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MAY 2008

As the IRS steps up auditing efforts with respect to the personal use of employer-provided cell phones, new legislation introduced in Congress would eliminate the employment tax consequences related to such personal use.

## Employment Taxes

A Littler Mendelson Newsletter  
specifically for the Employment Taxes

### Legislation Proposed to Eliminate Employment Taxes on Employer-Provided Cell Phones

By William Hays Weissman

The use of cell phones is a fact of life today. Many employees are provided cell phones or BlackBerries (or similar devices) by their employers, and, until recently, very few employers gave much thought to doing so. That is starting to change, however, thanks in part to the Internal Revenue Service. Recently, the IRS has begun to include the review of personal use of company-provided cell phones in its audits.

#### Employment Tax Implications of Company-Provided Cell Phones

In 1989, Congress amended the Internal Revenue Code (IRC) to include cell phones among "listed property."<sup>1</sup> Listed property includes items obtained for use in a business, but designated in the IRC as lending themselves easily to personal use. Besides cell phones, other "listed property" includes automobiles, computers, and entertainment or recreation-related items.

From an employer's perspective, business use of listed property is treated as a working condition fringe benefit. However, if the employee uses the property for personal use, such use is treated as additional wages and is subject to income tax withholding, FICA and FUTA taxes.

In order to exclude an employee's cell phone use from wages, the employer must have some method to require the employee to keep records that distinguish business from personal phone charges.<sup>2</sup> This basically requires employees to go through their itemized statement of calls every month, highlight for the employer all personal calls and provide a business purpose for each

business call. This recordkeeping requirement is extremely burdensome for both employees and employers, who are required to keep such records for audit purposes.

The calls that are personal in nature must be included in the wages of the employee. This includes not only the individual personal calls, but a pro rata share of monthly service charges as well.

IRS guidance provides the following three examples:

Example 1: A municipal government provides an employee a cell phone for business purposes. The government's written policy prohibits personal use of the phone. The government routinely audits the employee's phone billings to confirm that personal calls were not made. No personal calls were actually made by the employee. The business use of the phone is not taxable to the employee.

Example 2: A municipal government provides an employee a cell phone for business purposes. The government's written policy prohibits personal use of the phone. However, the government does not audit phone use to verify exclusive business use. The fair market value of the phone, plus each monthly service charge and any individual call charges are taxable income to the employee, reportable on Form W-2.

Example 3: A state agency provides an employee with a cell phone and pays the monthly service charge. The employee is required to highlight personal calls on the monthly bill. The employee is then

required to timely reimburse the agency for the cost of the personal calls, and the employee is charged a pro rata share of the monthly charge. The value of the business use portion of the phone is not taxable to the employee.<sup>3</sup>

Although the rules have been in place for nearly 20 years, until recently the IRS did not put a lot of effort into determining whether employer-provided cell phones involved personal use, and thus whether the employer had been properly treating such personal use as wages on which employment taxes were reported and paid. However, the IRS has now made the audit of cell phone records a standard practice, and many employers have been caught unaware in recent audits.<sup>4</sup> Because many employers have not followed the substantiation requirements, they have been hit with assessments for failure to report and pay over the employment taxes owed on the personal use of cell phones.

## The New Legislation Would Eliminate the Employment Tax Problem

The “Modernize Our Bookkeeping In the Law for Employee’s Cell Phone Act of 2008”<sup>5</sup> would eliminate the employment tax consequences of personal use of cell phones by deleting cellular phones from the items treated as “listed property” under the IRC for tax years beginning on January 1, 2008. Senator John Kerry (D-MA), a principal sponsor of the Senate bill, stated in a press release: “We need to modernize the law now to reflect the reality that the use of cell phones by businesses has changed dramatically in the last ten years. In the last twenty years, the use of communication devices has skyrocketed, making them cheaper, faster, and more accessible than ever. Cell phones are no longer executive perks or luxury items, and an antiquated tax code shouldn’t treat them that way any more.”<sup>6</sup>

Senator John Ensign (R-NV), another principal sponsor of the bill, stated: “Wireless

communication has come a long way since 1989, moving from rare usage to an everyday business necessity, but our tax code has not kept pace. Today’s wireless devices are smaller, cheaper and offer much better service, yet our tax code remains as cumbersome as some of the first cell phones. The outdated tax code creates a needless and bulky burden on businesses and employees using wireless devices, and our bill would bring the law up-to-date to reflect the broad use of wireless communication today.”

The intended effect of removing cell phones from among the items treated as listed property is to eliminate the burdensome recordkeeping requirements and the employment tax consequences of employees using their employer-provided cell phones for personal use.

## Employers Should Review Their Cell Phone Policies Pending Enactment

Until the legislation is enacted, however, employers should be wary of employees’ personal use of employer-provided cell phones and should review their policies (or create a policy if none exists). Employers have several options under the current rules, including:

- Require employees to have their own cell phones and reimburse employees for business calls;
- Require employees to itemize each cell phone call on a monthly bill and provide a business reason for each business call;
- Prohibit employees from using employer-provided cell phones for personal use of any kind; and
- Treat the employer-provided cell phone as a taxable fringe benefit and impute income to the employee for the entire cost of the service.

For many employers, itemization is administratively impossible. In many instances employers receive the bills directly,

so itemization would entail distribution of hundreds if not thousands of bills, employee time spent marking and returning the bills, and employer time spent figuring the imputed income and tax costs associated with the personal use. It is for these reasons that there has traditionally been poor compliance with the recordkeeping requirements.

Having a policy in place that prohibits personal use of a cell phone may provide some protection to employers; however, if employers do not take steps to occasionally audit use, the IRS may refuse to accept on audit that 100% of cell phone use is for business purposes. Further, imputing less than 100% of costs may only be permissible if there is at least some effort made to gauge the level of business use, such as surveying the employee on their personal use.<sup>7</sup>

Employers that provide cell phones (or BlackBerries or similar devices) to their employees should take an interest in the pending legislation and support its passage. This legislation is the only way to truly resolve this burdensome issue.

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<sup>1</sup> IRC § 280F(d)(4)(A)(v).

<sup>2</sup> See IRC § 274; Treas. Reg. § 1.274-5 (explaining recordkeeping requirements).

<sup>3</sup> “Employee Cell Phones,” available at <http://www.irs.gov/govt/fslg/article/0,,id=167154,00.html>.

<sup>4</sup> See INFO 2007-0030 (June 21, 2007) (explaining rules governing cell phone use).

<sup>5</sup> S. 2668 and H. R. 5450.

<sup>6</sup> “Kerry, Ensign Bill Would Modernize Tax Treatment of Business Cell Phones,” February 26, 2007, Press Release.

<sup>7</sup> While surveys may be useful in convincing the IRS on audit that less than 100% of the costs must be included in income, they are unlikely to provide a complete defense, and, thus, the IRS probably would issue an assessment for at least some personal use.