" presentation.

Education Assistance Plans

An educational assistance program under IRC Section 127 allows an employee to receive up to \$5,250 tax free annually for educational expenses pursuant to certain statutory requirements. Educational expenses include tuition, fees, books, supplies, and equipment. Educational expenses do not include the payment for tools or supplies, which may be retained by the employee after completion of a course of instruction, or meals, lodging or transportation. Graduate course expenses are no longer excludable.

Irrespective of IRC Section 127, expenses for continuing education related to your professional profession are deductible. However, a doctor becoming a lawyer would not qualify as it is another profession. Similarly, a dental assistant becoming a hygienist would be another example of non-deductibility for continuing education related to the employee's existing profession.

Cafeteria Plans

A cafeteria plan under IRC Section 125 offers employees a choice between one or more qualified fringe benefits and cash. The primary advantages of such a plan are as follows: (i) the corporation can limit its present and future cost of providing fringe benefits; e.g., health insurance, by allowing pre-tax contribution on behalf of employees obtaining benefits from such plan; (ii) the employee has the ability to "tailor" certain fringe benefits according to the employee's needs, such as health insurance, group-term life insurance, disability insurance or dependent care assistance on a pre-tax basis, or receive cash, and be taxed currently; and (iii) the benefits are not subject to Federal employment taxes, saving both the corporation and employee Social Security taxes. While in a single year the effect of these benefits may not appear significant, the accumulative effect of such benefits may be substantial. It should be noted that cafeteria plans must file a Form 5500 for each year and your accountant should be alerted prior to the adoption of such a plan.

There is legislation pending which would allow sole proprietors, partners and more than two percent S corporation shareholders to participate in cafeteria plans.

Summary Plan Descriptions

Generally, fringe benefit plans are regulated by the Department of Labor through ERISA, the Employee Retirement and Security Act of 1974. ERISA plans are defined in Section 3(1) of the Treasury Regulations. Plans covered by ERISA include health and medical insurance plans, disability plans, group-term life insurance plans and employee assistance programs.

For any fringe benefit plan covered by ERISA, the employer is required to provide the employee/participant with a summary plan description ("SPD") within 120 days of the commencement of the plan under Treasury Regulation 2420-102-3. The SPD is the basic disclosure document required by ERISA which designates the eligibility, benefits and other statutory provisions to participants. The SPD's required for fringe benefit plans are substantially similar to the SPD which is required under ERISA for tax-qualified retirement plans. The SPD is designed to inform participants and beneficiaries of their rights and obligations under the plan. Because insurance companies do not want the fiduciary responsibility of the employer, the insurance booklet typically does not qualify as an SPD under ERISA.

It is not that difficult to prepare and distribute SPDs, which must be updated and redistributed after any significant changes to the ERISA plan are made or after a certain time period. However, the problem is that most business and practice owners are not aware of the SPD requirements. Don't let the SPD requirements overly concern you. Just understand that they are required by ERISA and make sure that they are prepared and distributed by your advisor(s).

Business Deductions

Entertainment and Meal Expenses

Deductions for entertainment and meal expenses are allowable, subject to the 50% limitation, if the taxpayer establishes that the activity was either:

- (a) directly related to or
- (b) directly preceding or following a substantial and bona fide business discussion which related to the active conduct of the taxpayer's business. IRC Section 274(a)(1)(A).

Questions and Answers

- (1) What is "directly related to" mean?

In order for entertainment to be directly related to business, there must be evidence of all of the following:

- (a) the taxpayer has more than a general expectation of deriving some income or benefit, other than goodwill, at some indefinite time in the future; and
 - (b) the taxpayer engaged in a business discussion; and
 - (c) based upon the facts and circumstances, the principal character of the event was the active conduct of business; and
 - (d) the expenditure is allocable to the taxpayer and the person(s) engaged in the active conduct of business. Reg. Section 1.274-2(c)(3).
- (2) How does a taxpayer prove that the entertainment was directly related to its business?

The taxpayer must substantiate the entertainment through adequate records or by sufficient evidence corroborating the taxpayer's own statements, including the:

- (a) amount of the expenditure; and
 - (b) time and place of the entertainment and business discussion, if before or after the entertainment; and
 - (c) business purpose of the entertainment; and
 - (d) business relationship of the individual's involved. IRC Section 274(d).
- (3) What will the IRS accept as substantiation?

An account book, diary, statement of expense or similar record prepared at or near the time of the entertainment setting forth the items noted above will fulfill this requirement. Reg. Sections 1.274-5(c) and 1.275-5T(c).

