

Office of Chief Counsel
Internal Revenue Service
Memorandum

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date: January 30, 2009

to: LMSB

from: Branch Chief

(Tax Exempt & Government Entities)

subject: Qualified Employee Discounts under IRC section 132

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Contract = [REDACTED]

ISSUES

1. Whether discounts provided to the Employer's employees who purchase or lease property from the Company constitute taxable fringe benefits.
2. How are the fringe benefits valued?
3. Whether the discounts constitute wages for purposes of the Federal Insurance Contributions Tax Act (FICA).
4. Should the claims for refund be allowed?

CONCLUSIONS

1. The discounts provided to the Employer's employees who purchase or lease property from the Company constitute taxable fringe benefits.
2. The fringe benefits are valued at fair market value.
3. The discounts provided to the Employer's employees constitute wages for purposes of the Federal Insurance Contributions Tax Act (FICA).
4. The claims for refund should be disallowed.

FACTS

The Employer filed claims for refund to recover FICA taxes that the Employer says were erroneously paid and/or collected with respect to certain discounts on the purchase or lease of Company property by the Employer's employees.

The Employer _____ was formerly owned by the Company. After _____ years of ownership by the Company, the Employer became an independent entity and the Company _____ the Employer.

During the relevant period the Company offered a discount Program to eligible employees of the Employer. The discount Program offers discount purchasing and leasing opportunities for property manufactured by the Company and its affiliates.

All full-time employees of the Employer, retirees, surviving spouses, and immediate family members are eligible to participate in the discount Program. Immediate family member eligibility has been extended to include brothers- and sisters-in-law, siblings' spouses and spouses' siblings, sons- and daughters-in-law, stepbrothers and stepsisters, grandchildren and step-grandchildren. Surviving spouses may also sponsor full, half-, and step-siblings of deceased Company employees or retirees.

To participate in the discount Program, eligible employees obtain authorization numbers from the Company. Under program guidelines, an eligible employee presents the authorization number to an authorized seller of the Company's products. The property is priced at the cost to the seller of the Company's products plus handling fees.

The Employer received data transmitted by the Company as to the value of the discounts. The Employer notified its employees and former employees that the discount was a taxable fringe benefit in accordance with IRS Regulations. The discount was reflected on the information returns issued to the employees and former employees. The Employer paid employment taxes on the discount amounts attributable to the employees.

The Employer historically treated the amount of discount as taxable income to its employees (including active and retired employees) who purchased or leased items pursuant to this Program. The Employer also imputed income equal to the discount to any surviving spouse or family members of deceased employees who participated in the Program. Employment taxes were collected following the Company's notification to the Employer of an employee purchase or lease, and the income was reported on each employee's Form W-2. In the case of former employees, the Employer historically filed Forms 1099-MISC reporting the discount as income, but did not collect or deposit employment taxes with respect to the reported income.

The Employer stated that as of a certain date the Company stopped transmitting the discount data to the Employer. Therefore, after that point, the Employer no longer withheld and paid the employment taxes attributable to the discount amounts. The Employer now claims that the discounts were nontaxable. Accordingly, the Employer is seeking a refund of the FICA taxes it paid with respect to the discounts.

The Employer's Benefit Handbooks consistently described the discounts offered under this program as taxable fringe benefits in accordance with IRS Regulations. According to the Handbooks, the discount is deemed a taxable benefit in accordance with IRS Regulations and is therefore subject to taxation. Additionally, letters are sent to inform the individuals of taxes to be taken out of their paychecks.

Memoranda between the Employer and the Company indicate that the Employer periodically sought to extend and continue the Program for the benefit of its eligible employees. Other memoranda indicate that the Program has repeatedly been extended by the Company in response to these requests. Over the years the memoranda indicate that the Program has also been extended to other classes of the Employer's employees by the Company.

The Employer periodically provides information to the Company about the names of new employees who are eligible for the Company discounts, as well as those who left the Employer's employment and are no longer eligible for the Company discounts.

