

NO-ADDITIONAL-COST SERVICES AND QUALIFIED EMPLOYEE DISCOUNTS FOR PUBLIC EMPLOYEES

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Fringe benefits are a form of pay for the performance of services. Generally, any fringe benefit provided by an employer is taxable and includible in a recipient's pay unless the law specifically excludes it. If an employee is the recipient of a taxable benefit, the benefit is subject to employment taxes and must be reported on Form W-2, Wage and Tax Statement. This article will primarily address two of the fringe benefits excluded from gross income: "no-additional-cost services" and "qualified employee discounts".

Many public municipalities have park districts that offer a variety of amenities to the public. Examples of such amenities can include swimming pool facilities, fitness and weight room facilities, and public golf courses. When these amenities are offered to the public for a fee and the same amenities are offered to an employee at no cost, the possibility of a taxable benefit to the employee has to be weighed and considered by the employer.

Generally speaking, the benefit may be totally excluded from income as a "no-additional-cost service" (see Internal Revenue Code (IRC) section 132(a)(1)) or partially excluded from income as a "qualified employee discount". (IRC section 132(a)(2)). However, this may not always be the case, depending on how the benefit is offered to the employee and who is allowed use of the facility. The benefit must be offered only to a person who is defined as an "employee" (IRC section 132(h)) and the benefit cannot be excluded from income if it is only offered to highly compensated employees. (IRC section 132(j)).

No-Additional-Cost Service

A "no-additional-cost service" is a service offered by the employer to its customers in the ordinary course of the line of business of the employer in which the employee performs substantial services, and the employer incurs no additional cost (including foregone revenue) in providing the service to the employee. (IRC Sections 132(b)(1) and (b)(2)).

First, the employer must provide the service to its customers in the ordinary course of its line of business. This statement contains two conditions that should be evaluated separately. First, the service must be offered by an employer to its customers. In the case of park district, facilities such as golf courses, fitness facilities, and swimming pools are made available to the public and usually for a fee of some amount.

Second, the service must be offered in the "line of business" in which the employee performs substantial services. An employer's "line of business" is determined by reference to a two-digit standard industrial classification coding (Income Tax Regulations 1.132-4) that is found in the Enterprise Standard Industrial Classification Manual. Although presently the Statistical Policy Division of the U.S. Office of Management and Budget uses the North American Industry Classification System (NAICS) which

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provides detailed coding up to six digits in description, the Internal Revenue Service still uses the codes provided in the Enterprise Standard Industrial Classification (ESIC) Manual to determine an employer’s line of business for purposes of the availability of exclusions from gross income for certain fringe benefits under section 132 of the Internal Revenue Code.

Determining the line of business in which an employee performs substantial services can be difficult with respect to government entities. The two-digit coding for the administration of government entity programs under ESIC is 90. Many governmental functions are unique to governmental entities (maintaining a police force, collecting real estate taxes, passage of legislation, etc.).

Other functions of a governmental entity may be analogous to private sector operations such as schools, hospitals, or transportation facilities and are listed along with private sector enterprises of the same type under different “line of business” codes. For example, schools would be classified in ESIC as educational services with a two-digit code of 82; hospitals are classified under a two-digit code of 80.

Public Administration is shown in ESIC Manual as a two-digit code of 90. It can be difficult to identify separate establishment details for many government agencies. To the extent that separate establishment records are available, the administration of governmental programs is classified as two-digit code 90, Public Administration, while the operation of that same governmental program is classified elsewhere in ESIC based on the activities performed (emphasis added).

The governmental employer must determine what the “line of business” is and which employees perform substantial services in that “line of business”. A city that administers community recreation programs (such as golf programs, fitness centers, swimming pools, etc.) may have employees who administer the program under one “line of business” coding, Public Administration (92), and employees who operate the program under “line of business” coding, Arts and Recreation (71). Employees who operate the recreation programs can have income excluded because the fringe benefit is considered as a no-additional-cost service; those employees who administer the program may not.

The employer must incur no additional cost (including foregone revenue) in providing this service to the employee (IRC section 132(b)(2)). Services that are eligible for treatment as no-additional-cost services include excess capacity services such as hotel accommodations; transportation by aircraft, train, bus, subway, or cruise line; and telephone services. (Regs. 1.132-2(a)(2)). Presumably, overhead and operating costs remain substantially the same whether or not employees are provided the service and thus, no additional cost is incurred. No revenue should be lost because an employee is offered this service. A common example of a “no-additional-cost service” is an empty seat on an airplane when boarding begins. At the time an employee on standby boards the plane, the airline incurs no additional costs either in operating expenses or in foregone revenue from a paying passenger.