Examples of substantiation include the following statements:

- (a) April 3 — Lunch and tip (\$64.00); Favorite Restaurant, Chicago, Illinois, with general dentist [add name] concerning referrals and cases in progress for [add name(s)] of patients.
 - (b) January 6 — Taxi and tip (\$12.00); Drinks at bar and tip (\$24.00); dinner (\$198.00) and tip (\$40.00) at Favorite Restaurant, Washington, D.C.; Entertainment of general dentist [add name] following our business meeting at my office re: referrals and specific cases of [add name(s)].
- (4) Can I just give the tickets to referral sources or patients?

An event is not directly related to business when the taxpayer is not present at the event and, therefore, is not deductible. The event tickets will be deemed to be a

gift; and a business gift is deductible up to \$25.00, per recipient, per year. Reg. Sections 1.274-2(b)(1)(iii)(b)(2) and 1.274-3(a). For example, the specialty practice gives doctor A four tickets to a baseball game valued at \$160.00. The specialty practice may only deduct \$25.00 as a business gift if it is substantiated, e.g., August 23, 2____, — four baseball tickets, valued at \$160.00, given to doctor A to take doctor A's family to the game.

(5) How are season tickets to events treated?

Each ticket must be treated separately and must be substantiated separately. Rev. Proc. 63-4.

(6) What if you do not substantiate the entertainment?

- (a) Effect to the employer — the employer will not be able to deduct any amounts paid for the entertainment. IRC Section 274(a)(1)(A). However, the employer may deduct the expense if it is treated as compensation.
- (b) Effect to the employee — the employee may have to include the entertainment amount as income. IRC Section 61 defines gross income as all income, from whatever source derived. Therefore, any nonexcludable fringe benefit would be considered as additional compensation and includable in income. Reg. Section 1.61-21. However, compare Reg. Sections 1.132-6(c)(1) and (2) — examples of benefits excludable from income include occasional sporting event tickets and examples of benefits not excludable as de minimis fringes include season tickets to sporting events.

If the IRS determines that entertainment expense may not be properly deducted by the employer and that the expense was made for the employee's personal purposes, the IRS will treat that expense as a constructive dividend under IRC Section 61(a)(7). *See: Erickson v. Comm.*, 598 F.2d 525 (9th Cir. 1979); *Ashby v. Comm.*, 50 T.C. 409 (1968); *Challenge Manufacturing Company v. Comm.*, 37 T.C. 650 (1962); and *Henry Schwartz Corporation v. Comm.*, 60 T.C. 728 (1973). To the extent that the employee can demonstrate that the entertainment expense was not for his/her personal benefit, or was not all for his/her personal benefit, the IRS may determine what portion is properly allocated as a business expense. However, without the substantiation as required by IRC Section 274, the employee is at the mercy of the IRS to make this determination.

How does a taxpayer prove that during the entertainment, there was an active business discussion?

The taxpayer must prove the following elements:

- (1) Proximity. At the time the taxpayer makes or commits to the expenditure, he/she must have more than a general expectation of deriving some business benefit at some indefinite future time. If the purpose of the expenditure is only to establish business goodwill, this part of the test is not met. Reg. Section 1.274-2(c)(3)(i); *Rowell v. Comm.*, 884 F.2d 1085 (8th Cir. 1989); *Hippadrome Oldsmobile, Inc. v. U.S.*, 474 F.2d 959 (6th Cir. 1973); *J.E. Gardner*, 45 TCM 1116 (1983), oral surgeon's cocktail party attended by referring doctors, dentists and their spouses was not directly related to the active conduct of the taxpayer's practice, but was merely to create goodwill.
- (2) Active conduct of business. The taxpayer must show that during the entertainment he/she was actively engaged in a business meeting, negotiation, discussion or other bona fide business transaction for the purpose of obtaining a business benefit. Reg. Section 1.274-2(c)(3)(ii). In order to meet this requirement, the taxpayer must be present at the entertainment. *Rowell v. Comm., Id.* Additionally, the Sixth Circuit held that to satisfy this portion of the test, the taxpayer must not only be present, but must seize the initiative to discuss business. In *Hippadrome Oldsmobile, Inc.*, the active conduct of business was not met where the taxpayer's representatives entertained on the taxpayer's boat and waited for the customers to bring up business topics. The Regulations presume that there is no active conduct of business where there is little or not possibility of engaging in the active conduct of a business during the entertainment unless the taxpayer clearly establishes the contrary. For example, there are substantial distractions at a night club or cocktail party; therefore, the active conduct of the business is presumed not to have been met. Reg. Section 1.274-2(c)(7).
- (3) Principal aspect. The principal aspect of the combined business and entertainment must have been the active conduct of a business. The taxpayer need not demonstrate that more time was devoted to the business than the entertainment; however, the taxpayer must prove that the principal purpose of the gathering was business. Reg. Section. 1.274-2(c)(3)(iii).
- (4) Exclusion of non-business guests. The expenditure must be attributable to the taxpayer and a person with whom the taxpayer engages in business. Reg. Section 1.274-2(c)(3)(iv).