While the precise details of the purchases and leases that were made by the general public were not made available for comparison purposes, a sampling of the Employer's employees was made to determine if they received benefits in excess of rebates, incentives, etc., that the general public received. The sampling was made of employees who received discounts for a relevant two year period. Most of the individuals had used the discount Program at least twice personally and one had used it five or six times. Two had used it at least twice for family members. According to information provided by employees and by the Company, the property discount was in addition to all other rebates, incentives, etc. available to the public. The Company suggested that eligible employees' family members be reminded that "they can combine their discount with the most current incentives for an even better deal." Information provided indicated that the discount was a benefit on top of any rebates, regional incentives, etc. available to the general public.

LEGAL AUTHORITY

Internal Revenue Code (Code) section 61(a) defines “gross income” as all income from whatever source derived, including (but not limited to) compensation for services such as fees, commissions, fringe benefits, and similar items. Regulations section 1.61-1(a) provides that gross income includes income realized in any form, whether in money, property, or services. For example, Regulations section 1.61-21(a)(1) provides that a fringe benefit may include, for example, an employer-provided discount on property or services. Regulations section 1.61-21(a)(3) provides that a fringe benefit provided in connection with the performance of services is considered to have been provided as compensation for such services.

Regulations section 1.61-21(a)(4) provides that a taxable fringe benefit is included in the income of the person performing the services in connection with which the fringe benefit is furnished. Thus, a fringe benefit may be taxable to an employee even though that employee did not actually receive the fringe benefit. This could occur, for example, when a benefit is provided to a relative of an employee.

Under Regulations section 1.61-21(a)(5), the provider of a fringe benefit is that person for whom the services are performed, regardless of whether that person actually provided the fringe benefit to the recipient. The provider of the fringe benefit need not be the employer of the recipient of the fringe benefit, but may be, for example, a client or customer of the employer. Thus, a fringe benefit need not be provided by the common law employer to be includible in an employee’s gross income.

Regulations section 1.61-21(a)(2) provides that to the extent a particular fringe benefit is specifically excluded from gross income pursuant to another Code section, that section shall govern the treatment of that fringe benefit. Many fringe benefits specifically addressed in other sections of the Code are excluded from gross income only to the extent certain requirements are met.

Code section 132 excludes from gross income certain fringe benefits provided to an employer’s employees. Section 132(a)(3) provides that gross income does not include any fringe benefits which constitute “qualified employee discounts.”

Code section 132(c)(1) defines a “qualified employee discount” as any employee discount with respect to qualified property or services to the extent that the discount does not exceed certain specified limits.

Under Code section 132(c)(4), 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 to customers in the ordinary course of the line of business of the employer in which the employee is performing services.

Code section 414(t) provides that all employees who are treated as employed by a single employer under the controlled group provisions of section 414(b), (c), or (m) are treated as employed by a single employer for purposes of section 132.

Regulations section 1.132-1(b)(1) provides that for purposes of qualified employee discounts the term “employee” includes (i) any individual who is currently employed by the employer in the line of business, (ii) any individual who was formerly employed by the employer in the line of business and who separated from service with the employer by reason of retirement or disability, and (iii) any widow or widower of an individual who died while employed by the employer in the line of business or who separated from service with the employer in the line of business by reason of retirement or disability.

Regulations section 1.132-3(a)(3) provides that the exclusion for qualified employee discounts does not apply to property or services provided by another employer pursuant to a written reciprocal agreement that exists between employers to provide discounts on property or services to employees of the other employer.

Regulations section 1.132-3(a)(5) provides that a qualified employee discount may be provided either directly by the employer or indirectly through a third party. For example, an employee of an appliance manufacturer may receive a qualified employee discount on the manufacturer’s appliances purchased at a retail store that offers such appliances for sale to customers.

The General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984 (DEFRA '84), P.L. 98-369, which added section 132, Certain Fringe Benefits, to the Code, provides background for the fringe benefit rules and why Congress thought such rules necessary.

[C]ongress was concerned that without any well defined limits on the ability of employers to compensate their employees tax-free by providing noncash benefits having economic value to the employee, new practices will emerge that could shrink the income tax base significantly. This erosion of the income tax base results because the preferential treatment of fringe benefits serves as a strong motivation to the employers to substitute more and more types of benefits for cash compensation. A similar shrinkage of the base of the social security payroll tax could also pose a threat to the viability of the social security program.

