

# **TAXATION OF PERSONAL USE OF BUSINESS CELL PHONES**

## **ISSUE**

Under the Internal Revenue Code (Code), there are some quirky rules for determining what is a fringe benefit to an employee and for determining what is included in a subset of fringe benefits known as “working condition fringe benefits.” While we suspect most employers and employees would not consider an employer-provided cell phone to be a “fringe benefit,” it is.

If an employer provides a cell phone to an employee (including the owner), and the employer acquires and pays the costs of using the cell phone, the assumption under the Code is that the employee receives a fringe benefit. To the extent that the employee uses the employer’s cell phone for business purposes, the fair market value of such usage qualifies as a working condition fringe benefit excludable from the employee’s gross income. As such, the cell phone expense is a deductible business expense for the employer, PROVIDED that the substantiation requirements of the Code are met. (The substantiation requirements are requirements that most small business owners are familiar with, since these are the same ones that apply for documenting business use of cars and computers.)

To the extent the employee uses the employer’s cell phone for personal purposes (i.e., only a portion can be substantiated as business use), the fair market value of such personal use is includable in the employee’s gross income.

What happens if the employee fails to substantiate the business use? The ramification for the employee is income tax liability on the imputed income as well as FICA tax (7.15 percent). The ramification for the business is the additional FICA tax (7.15 percent) on the amount of imputed income. In addition, the business will lose a portion (or all, if no substantiation) of the deduction for the cost of the purchase of the telephone (probably a Section 179 direct expensing deduction for the full amount, but a depreciation deduction over ten years otherwise) and lose a portion (or all, if no substantiation) of the deduction for the on-going service charges. Since some or all of those expenses will now be income to the employee, those expenses should still be deductible as wages, and the business exposure should be limited to the employer’s FICA tax on imputed income equivalent of those costs.

For the self-employed, it basically means paying for it with after tax dollars

The section of the Code that defines the property for which substantiation is required includes the phrase: “any cellular telephone (or other similar telecommunications equipment).” So yes, your Blackberry is covered too.

## **STATUS**

The issue is being raised in audits. Universities have been among the early targets. Very few employers and employees are aware that personal use of a business phone might create taxable income for the employee and therefore few are keeping records to substantiate the business use.

A regulatory effort to provide some recordkeeping relief has been initiated by the IRS. Several bills have been introduced to eliminate the recordkeeping requirement. Representative Sam Johnson (R-TX) has introduced H.R. 690, the Modernize Our Bookkeeping in the Law for Employees' Cell Phone Act of 2009. In the Senate, Senators John Kerry (D-MA) and John Ensign (R-NV) have introduced the companion bill, S. 144.

## **RELIEF**

### *Regulatory*

The IRS has proposed three alternatives for substantiating the business use. They would be optional and the employee could still keep detailed records. The three options under consideration are:

#### 1. Minimal Personal Use Method

The IRS is considering two proposals that would allow an employer to deem all of an employee's usage of an employer-provided cell phone as business usage. Under the first proposal, the entire amount of an employee's use of an employer-provided cell phone would be deemed to be for business purposes if the employee can account to his or her employer with sufficient records to establish that the employee maintains and uses a personal (non-employer-provided) cell phone for personal purposes during the employee's work hours.

Alternatively, the second proposal would define a specified amount or type of "minimal" personal use that would be disregarded in determining the amount of personal use of an employer-provided cell phone. For example, "minimal" could be defined by reference to a particular number of minutes of use or for certain personal purposes.

#### 2. Safe Harbor Substantiation Method

The IRS is considering a safe harbor method under which an employer would treat a certain percentage of each employee's use of an employer-provided cell phone as business usage. The remaining percentage of use would be deemed to be for personal purposes. For this proposal, the IRS is proposing a business use percentage of 75 percent.

#### 3. Statistical Sampling Method

The IRS is considering a proposal that would allow employers to use statistical sampling techniques to measure an employee's personal use of an employer-provided cell phone. The employer would multiply that percentage times the value of each employee's total usage to determine the value of personal usage. The remaining portion of the employee's usage would be deemed to be for business purposes.

### *Legislative*

H.R. 690 and S. 144 delete the reference to cellular telephones and similar equipment in the section of the Code that requires substantiation of the business use.

## **OUTLOOK**

We expect the IRS to adopt one or more of the simplified substantiation requirements. Will that make the issue go away? While not the highest priority on anybody's tax relief list, even with simplified options, the more the IRS audits, the more likely Congress will provide relief. That's because this requirement falls into the nuisance category to which everybody can relate. The "problem" is that it just has not become a nuisance for enough taxpayers yet.

Recently the Department of Treasury and the IRS sent a letter asking Congress to repeal the requirement.