If any information relating to the business purpose is confidential, such information need not be stated in the statement of expense or similar record, provided such information is recorded at or near the time of the expenditure and is elsewhere available to the district director to substantiate such element of the expenditure. Reg. Section. 1.74-5(c)(2)(ii)(c).

Expense Reimbursement Plans

IRC Section 62 discusses reimbursement of expenses to employees by employers. This Section distinguishes accountable and nonaccountable expense reimbursement plans. Amounts

paid to employees under accountable plans are: (i) excludable from the employee's gross income; (ii) are not reported as wages on the employee's Form W-2; and (iii) are excludable from the withholding and payment of employment taxes. Reg. Section 1.62-2(c)(4). Alternatively, amounts paid by employers to employees under nonaccountable plans must be included in the employee's income. Reg. Section 1.62-2(c)(5).

Expenses which meet the following conditions are accountable expense reimbursement plans, Reg. Section 1.62-2(c)(2):

- (1) there must be a business connection for the expenses, Reg. Section 1.62-2(d);
- (2) the employee must substantiate the expenses, Reg. Section 1.62-2(e); and
- (3) the employee must return to the employer amounts in excess of the substantiated expenses, Reg. Section 1.62-2(f).

If the practice maintains an accountable expense reimbursement plan and expenses reimbursed to practice's employees are excludable from their gross income, are not reported as wages on Form W-2 and are not subject to withholding and employment taxes.

If an expense does not meet the accountable plan criteria of Reg. 1.62-2(c)(2), the expense would be considered a non-accountable plan and any amounts paid to the doctor in this situation would be includable in the doctor's income and would be reportable as wages on Form W-2. Reg. 1.62-2(c)(5). Alternatively, the amount includable in the doctor's income would be deductible by the practice as compensation. Reg. 1.274-2(f)(2)(iv)(b)(2).

In the event that a meal or an entertainment event, assuming such expense to be business related, e.g., lunch or sporting event with a referring doctor, would not qualify as a business deduction under IRC Section 162 or Section 274 for any reason, e.g., no substantial business discussion, the expenditure was for general goodwill, etc., IRC Section 274(e)(3) provides specific rules for determining whether the employer or employee assumes the risk of disallowance in order to prevent the double disallowance of a single expenditure. In other words, an employer may not deduct a business expense which is non-deductible under the expense disallowance Regulations of IRC Section 274, unless the employer treats the expenditure as income to the employee. Reg. 1.274-2(f)(2)(iv)(b)(1). If the expense is treated as income to the employee, the employer may deduct the expense as compensation. It should be noted that there are no Regulations, or other rules, which prohibit an employer from determining its expense reimbursement policy.

Where the doctor is an owner of the practice and the expense is of a personal nature, the non-deductible portion of the expense, in all likelihood, would be considered a dividend under Reg. 1.61-9. See *Challenge Manufacturing Company v. Comm.*, 50 T.C. 409 (1968).

Certain expenses under a non-accountable plan may be considered "di minimis" under Reg. 1.132-6(c)(1) and (2). If a doctor who receives the benefit is a practice owner, e.g., baseball tickets to a practice owner and his or her family members, the di minimis argument may have merit, depending upon the degree of personal use of the tickets. At a minimum, sports tickets to

practice owners should be considered as to their tax character on a ticket-by-ticket basis. Arguably, sports tickets for the personal use of practice owners and their family members would be considered as dividends, taxable to the practice owners under Reg. 1.62-9. However, to the extent that certain tickets are used for business entertainment, those tickets would be tax-deductible by the practice and not includable in the practice owner's income under the accountable plan rules of Reg. 1.62-2(c)(2). Additionally, the single disallowance rules under IRC Section 274(e)(3) would also be applicable in the event that there would not exist a business connection, e.g., no substantial business discussion, which would not be tax deductible under IRC Section 162 or Section 274.

The chart contained in Figure 23-2 should assist in understanding the tax treatment of business expenses in various situations.

Record Keeping Requirements

Taxpayers are required to substantiate four elements of each business expense taken as a deduction. The requirements are: (1) amount, (2) time and place, (3) business purpose, and (4) business relationship.