The House Report provides that “the discount exclusion is not available for goods or services provided by another employer, whether or not a reciprocal agreement exists, except where commonly controlled businesses are treated as one employer.” H.R. Rep. No. 98-432, Part II, 1598 (1984).

LEGAL ANALYSIS.

Issue 1. Whether discounts provided to the Employer’s employees who purchase or lease property through the Company’s Program constitute a taxable fringe benefit.

The Company discounts are not excluded from gross income under Code section 132(a) and (c) as qualified employee discounts. Code section 132(c) provides that qualified employee discounts are limited to discounts on “qualified property or services”. Section 132(c)(4) limits “qualified property or services” to property or services “offered for sale to customers in the ordinary course of the line of business of the employer in which the employee is performing services.” The legislative history clearly provides that the discount exclusion is not available for goods and services provided by another employer. H.R. Rep. No. 98-432, Part II, 1598 (1984). The discounts in this case are not qualified employee discounts because the discounted property was not offered for sale to customers by the same employer for which the employees receiving the discount performed services.

Moreover, a qualified employee discount can only be provided as an excludable fringe benefit to individuals who satisfy the definition of “employee” in Regulations section 1.132-1(b)(1). Section 1.132-1(b)(1) defines “employee” as current employees, spouses of employees, dependent children of employees, former employees who have left the service of the employer due to retirement or disability, and widows and widowers of employees who died while employed in the line of business or left service due to retirement or disability. However, the Employer provided the discounts to a much broader group (e.g. siblings, siblings’ spouses and spouses’ siblings, grandchildren and step-grandchildren). The discounts provided to this latter group are not excludable under Code section 132(c).

In this case, the discounts are offered in connection with the performance of services by full-time Employer employees or retirees. Others who receive the discount derive their right to the discount from their blood or legal relationship with the Employer’s employee or retired employee. The Employer periodically provides information to the Company about the names of new Employer employees who are eligible for the Company discounts, as well as those who left the Employer’s employment and are no longer eligible for the Company discounts. A participant in the Company discount Program is required to present an authorization number when the property is selected. The authorization number can only be obtained by current employees, former employees who retired or are disabled, and surviving spouses of such current and former employees. The other individuals who participate in the Company’s discount Program must obtain an authorization number from their relative, a current employee, a former employee who retired, or survivors of the Employer’s employees. The Employer periodically received information from the Company about the Employer’s employees who took advantage of the Company discounts. Thus, the Employer and the Company monitored the status of the Employer’s employees to ensure that the program was only offered to individuals eligible to participate by virtue of current employment or prior employment, surviving spouses, and individuals who derive their right to a discount by virtue of a blood or legal relationship with those Employer employees. Therefore, the facts and circumstances establish that the Employer’s employees and related individuals received the discounts on account of the Employer’s employees’ employment relationship with the Employer.

Moreover, evidence suggests that the discount program is a bargained for benefit. A memorandum from the Company concerning the Program states: [Y]our recent request was approved at the August ... meeting.” In similar manner another memorandum states that “the extension of the Program has been granted....” The negotiated aspect of the agreement is also reflected in the changing terms of the Program as extended. Another memorandum provides that the “extension does not apply to Employer employees hired after the .” In contrast, a later memorandum provides that “this extension cover(s) all active Employer employees, including acquired subsidiaries, such as ... and” Taken as a whole, these memoranda suggest that the Company and Employer have bargained for and negotiated the extension and re-extension of the Program as a fringe benefit for the Employer’s employees. The fact that the benefit was bargained for indicates that the Employer intended for the benefit to be compensatory. The benefit was not merely a benefit unilaterally provided by a third party outside the control of the Employer.

