Employer's Guide to

Fringe Benefit Rules

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The 'Taxing' Matter of Long Term Incentive Programs

House lawmakers on June 30 approved the Restoring American Financial Stability Act of 2010, a major financial regulatory reform bill that would make significant reforms to executive compensation practices. At press time, the measure was before the Senate.

Compensation and incentive plans frequently go hand-in-hand with fringe benefits, but some professionals — including guest columnist Jim Moniz, an expert on management compensation — focus on other types of "fringe benefits," including long term incentives (LTIs). Moniz provides a definition of each of the components of this group of fringe benefits. ***Page 2***

Business Travel Begins to Show Signs of Life — and of Frugality

Employers have gotten creative in cutting business travel expenses in recent years. The *New York Times* reported June 21 that Energizer Battery Company, based in St. Louis, Mo., started offering employees monetary incentives to fly in coach instead of business class. Embassy Suites Hotels found in a survey that 17 percent of respondents have shared hotel rooms with colleagues on business trips in the past year.

The flagging economy may be a reason for some employers' novel approaches to reducing travel costs, but Energizer began its incentive program before the recession began. Air transportation and lodging are common working condition fringe benefits. Such new twists in these aspects of business travel deserve a closer look, especially in light of their tax implications. ***Page 6***

Bill Seeking to Reduce Misclassification Gets Attention in Congress

Employers that misclassify employees as independent contractors hurt workers and law-abiding businesses alike, said witnesses at a recent Senate hearing. Some witnesses urged passage of a bill to address the matter; however, one countered that the bill could end up harming true independent contractors and businesses that deal with them.

This occurs against the backdrop of the IRS conducting its biggest audit initiative in 25 years in the area of fringe benefits and employee misclassification to help close a massive tax gap. Washington Watch takes a look at how Congress is tackling the problem of employee misclassification. ***Page 10***

Also In This Issue

Qualified Employee Discounts
Tips for Making Discount Offers Available to Employees 4

Washington Watch
Bill Seeking to Reduce Misclassification Gets Attention in Congress 5
Financial Reform Legislation Includes Executive Compensation Reforms 5

Reporting and Recordkeeping
A Primer on the Form 5500 E-Filing Requirement 9

Working Condition Fringe Benefits
Police Officers' Donning and Doffing Victories Overturned 11

Agency Briefs
GSA Publishes Guidance on Premium-class Air Travel 11
Private Letter Ruling Addresses Housing Expenses at Church-affiliated Orphanage 11

Featured Columnists

James E. Moniz
The 'Taxing' Matter of Long Term Incentive Programs 2

Practice Tools

Ground Rules an Employer Can Set for Discount Offers 4
Code Section 162 on 'Lavish and Extravagant' Expenses 6

Updates to the *Guide*

- ¶1170 — Added discussion of Employment Tax National Research Program.
- Index — Updated Subject Index.

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The 'Taxing' Matter of Long Term Incentives

By James E. Moniz

James E. (Jim) Moniz is CEO of Northeast VisionLink, a company that specializes in executive compensation and works with businesses to structure compensation and rewards strategies. Moniz is a national speaker on the topic of wealth management and executive compensation. He holds a Master of Science in Financial Services, and Graduate Certificates for specialized study in pensions and executive compensation, estate planning and financial asset management. Moniz is a chartered financial consultant and chartered life underwriter.

On the same par with profitability and growth, a primary goal of most company owners is to create a business culture that fosters achievement by key employees. Long-term incentive (LTI) programs are important to recruiting, retaining and motivating vital employees whose skill and knowledge are fundamental to the overall success of the organization.

To an increasing extent, executive compensation includes an array of LTIs, including:

- performance unit plans;
- phantom stock;
- restricted stock;
- non-qualified stock options;
- incentive stock options; and
- deferred compensation plans

The definition of these "fringe benefits" varies significantly, as does their tax implications.

Performance Unit Plans

A performance unit plan is an award with a value tied to the increase in the financial metrics of a company as defined by a formula specific to a company, is typically vested over a period of three or four years.

While the employee, independent contractor or outside director has no tax liability at the time of grant, cashing out of the unit becomes a taxable event at which time the recipient is liable for ordinary income.

In terms of the company's tax ramifications, the Financial Accounting Standards Board (FASB) requires anticipated payments to be expensed as compensation during the performance period and no tax deduction is available until executives are paid.

Phantom Stock

Phantom stock is an LTI designed to provide employees, independent contractors or directors with cash payments equivalent to amounts they could receive under an actual stock option or similar program, but without the issuance of actual stock. Based on "phantom" or "simulated" shares, these units may be equivalent to a public company's fair market value of the stock, or a private organization's calculated value.

The executive does not have income tax liability at grant or vesting, but is taxed at ordinary income rates upon exercise/payout of the phantom stock unit.

The company's tax treatment of phantom stock is more complicated. A charge to earnings is made equal to the value plus appreciation, spread over the vesting period; in addition, the tax deduction must be equal to the amount of income recognized by the phantom stock holder.

Restricted stock is generically defined as forfeitable shares of employer stock which become non-forfeitable upon meeting certain terms and conditions. Under this LTI option, shares of the employer's stock are issued to an employee, independent contractor or director with the

See *LTIs*, p. 3

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Insight you trust.