According to the IRS, taxpayers must substantiate every element of each expenditure by adequate records supported by the appropriate documents, or by sufficient corroboration of the taxpayers oral statement. For IRS purposes, the value of written documentation holds greater weight than does an oral statement made by the taxpayer. Also, the value of written documentation recorded "at" or "near" the time of the expenditure is given greater weight than is documentation made later in time.

An adequate record is an account book, diary, statement of expense or similar record in which the taxpayer records each of the required elements for the expenditure "at" or "near" the time of the expenditure. Adequate records must be supported by documentation evidence, such as a receipt, for any expenditure which is \$75.00 or more.

Where a taxpayer's records are lost due to circumstances beyond his or her control, such as in a fire, flood, earthquake or some other casualty, the taxpayer may substantiate his or her expenses by making a "reasonable construction" of them.

Automobile Expenses

Automobile expenses are deductible to the extent that the taxpayer uses the automobile in a trade or business.

Automobile expenses incurred in traveling between the residence and place of business are nondeductible personal expenses. Also nondeductible is the trip from home to the first place of business and the return trip home from the last place of business. Automobile operating costs can include the cost of gas, oil, repairs, tires, as well as insurance, storage, depreciation, taxes, registration, interest, automobile club, parking fees and tolls. Some costs are required to be capitalized, such as the purchase of a new car, and must be recovered through depreciation tables supplied by the IRS. If you lease an automobile for business, leasing costs are deductible, in

addition to the operating expenses paid. Deductible rental costs are in lieu of depreciation paid by the lessor.

Where an individual uses his or her car for business and personal purposes, an apportionment of the total expense must be made, usually on a mileage basis, to determine the part of the expense that can be deducted. As with other business expenses, the IRS requires the taxpayer to substantiate automobile deductions by adequate records. In addition, for automobiles, the records must show the business miles as well as the total miles driven during the tax year. Taxpayers are required to keep a diary that shows the amount of the expenditure, the time and place, the business purpose, and a description of the expense. To avoid a need for the computation and substantiation of actual automobile expenses, the taxpayer can elect to use the standard mileage rate supplied by the IRS, but still must maintain mileage records.

Purchasing an Automobile

Almost every year, the IRS has increased the standard mileage rate for business use through legislation. At the time of this writing, the rate is 32.5¢ per mile. The taxpayer should note that the mileage rate may change from year to year.

Where a taxpayer uses the standard mileage rate, parking fees, tolls, interest expenses, plus state and local taxes are still deductible business expenses.

There are dollar limits in effect on depreciation write-off and first year expensing for passenger automobiles, even if the car is used 100% for business.

Leasing and Automobile

For taxpayers leasing mid-priced and luxury automobiles, there is an annual income inclusion that reduces the deduction for lease payments. This inclusion is leasing's equivalent to the depreciation limits that apply when an automobile is purchased.

The inclusion amount is calculated from tables supplied by the IRS. Different tables are provided whenever depreciation limits change. There are separate tables depending on what year the automobile was leased. Tables have also provided for additional inclusion amounts where business use of the automobile is less than 50%.

When determining whether to purchase or lease an automobile, the taxpayer should have his or her accountant compare the costs and potential tax savings of each method after the net cost of the automobile is determined. It is important to know whether the dealer is basing the loan or lease payments on the retail price or what the dealer could actually sell the car for.

In attempting to determine whether mileage is deductible for business purposes or for personal use, the accountant should review Figure B, "When are Local Transportation Expenses Deductible?" from IRS Publication 463; Travel, Entertainment, Gift and Car Expenses.

Deductible Travel Expenses

Travel expenses are normally deductible for business related to your practice or continuing education. Travel costs include travel, meals, lodging, transportation, plus a reasonable amount for baggage, telephone and fax services, and the costs of maintaining and operating a car for business purposes.

Travel expenses are not allowed for a spouse, dependent, or other individual who accompanies the taxpayer on a business trip unless such person is an employee of the person who is paying or reimbursing the expenses, or the travel of such person serves a legitimate business purpose.

Travel expenses of a taxpayer who travels outside the United States must be allocated between the time spent on the trip for business and time spent for pleasure. However, when the trip is for more than one week or when time spent on personal activities of the trip is less than 25% of the total away from home, no allocation is required under IRC Section 274(c)(2).

If the trip is primarily personal in nature, travel expenses are not deductible even though the taxpayer engages in some business activities while at the destination. However, business expenses incurred while at the destination are deductible even though the travel expenses are not. IRC Reg. 1.162-2(b).

Many practice owners do not use statutory fringe benefit plans or take available deductions available to them through their practices. These topics should be included as agenda items for any annual year-end meeting with the accountant and attorney for the practice.