The Employer asserts that if the Program discounts are wages for employment tax purposes, then the Company is responsible for the withholding and reporting because the Company was the statutory employer within the meaning of Code section 3401(d)(1). Code section 3401(d)(1) is not controlling with respect to non-cash fringe benefits. Code section 3501(b) provides that taxes imposed with “respect to non-cash fringe benefits shall be collected (or paid) by the employer.” Regulations section 31.3501(a)-1T Q/A-5 provides in this regard that “[t]he provision of noncash fringe benefits by an entity to an employee of another employer does not make such entity the employer of such employee with respect to such noncash fringe benefits for any purposes of subtitle C, so long as such noncash fringe benefits are incidental to the provision of wages by the employer to such employee.” The Company discounts are incidental benefits and the Employer is responsible for taxes imposed with respect to the discounts. Regulations section 31.3501(a)-1T Q/A-6 provides that “[t]he employer must take the steps necessary to obtain the relevant information from the provider of the benefits in order to enable the employer to satisfy, in a timely manner, its obligation under subtitle C to collect and pay taxes with respect to noncash fringe benefits provided by the nonemployer.” Therefore, the Employer was required to obtain the information necessary to report and withhold on the discounts, as it had done for several years preceding its change in position.

The Employer stated that the Company discount is essentially only a rebate program and the discount is not wages subject to employment taxes. Rev. Rul. 79-96, 1976-1 C.B. 23, concerned the federal income tax treatment of rebates by a taxpayer to qualifying retail customers who purchased or leased its automobiles. The ruling held that the rebates were deductible by the taxpayer as ordinary and necessary business expenses and the rebates were not includible in the customers’ gross incomes. The rebates represent a reduction in the purchase price of the automobiles sold. The Employer states that the rationale in Rev. Rul. 79-96 is reinforced in several private letter rulings with facts similar to the facts in their situation.

Discounts arising from an employment relationship are not price rebates as described in Rev. Rul. 76-96 because the discounts provided to the Employer's employees arise from the employees' employment relationship with the Employer. See, Regulations section 1.61-21(a)(3). The rebates described in Rev. Rul. 76-96 were available to the general public and did not arise on account of an employment relationship. The regulations specifically provide that discounts are considered a taxable fringe benefit, and the taxable fringe benefit may be provided by a customer of the employee. See Regulations sections 1.61-21(a)(1) and (5). Further, private letter rulings have no precedential value. See Code section 6110(k)(3) ("... a written determination may not be used or cited as precedent."); see also, Western Waste Industries v. Commissioner, 104 T.C. 472, 482 (1995). The reasoning behind section 6110(k)(3) is more directly explained by the Joint Committee on Taxation:

Under prior administrative rules, a private letter ruling, technical advice memorandum, or determination letter was not to be used as a precedent by the IRS or any person. If all publicly disclosed written determinations were to have precedential value, the IRS would be required to subject them to considerably greater review than is provided under present procedures. The Congress believes that the resulting delays in the issuance of determinations would mean that many taxpayers could not obtain timely guidance from the IRS and the ruling program would suffer accordingly Thus, if the IRS issued a written determination to a taxpayer with respect to a specified transaction which occurred in a particular year ... the earlier determination could not be used by the taxpayer or the IRS as a precedent for the subsequent year unless the determination specifies that it applies to a series of such transactions.

See Staff of the Joint Comm. on Taxation, 94th Cong., General Explanation of the Tax Reform Act of 1976, at 309 (Joint Comm. 1976).

The Employer also asserts that the IRS is treating taxpayers differently and notes the results of other examinations. The IRS strives to treat similarly situated taxpayers consistently and fairly. However, the IRS is statutorily prohibited under Code section 6103 from discussing examinations of other taxpayers and particular facts that may have resulted in a particular conclusion in a particular audit cycle of a particular employer, as the discussion would lead to disclosure of tax return information.

The Company property discount provided to current employees of the Employer constitutes a taxable fringe benefit. These amounts were reflected on Forms W-2 for the tax periods in question and were treated as wages prior to the Employer's filing claims for refund of the employment taxes paid. The discount was a benefit the Employer bargained for with the Company, and as such was intended to be compensatory for the Employer's employees. Since the discounts constitute a taxable fringe benefit, they are considered wages and should be subject to employment taxes.