LTIs (continued from p. 2)

recipient paying nothing, a discounted purchase price, or full value for the shares.

Tax is not levied on the executive at issuance; however, the shares are subject to tax once vested. At that time, the holder realizes ordinary income equal to the difference between the stock's fair market value at vesting and, if applicable, the amount paid by the recipient to purchase the shares.

The company receives a tax deduction for the full value of shares upon vesting, but is required to charge earnings only for the fair market value of the shares at issuance.

Non-qualified Stock Options

Non-qualified stock options (NSOs) are granted by a company and allow an employee, independent contractor or director to purchase shares of the company's stock in the future at a predetermined purchase price. NSOs are an option that typically vests over time.

There is no tax at either grant or vesting for the receiving executive; however, an NSO is taxed upon exercise. At this time, the holder realizes ordinary income equal to the difference between the stock's fair market value at exercise and the exercise price. NSOs also are taxed upon sale of the stock; the holder realizes income at sale of the stock equal to the stock's appreciation after the exercise of the NSO and may be taxed at capital gains rates. Employees can pay taxes through withholding and year-end reconciliation on their tax return.

The combination of tax deductions, fixed charges to earnings and cash inflow, makes an NSO attractive to companies — the tax benefit of the deduction is credited directly to the capital account and the company receives cash inflow from the NSO's exercise price and from the cash value of the tax deduction.

Incentive Stock Options

Incentive stock options (ISOs) allow an employee to purchase shares of the company's stock in the future at a predetermined purchase price and on favorable terms for income tax purposes. Available only to employees and not to independent contractors, ISOs may be granted for a term not to exceed 10 years and an exercise price not less than 100 percent of the stock's fair market value at grant.

No tax at exercise and tax at sale at long-term capital gains rates makes an ISO an appealing option for employees; however, one drawback is the necessity to hold stock at least one year after exercise to satisfy holding period requirements.

For the company, a primary negative feature is the lack of a tax deduction and the limitation of grants to employees only.

> The bottom line is: the more effective a long-term incentive plan is, the more focused the employees will be on the long term growth needs of the company and it will be more difficult for key employees to leave their post for other opportunities.

Deferred Compensation Plans

Deferred compensation plans (DCPs), which are limited to management and/or highly compensated employees (HCEs, see ¶105 and ¶270 of the *Guide*), are designed to provide a tax-deferred opportunity in excess of 401(k) limitations; supply supplemental retirement income for executives and allow for tax deferred capital accumulation potential. Monies otherwise payable to executives are withheld by the company until payment upon retirement or other specified future date; voluntary employee deferrals may be augmented by an additional company contribution or match.

Employee deferrals, company contributions and subsequent earnings are taxable to executives when distributed in the future, allowing for the pre-tax buildup of employee accounts.

See *LTIs*, p. 4

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Qualified Employee Discounts

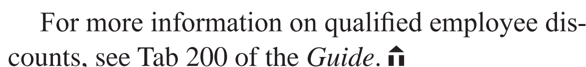
Tips for Making Discount Offers Available to Employees

If an employer is approached by local businesses — such as fitness centers, tire shops and phone service companies — that want to make special discount offers available to its employees, how should an employer handle it?

There are many ways an employer can respond. These include:

- Seeking scrupulously to avoid making any solicitations for, or endorsements of, specific businesses and even the appearance of doing so. Such employers, which include those that have employees that belong to unions or in which there is a union organizing campaign, do not make information about discount offers available at all.
- Putting brochures and flyers from the businesses in a break room. This makes information available, but does not actually make a good or a service available. This approach has no tax consequences and does not result in any taxes being imposed on the employees or the employer.
- Trying to strike a balance between providing offers from organizations that support the employer through a partnership or other business arrangement and those that do not, so as to provide employees with as many options as possible while also supporting businesses with which the employer may have a relationship.
- Entering into contracts with third-party administrators (TPAs) that make employee discounts available. Such TPAs recruit vendors that actually offer discounted goods and services, make those offers available to the employees and provide employee support so the employer and its human resources department do not have to be involved in making discounts available. TPAs that offer such services can charge employers for their services.
- Providing information on its intranet concerning discounts available to employees.
- Setting the parameters within which it will make discount offers known to employees (see box).

For more information on qualified employee discounts, see Tab 200 of the *Guide*.



Ground Rules an Employer Can Set For Discount Offers

Following are examples of guidelines an employer can set for the discount offers it will make available, or known, to employees.

1) An offer for employees should be uniquely for them and not typically be available to non-employees. Through this requirement, an employer can weed out businesses that just want the employer to send free ads to their employees.
2) The vendor is responsible for notifying the employer when the terms of the discount change or are no longer available.
3) No on-site meetings will be held for outside businesses that only want to sell something to employees. Such vendors can be limited only to electronic means of making their offers known to employees.

LTIs (continued from p. 3)

Deferred compensation is subject to ordinary tax rates when paid out to the employee with the company receiving a tax deduction in the amount of the payment when made to the employee.

Companies considering any specific LTI plan should consult with appropriate experts for design, management, funding, comprehensive requirements and a review of the specific legal and tax consequences.

Motivation and Golden Handcuffs

The bottom line is: the more effective a long-term incentive plan is, the more focused the employees will be on the long term growth needs of the company and it will be more difficult for key employees to leave their post for other opportunities.

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