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A LOOK AT FRINGE BENEFITS

From a tax savings perspective, fringe benefit planning can achieve considerable results. The business would be able to deduct the cost of these qualified benefits to save on taxes; yet the recipient would not have to pay current taxes on the value of the benefits received. A "two for one savings" results, especially for an owner who is also a qualified employee. So a business owner should have an overview of some of the options in regard to fringe benefits, and potential limitations or caveats.

By definition, a fringe benefit is a form of compensation–other than cash–given to a qualified recipient. Generally speaking, the bulk of the tax-free fringe benefits can be granted to a qualified recipient who is an employee or to an owner who can also be set up as a qualified employee.

An Overview Of The Possible Fringe Benefit Options

While there are limitations, compliance issues, and non-discrimination rules that can vary according to the particular fringe benefits being set up and the type of business structure you have, it's important to get an idea of the major fringe benefits that may be available. The following list gives a brief synopsis of the main ones:

Health & Accident Insurance: The cost of this tax-free benefit for employees, their spouses and dependents may be deducted by the business. If provided, employer generally must also follow COBRA rules upon employee termination.

Life Insurance: Group-term up to $50,000 in coverage for employee, and up to $2000 coverage for employee spouse or dependents is a tax free benefit. Beyond that limit, a portion of premium cost may be taxable, but usually at far lower rates than if privately obtained. Certain other types of life insurance arrangements(such as split dollar) may be set up with some limited tax-free or tax-deferred benefits.

Disability Insurance: The premiums paid by the business for the policy are a tax-free benefit to employee.

Conditional Meals & Lodging: If meals provided to employee on business premises, and lodging provided as a condition of employment–both for the employer's convenience–these are tax-free to the employee. Business deducts the full cost of lodging, and 50% of the cost of meals.

Day Care Services: Up to $5,000 per year of cost of these services may be tax-free to employee. Must be either provided by employer, or paid to a qualified outside day care provider.

Qualified Retirement Plan: Contributions made by employer and/or employee may be deducted. Various limitations on amount of contributions depending on type of plans and participation percentages. Examples of such plan: SEP, Sar-SEP, SIMPLE, Keogh, 401(k), Customized Defined Benefits and/or Defined Contribution plans.

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Working Condition Fringes: If primarily for benefit of employment conditions, tax-free to employee. Examples: parking costs, professional association dues, business publications, business equipment(including computers, telephones, etc.) for required use at home, entertainment and travel/transportation expenses, convention expenses, required qualified office in home expense reimbursement, etc.

Vehicle Expenses: Cost of vehicle used for business purposes and/or as required by employer for business use may be tax-free to employee and deductible by business.

Transportation Benefits: Qualified commuter transportation expense, transit passes, commuter parking costs may be tax-free to recipient.

On-premises facilities: Eating facilities, daycare facilities, and athletic facilities available to all employees can be provided tax-free.

De Minimus Benefits: Occasional personal use of business equipment such as copiers, faxes, phones are tax free to employee, and fully deductible by business. Similar rules for such things as coffee, doughnuts, soda, occasional tickets to shows, office parties and picnics, small gifts to employees
.

Outplacement Assistance: This can be a very valuable fringe to a terminated employee. Costs associated with finding another job may be fully tax-free: secretarial services, use of business facilities, counselling and resume services, etc.

Moving Expense Reimbursements: Subject to various dollar cost limitations, certain costs associated with a qualified job-related move would be tax-free to employee and tax-deductible by the business.

Achievement Awards: Tax-free up to certain dollar limitations($400 for non-qualified plans; $1600 for qualified plans) for actual gift or cash award instead.

Spousal Travel Costs: If the business requires an employee's spouse to travel with the employee for business purposes, these costs can be paid by the business and not taxable to employee.

Educational Costs: Up to $5250 of educational costs for graduate level work is tax-free. Other types of education costs to meet continuing job requirements are tax-free to employee and deductible by business.

Interest Rate Advantaged Loans: If set up properly, employee can get lower rate loans(in some cases NO interest charges) than on the outside without paying taxes on the differential costs.

Various Stock Options: Depending on the types, and employee status, the value of these options may be tax-free, or tax-deferred. Overall goal of these options is to create opportunity to buy stock at a price lower than its actual worth. Incentive Stock Options: Employee buys at reduced value, benefit not normally taxable when exercised, but when stock is sold. Restricted Stock Option: Given subject to forfeiture rules if employee leaves prematurely. Not taxable until forfeiture period elapses, then taxed at fair market value. Provides possible capital gains tax savings. Non-qualified Option: Taxable when exercised.