The Employer as the common law employer is responsible for withholding the appropriate amount of employment taxes and for including any income on the Form W-2

of the employee who received the taxable fringe benefit even if the value of the discount is not transmitted by the Company. If the Company refuses to transmit the discount data to the Employer, then the Employer has the choice of discontinuing the discount program currently available to its employees or continuing the program using alternative methods of obtaining and reporting the data. The provision of Company discounts to the Employer's employees is a taxable fringe benefit, and the Employer has an obligation to withhold employment taxes on this taxable fringe benefit and report the benefit as income and wages on Forms W-2.

Any similar discounts for former employees, such as retirees, constitute taxable fringe benefits. The Employer reflected these amounts on Forms 1099, but these amounts should be treated as wages and reported as such on Forms W-2. Regulations section 31.3121(a)-1(i) provides that remuneration for employment constitutes wages even though at the time paid the relationship of employer and employee no longer exists between the person in whose employ the services are performed and the individual who performed them.

Issue 2. How are the fringe benefits valued?

Regulations section 1.61-21(b) provides rules with respect to valuing fringe benefits. Under subparagraph (1), an employee must include in gross income the amount by which the fair market value of the fringe benefit exceeds the sum of (i) the amount, if any, paid for the benefit by or on behalf of the recipient, and (ii) the amount if any specifically excluded from gross income by some other section of subtitle A of the Code.

Regulations section 1.61-21(b)(2) provides that in general fair market value is determined on the basis of all the facts and circumstances. Specifically, the fair market value of a fringe benefit is the amount that an individual would have to pay for the particular fringe benefit in an arm's length transaction. Thus, for example, the effect of any special relationship that may exist between the employer and the employee must be disregarded in valuing the benefit.

The Employer's employees have gross income based on the fair market value of the fringe benefit. The fair market value of the fringe benefit in this case is based on the amount an individual would have to pay to purchase or lease the property in an arm's length transaction. In this regard, Regulations section 1.132-3(b) provides that the term "employee discount" means the excess of (i) the price at which the property or service is being offered by the employer for sale to customers, over (ii) the price at which the property or service is provided by the employer to an employee for use by the employee.

Pursuant to the terms of the Program, the Employer's employees' discount is % of the retail price. It would not be unreasonable to use the retail price as the measure of the fair market value of the taxable fringe benefit. The % represents the difference between the fair market value of the fringe benefit at the suggested price that the property is offered for sale to customers of the Company's products in the ordinary

course of business and the price paid by the Employer's employee, and is a reasonable figure to use in computing the income attributable to the property discount.

The Employer asserts that similar savings were also available to the Employer's employees under other property discount programs offered by other manufacturers. The Employer argues that the Company's discounts would have a fair market value only to the extent the Company's discounts exceeded the discounts available under these other discount programs.

This argument is without merit. The value of each fringe benefit is determined based on the value of that particular benefit. The information provided to the IRS for the years at issue discusses the discount Program but does not discuss any similar discounts offered by other manufacturers or suppliers. The information provided by the Employer's employees on a sample basis indicates that the discounts were approximately % of the retail price as outlined in program materials. The Company transmitted to the Employer a discount amount which was a "deemed benefit" to the Employer's employees who received the discount, and that amount was, at a minimum, % of the retail price. It is irrelevant whether the employees received property discounts from other property manufacturers.

The Employer states that the amounts transmitted by the Employer are no longer the correct amounts to value the discount because the % of retail price is no longer a correct amount for the "deemed benefit." The Employer asserts that % is not the correct value for the benefit because the public may be able to negotiate for a more favorable price.

We note again that information provided by the Company to the Employer indicated that the value of the discount is equal to at least % of the retail price. If the Employer's position is that the Company was transmitting incorrect data to the Employer, then the Employer could have discontinued participation in the Program by not requesting the renewals, or requested that the Company provide the level of detail for the purchases and leases so that the Employer could properly determine the correct amount of the "deemed" benefit to be included in participating employees' income.

Issue 3. Whether the Company discounts constitute wages for purposes of the Federal Insurance Contributions Tax Act (FICA).