With the operation of a public golf course, the same issues must be weighed. Particularly in summer months, excess capacity at a popular public golf course is at a minimum for certain times of the day. If employees are allowed to play without limitation during prime tee times on the golf course in summer months, paying customers would not be able to use the course: the employer incurs an additional cost in foregone revenue. Routinely reserving the golf course facilities well ahead of time would also present a real possibility of foregone revenue from the paying public. If potential revenue is lost, the benefit cannot meet the “no-additional-cost” conditions. (IRC section 132(b)(2)).

Even if “no-additional-cost service” exclusion from gross income does not apply, some gross income for the dollar value portion of the service that is a “qualified employee discount” can be excluded. (IRC section 132(a)(2)).

Qualified Employee Discount

A “qualified employee discount” is allowed if the discount does not exceed (in the case of qualified property) the gross profit percentage of the price at which the property is offered by the employer to customers. In the case of qualified services, the discount can be up to 20 percent of the price at which the services are being offered by the employer to customers. (IRC section 132(c)).

The term “qualified property or services” means any property (other than real property and other than personal property of a kind held for investment) or services which are offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services. (IRC section 132(c)(4)).

For example, an employee wishes to reserve a prime period “tee-time” on the golf course. This will not qualify as a “no-additional-cost” service because of probability of foregone revenue. However, up to 20 percent of the price at which the service is offered to customers can be excluded from his taxable wages as a “qualified employee discount”. A “qualified employee discount” can also apply to the rental of a golf cart by an employee. Use of a golf cart may not be a “no-additional-cost service” since expenses for gas, maintenance, and repairs are incurred when it is used. However, up to 20 percent of the price at which the service is being offered by the employer to customers may be excluded from the employee’s taxable wages as a “qualified employee discount.”

Who Is Treated As an Employee?

It is important to note that when an employer provides fringe benefits that are either “no- additional-cost services” or “qualified employee discounts”, the person receiving the service must meet the definition of “employee” in order for the income to be excluded. (IRC section 132(h)).

Certain individuals can be treated as employees for purposes of the “no-additional-cost” and “qualified employee discount” exclusions. These individuals include former employees in that line of business who are separated from service with that employer because of retirement or

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disability, and any widow or widower of any individual who died while employed by the employer in the line of business in which the service is being offered.

In general, the use of “no-additional-cost services” and “qualified employee discounts” by the spouse or a dependent child of the employee shall be treated as use by the employee. A dependent child means any child of the employee who is a dependent of the employee, or both of whose parents are deceased and who has not attained age 25. (IRC section 152(e)).

Reciprocal agreements between employers allow any service provided by an employer to an employee of another employer to be treated as provided by the employer of such employee if the service is provided pursuant to a written agreement between those employers, and neither of the employers incurs any substantial additional costs (including foregone revenue) in providing the service.

In practical terms, why does the definition of an “employee” matter? If a municipal park district offers free golf course passes to an employee with no restrictions as to who can join him on the golf course, the dollar value of those passes may be taxable wages to that employee if those persons do not meet the definition of an “employee” as described in the preceding paragraphs above. For example, an employee receives four passes to the golf course worth \$25 each. He decides to invite three friends to join him. If these individuals are not “employees” by virtue of either a relationship test or a reciprocal agreement between employers as described above, \$75 of the value of the services received by that employee is taxable wages to him. This would be case whether a “no-additional-cost” exclusion was considered or if a “qualified employee discount” was considered.

Finally, before applying exclusion of income rules to either no-additional-cost services or qualified employee discounts, there can be no discrimination in favor of highly compensated employees. Exclusions for “no-additional-cost” services or “qualified employee discounts” services apply to highly compensated employees only if the fringe benefit is available on substantially the same terms to each member of a group of employees which is defined under a reasonable classification set up by the employer which does not discriminate in favor of highly compensated employees. (IRC section 132(j)). As a general rule, this caution is probably less relevant to government employers than to those employers in the private sector. Nevertheless, it is an important consideration to keep in mind.

Facts and circumstances can vary from employer to employer with respect to questions regarding lines of business, highly compensated employees, excess capacity, what constitutes lost revenues, etc. For specific written advice about a unique set of conditions, the employer can contact IRS for a private letter ruling.