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Stock Grants: Business grants employee actual stock, not just options. The fair market value of the stock is taxable to employee. But if stock appreciates this hidden value is tax deferred, and may be taxable at reduced capital gains rates later on when sold. This can be a substantial tax benefit to people in high tax brackets.

Deferred Compensation Plans: Allows business to defer paying an employee for current work until a future date. Can be a good tax saving tool in situations where the expectation exists that the tax bracket for the recipient will be lower at the future date vs the current date and/or vice versa for the business paying it. This is primarily a tax-deferring benefit, and the business takes the deduction for the paid compensation at the future date as well.

Cafeteria Plans: A benefit plan in which the employee has a choice of either receiving cash or two or more qualified benefits in lieu of cash. The allowable benefits that can be included in this plan are: disability, accident, health, dental insurance premiums, medical costs not covered by insurance, dependant care costs, and qualified 401(k) pension plans.

In addition, under Code Section 125, a special flexible spending account can be set up for the employee to directly pay for dependant care or various health care costs. Up to $5,000 per year of this benefit cost can be deducted "off the top" of the employee's compensation. This FSA provision has two main caveats for an employee. First, the cost for these qualified expenses must be established in advance and paid for currently, not after the fact. Second, if the employee fails to use up the pledged amount of expenses for the stated purposes, the unused portion cannot be given back. It is a "use it or lose it" restriction.

The Cafeteria-type plans thus allow employees to be able to customize their benefits package and/or coordinate it with a working spouse's benefits to maximize the tax-free/tax-deferred benefits.

This can be ideal for smaller businesses that can't pay for the total cost of these benefits, but still want to offer employees some tax advantages. The flexible spending account arrangement benefit can do this.

Compliance & Qualifying Issue #1: Type Of Business Entity

To be deductible by the business and tax-free/tax-deferred by the recipient, most fringe benefits must meet certain compliance and qualifying requirements. These requirements fall into two main categories for this purpose: 1) The type of business entity, and 2) the so-called highly compensated/non-discriminatory tests.

In regard to category #1, the type of business entity may limit which fringe benefits are allowable from a qualified position. For this form of limitation, the four types of business entities are: Sole Proprietorship, Partnership, C Corporation, and Subchapter S Corporation. Certain qualified fringe benefit plans may not be allowed for the owners/controllers of some of these business types, but allowed for other employees.

In this regard, sole proprietors, owners of partnerships, and employee/shareholders who own more than 2% of a Subchapter-S corporation do not usually get to share in all of the potential tax free benefits available. There are some that they cannot get 100% tax free, most specifically for the current year, 2000: health insurance, group term life insurance, death-benefit exclusion, and employer-furnished meals and lodging for on premises containment.

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There is a partial tax-deductible allowance for health insurance, however, in that a portion of the taxable premiums may be deducted by these individuals on their own tax returns. The new tax laws have set up a graduated scale with the result that an increasing portion will be deductible over the years, reaching 100% by the year 2007.

The bulk of the other fringe benefits that may not be allowed for the owners or controllers of the business entity types are summarized as follows:

Sole Proprietors: Cannot get tax-free status in on-premise facilities, outplacement assistance, deferred compensation, disability insurance, death benefits, achievement awards, transportation benefits, moving expense, cafeteria plans, interest rate advantaged loans, stock options, stock grants.

Partner/owners: Cannot get tax-free status in outplacement services, cafeteria plans, deferred compensation, disability insurance, stock options, stock grants, interest rate advantaged loans.

2% owner/shareholders of Sub Chapter S Corporation: Cannot get full tax-free/tax-deferred status in disability insurance, and cafeteria plans.

Be advised that these restrictions mostly apply to owners or controllers of these business entities. They usually do not restrict general employees from the tax-free/tax-deferred status of the above-mentioned fringe benefits.

Compliance & Qualifying Issue #2: Tests To Pass

The IRS attempts to reduce possible discriminatory use of certain fringe benefits so that businesses can't show favoritism among different levels of employees. In effect, the intent of these compliance tests is to prevent the "stacking of fringe benefits" in favor of owners and key personnel at the expense of other employees.

Two areas of qualification must be dealt with for setting up some of the tax-free/tax deferred fringe benefits. First, if a business wishes to EXCLUDE certain employees, it can only do so based on a limited number of parameters such as: full-time vs part-time status, age of employee, seasonal nature of the job, vesting periods, citizenship/residency status, and collective bargaining coverage.