Code sections 3121, 3102(a), and 3111 provide that every employer making payments of wages is required to withhold and pay FICA taxes. Section 3121(a) provides that for FICA purposes the term "wages" means all remuneration for employment unless otherwise excepted. Regulations section 31.3121(a)-1T Q/A-1 provides that fringe benefits are included in the definition of "wages" under section 3121(a) unless specifically excluded from the definition of "wages" pursuant to section 3121(a)(1) through (20).

Code section 3121(a)(20) provides that for FICA purposes the term “wages” does not include any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from income under section 132.

It was not reasonable to believe that the discounts provided by the Company were excludable from the employees’ income under section 132. Code section 132(c) and the regulations thereunder provide that the discount must be provided by the employer, and that separate corporations (like the Employer and the Company) are not considered a single employer unless they are treated as a single employer under section 414(b), (c), or (m).

Regulations section 31.3121(a)-1(e) provides that generally the medium in which the remuneration is paid is immaterial. Wages may be paid in something other than cash, such as goods. Remuneration paid in something other than cash is valued at the fair market value of the item at the time of payment. See also, Regulations section 31.3121(a)-1T Q/A1 (fringe benefits are wages unless specifically excluded).

The legislative history accompanying DEFRA ‘84 indicates Congress’ intent to provide clear rules to achieve certainty with respect to the treatment of fringe benefits. The House Report provides that “[t]he second objective of the committee’s bill is to set forth clear boundaries for the provision of tax-free benefits.” H.R. Rep. No. 98-432, Pt. 2 at 1591 (1984). The Conference Report provides:

...statutory provisions under which (1) certain fringe benefits provided by an employer are excluded from the recipient’s gross income ... and from the wage base ..., and (2) any fringe benefit that does not qualify for exclusion under the bill and that is not excluded under another statutory fringe benefit provision of the Code is includible in gross income ..., and in wages for employment tax purposes

H.R. Rep. No. 98-861 at 1169 (1984).

Guidelines for reporting and withholding on the value of taxable noncash fringe benefits are provided in Announcement 85-113, 1985-31 I.R.B. 31. Pursuant to Announcement 85-113, an employer may elect, for employment tax and withholding purposes, to treat taxable noncash fringe benefits as paid on a pay period, quarterly, semi-annual, annual, or other basis, provided that the benefits are treated as paid no less frequently than annually. For example, an employer may treat the annual value of noncash fringe benefits as wages paid in December of each year and use the annual withholding table in Circular E (Publication 15, Employer’s Tax Guide). See also, Regulations section 31.3501(a)-1T.

The property discounts provided to employees were indeed taxable, and were required to be reported on Forms W-2 to these employees as remuneration for services

performed in the employment of the Employer. Moreover, property discounts provided to retirees are wages for employment tax purposes.

Regulations section 31.3121(a)-1(i) provides that remuneration for employment constitutes wages even though at the time paid the relationship of employer and employee no longer exists between the person in whose employ the services are performed and the individual who performed them.

With respect to non-cash fringe benefits, an employer has two options: (1) collect from the employee the amount of the employees' portion of employment taxes; or (2) gross-up the employee's wages. See Rev. Rul., 86-14, 1986-1 C.B. 304, and Rev. Proc. 81-48, 1981-2 C.B. 623.

Issue 4. Should claims for refund be allowed?

Although for the years at issue, the Employer treated the discount amounts as taxable, the Employer's current position is that the discount amounts are nontaxable. The Employer now believes that its inclusion of the discounts in income and wages on information returns was erroneous.

The Company's property discounts are taxable fringe benefits that the Employer provides to its current employees and former employees, such as retirees. In its original reporting, the Employer correctly reflected the discount amounts for current employees as wages on Forms W-2. These amounts are considered additional taxable wages for FICA purposes. These amounts were correctly reported as wages on Forms 941. All elements necessary to establish employment tax liability are present.

The claims for refund should be disallowed in full. The Employer filed "true-up" claims after soliciting employee consents and statements as required by Regulations section 31.6402(a)-2. However, inasmuch as the original wage reporting was correct, there is no overpayment of employment taxes and no refund should be made.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

If you have any further questions, please call Don Parkinson of my staff at (202) 622-6040.

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