LAW OFFICES
WEBSTER, CHAMBERLAIN & BEAN, LLP
1747 PENNSYLVANIA AVENUE, N.W.
WASHINGTON, DC 20006
(202) 785-9500
FAX: (202) 835-0243

ARTHUR L. HEROLD
ALAN P. DYE
EDWARD D. COLEMAN
FRANK M. NORTHAM
JOHN W. HAZARD, JR.
HUGH K. WEBSTER
DAVID P. GOCH
JAMES S. WILSON, JR.
CHARLES M. WATKINS
HEIDI K. ABEGG
DAVID M. ABRAHAMS
JOHN R. STROUT
SARAH E. MOONEY

GEORGE D. WEBSTER (1921-1996)
CHARLES E. CHAMBERLAIN (1917-2002)

OF COUNSEL
J. COLEMAN BEAN
KENT MASTERSON BROWN*
MICHAEL P. FARRIS

* NOT ADMITTED TO D.C. BAR

MEMORANDUM

To: Employers

From: Chip Watkins

Date: September 16, 2011

Re: **Taxation of employer-provided cell phones and reimbursements for business use of personal cell phones**

On September 14th, the IRS issued two documents addressing (1) the tax treatment of the value of employer-provided cell phones and (2) the tax treatment of reimbursements by an employer to an employee for the business use of the employee's personal cell phone.

Notice 2011-72

In Notice 2011-72, the IRS finally conceded that personal use of employer-provided cell phones will not be taxable when the employer provides the cell phone to the employee "primarily for noncompensatory business reasons."

An employer provides a cell phone to an employee primarily for noncompensatory business reasons when 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." Examples of such reasons include "the employer's need to contact the employee at all times for work-related emergencies, the employer's requirement that the employee be available to speak with clients . . . when the employee is away from the office, and the employee's need to speak with clients located in other time zones at times outside of the employee's normal workday."

Under these conditions, the employee's use of the cell phone in the employer's business is a working condition fringe benefit, and the employee's use for personal purposes will be treated as a *de minimis* fringe benefit. In either case, the value is excludible from gross income under §132 of the Internal Revenue Code.

In contrast, providing a cell phone to promote morale or good will, to attract a prospective employee, or to furnish additional compensation to an employee is evidence that there is no noncompensatory business reason.

An issue not addressed in Notice 2011-72 is how frequently the "need" must occur in order for the reason to be substantial. This will necessarily be determined on a facts and circumstances basis, but in determining whether a business reason is substantial, employers should consider balancing the frequency of actual need against the seriousness of the potential consequences if the employee cannot be reached by cell phone. Will the building be flooded? Or will someone merely be inconvenienced until the following day? If the "need" rarely or never arises, the IRS might question whether the "noncompensatory business reason" is "substantial."

Memo to auditors

In a complementary memo to its auditors, the IRS said that when the employer requires employees to maintain and use a personal cell phone for substantial noncompensatory business purposes, and reimburses employees for business use of the cell phone, auditors "should analyze reimbursements of employees' cell phone expenses in a manner that is similar to the approach described in Notice 2011-72. . . . However, the employee must maintain the type of cell phone coverage that is reasonably related to the needs of the employer's business, and the reimbursement must be reasonably calculated so as not to exceed expenses the employee actually incurred in maintaining the cell phone. Additionally, the reimbursement . . . must not be a substitute for a portion of the employee's regular wages."

The memo does not address how a reimbursement should be analyzed when the employee has a family plan with multiple phones, but it is safe to assume that the IRS would permit an exclusion only for the cost of the first phone on the plan, and that reimbursement for the marginal costs attributable to phones used by non-employee family members would be includible in gross income. For example, assume the first phone on a family plan costs $70 per month, and additional phones are $15 per month. I believe the IRS would allow reimbursement for $70 to be excludible, but not the $15 for additional phones.

Substantiation

The memo to auditors does not address substantiation of reimbursements. However, reimbursements of business expenses are generally excludible from gross income only if the employee substantiates (among other things) the amount of the expense. Nothing in the IRS guidance suggests that this substantiation rule does not apply. Thus, employers that reimburse an employee for costs attributable to business use of a personal cell phone should require the employee to submit a copy of the monthly bill and evidence that the bill has been paid.

Employer response

The IRS position is quite favorable. However, employers should review their policies for determining which employees are provided with cell phones, or reimbursed for business use of personal cell phones, to ensure that they have a substantial noncompensatory business reason for doing so. In general, this analysis should be conducted with respect to each employee. Most employers may generally have substantial noncompensatory business reasons for providing a cell phone (or reimbursing costs) for senior management, professionals, outside sales staff, and other employees who are frequently out of the office during the workday. It will be more difficult to justify providing a cell phone to non-management, support, or facilities staff

If an employer does not have a substantial noncompensatory business reason for providing a cell phone to an employee, or reimbursing the employee for business use of his personal cell phone, the value of the use of the phone, or the amount of the reimbursement is includible in gross income, reportable on Forms 941 and W-2, and is subject to federal and state employment tax withholding.

In the case of employers that are exempt from income tax under §501(c)(3) or §501(c)(4), the unreported value of taxable cell phone use by, or reimbursements to, an officer, director, or key employee may also be an "automatic" excess benefit transaction. If so, to correct the transaction, the individual would be required to repay the employer for the value of the use, and pay a 25% excise tax to the IRS.

Copies of Notice 2011-72 and the memo to field auditors are available at http://www.irs.gov/pub/irs-drop/n-11-72.pdf and http://www.irs.gov/pub/foia/ig/sbse/sbse-04-0911-083.pdf, respectively.