Thus, many of the fringe benefits can be set up in such a way as to exclude part-timers vs full-timers, employees under age 21, seasonal jobs that last less than 12 months, employees who have worked for you less than 1-3 years, non-resident aliens, and employees covered under certain collective bargaining agreements. So if your business has employees that fit into these categories, or you have a very high turnover rate of employees, you may be able to set up various fringe benefit plans to selectively cover certain people or groups. This could result in maximizing your own fringe benefits and minimizing the business expense of covering others.

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The second area of qualification to deal with involves meeting the IRS tests for "highly compensated" individuals. In a nutshell, the purpose of this test is to insure that the dollar value of contribution amounts or benefit amounts do not discriminate in favor of highly compensated individuals. It's not always enough to cover all the employees with a particular benefit. The dollar value of the benefit must also be spread out in such a way that the "lower compensated" employees are given a calculated fair share portion of the overall benefit according to IRS guidelines.

What is the IRS definition of a "highly compensated" individual? It can get quite complicated from a calculation standpoint. Normally, however, it is an owner, a shareholder(with 2%-5% or more of the holdings), an officer, or a key employee–or spouse or dependent of said individuals–whose earnings are such that they are in the top 20 percentile for the company.

Further, these tests can vary according to the particular type of fringe benefit plan, and can be very complicated in some instances, especially for fringes such as 401(k) plans, stock options and grants, cafeteria plans and qualified customized retirement plans. A benefits specialist is often used in the planning, implementation, and calculation of the benefit deductibility amounts when a question of this qualification test comes into the picture.

Now, what happens if the business doesn't meet this "highly compensated" test? It means part, or all of the particular fringe benefit may become taxable(or not available) to these highly compensated individuals. If this is a possibility, the options for the business owner are:

1. Rearrange the fringe benefit amounts so it does qualify
2. Don't make that particular fringe benefit available
3. Accept the consequences of not realizing the full amount of the potential tax savings for the highly compensated group so the other employees can still benefit.

Reporting Requirements

With few exceptions(such as a SEP plan) most fringe benefit plans require some form of reporting to appropriate government agencies, such as the IRS or Department Of Labor. This falls under the auspices of the Employee Retirement Income Security Act Of 1974, commonly abbreviated "ERISA." Failure to file timely and/or properly may result in civil or criminal penalties if wilful failure to file is proven.

The two major categories of benefit plans to which most of this ERISA reporting applies are Employee Pension Plans, and Employee Welfare Plans.

The Welfare Plans refer to other than pension plans, so they may run the gamut from insurance to cafeteria plans. The Pension Plans comprise the obvious: tax-qualified retirement plans such as Keoghs, 401(k) plans, etc.

The reporting requirements can be quite simple, or quite complex depending on the type and nature of the fringe benefit plan, whether or not the "highly compensated" test is required, how many employees are being covered, and whether any allowable discrimination restrictions are in place, to name a few.

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There are a few common denominators among the various reporting requirements. Most of these plans must be written, and a Summary Plan Description must be distributed to all covered employees. This Summary must contain a number of specific disclosures, and be filed with the Department Of Labor. An annual report or return(Form 5500) is usually required to be filed with the IRS. Any modifications to existing plans must also be filed in the year these changes occur.

If your business uses a professional benefit plan specialist(such as an insurance company, brokerage house, or mutual fund company), most of these reporting/filing/disclosure requirements are taken care of for you.

Conclusion

Fringe benefits can be a very valuable aspect of a business. First, the potential tax-savings can be substantial. The business may be able to deduct the entire cost of these benefits, yet the recipients(business owner, employees) may be able to enjoy these fringes tax-free. Second, offering fringe benefits can help to attract better employees, and reduce employee turnover. This can save a business a considerable amount of money since employee turnover is so expensive to deal with, and higher quality employees usually translate into higher business profits.

But it may require some advance planning for some of the potential fringe benefits, especially if there is any possibility of a problem meeting the highly compensated/non-discrimination tests for certain fringe benefits.

Finally, the administration and reporting requirements make some of the fringes a chore to maintain, while for others it is relatively simple. So an analysis of the risk to rewards in this area is always recommended before plunging in. Nevertheless, the business environment in regard to providing fringe benefits is getting more and more commonplace. So it is an area in which you, the business owner, should at least have a rough idea of the options and pitfalls.

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