

**IRS “Crackdown” on the Taxation of Business Cell Phones and PDAs:
IRS Commissioner Clarifies and Softens the IRS’s Stance**

June 17, 2009

Yesterday afternoon, June 16, U.S. Secretary of Treasury Timothy Geithner and IRS Commissioner Douglas Shulman weighed in on the potential taxation of employer-provided cell phones and personal digital assistant (PDA) devices such as BlackBerry devices. In IRS Commissioner Shulman’s statement (included in its entirety below), the Treasury Secretary and Commissioner seek to defuse the understandable concern among taxpayers caused by the IRS’s aggressive audits over the past five years. The IRS Commissioner has indicated a very significant change in IRS direction on this issue with the successive release of IRS Notice 2009-46 last week and his important statement yesterday. The extent of this shift in the IRS position is demonstrated when it is placed within the context of the IRS audits that have created this compliance nightmare.

IRS Audits Seeking Large Tax Assessments – As indispensable tools of modern business, cell phones and PDAs have been a controversial target of IRS auditors for more than a decade, with concerted audit activity since 2005. Even though the IRS has not issued guidance, many IRS auditors have sought to treat any personal use of these devices as taxable wages, often imposing multimillion-dollar assessments on employers and extracting large tax settlements. These IRS agents have aggressively pursued this audit position even though there is no specific guidance on whether or how to tax such secondary personal use. Until this apparent fundamental shift in the IRS’s approach, the IRS’s increasingly pervasive audit position has been that employees are required to allocate their personal and business use of employer-provided cell phones and PDAs and contemporaneously document such use in a business log or diary. Few, if any, employees document the business and personal usage to their employers. The lack of IRS guidance, combined with employers’ belief that the primary usage of the equipment is for business purposes, has led most employers (taxable, nontaxable, and governmental) to exclude all personal use of cell phones and PDAs from wages on the basis that any personal use of such relatively inexpensive devices is a de minimis fringe.

IRS Notice 2009-46 – Last week, no doubt in response to intense criticism from taxpayers and certain members of Congress, the IRS issued Notice 2009-46, seeking comments on proposed simplified procedures for substantiating the business use of employer-provided cell phones and PDAs. Unless a proposed legislative fix is enacted, the Notice is the first step toward the creation of future IRS guidance that will clarify how to substantiate the allocation between employees’ business and personal use of their employer-provided cell phones and PDAs. Last week’s notice caused significant concern and led some

practitioners to conclude that the IRS was beginning to “crack down” on taxpayers when in fact this has been a focused audit initiative for the past five years. We are informing clients that IRS Notice 2009-46 is the first important and practical step in the right direction, one which seeks to lessen the adverse impact of prior IRS audit positions that interpreted a statutory provision that is admittedly complex, burdensome, and subject to diverse interpretations.

In general, the value of an employee’s business use of an employer-provided cell phone and/or PDA is excluded from taxable income as a working condition fringe benefit. Even though cell phones are no longer the costly communication gadget they began as in the late 1980s, the federal tax laws impose specific substantiation requirements that apply to the extent that cell phones and PDAs remain classified as “listed property.” Listed property is a classification typically reserved for costly computers, automobiles, and entertainment property—a classification that, as a practical matter, no longer accurately describes cell phones and PDAs.

In issuing Notice 2009-46, the IRS seeks comments about the following proposed methods for substantiating an employee’s business use of employer-provided cell phones:

- **Minimal personal use method:** Under this method an employer could (a) disregard a specified amount of “minimal” personal use (e.g., a specified number of minutes) in determining any taxable portion of personal use of an employer-provided cell phone or (b) allocate an employee’s entire use of an employer-provided cell phone to business use if the employee can provide sufficient records to establish that he or she maintains and uses a personal cell phone for personal purposes during work hours. To exclude personal use of cell phones and PDAs from its own employees’ wages, it is generally believed that the IRS applies method (a), combined with a business use policy and employee statement. This approach certainly conforms to Commissioner Shulman’s remarkably candid and practical assessment of this tax issue.
- **Safe harbor substantiation method:** This method would permit an employer to treat a fixed, IRS-approved percentage of an employee’s use of an employer-provided cell phone as business use, with the remaining percentage of use deemed to be for personal purposes. The IRS proposes setting the business use percentage at 75%. (Many prior IRS audits have been resolved using assumptions of 20% to 25% personal use.)
- **Statistical sampling method:** This method would allow an employer to use statistical sampling techniques to measure an employee’s personal use of an employer-provided cell phone. The IRS indicates that this would be similar to the statistical sampling methodology set forth in Rev. Proc. 2004-29 for establishing the amount of substantiated meal and entertainment expenses excepted from the 50% deduction disallowance rules.

IRS Commissioner Shulman Asks Congress to Fix the Cell Phone Issue – On June 16, Commissioner Shulman released a statement in which he clearly stated that the purpose of Notice 2009-46 is to simplify the rules and ease taxpayer burdens. This marks a significant change from the IRS’s past audit positions and many large tax adjustments. The entire statement follows:

This month, the Internal Revenue Service asked for comments on ways to simplify compliance with rules related to employer-provided cellular telephones. The current law, which has been on the books for many years, is burdensome, poorly understood by taxpayers, and difficult for the

IRS to administer consistently. Some have incorrectly implied that the IRS [by issuing this notice] is “cracking down” on employee use of employer-provided cell phones. To the contrary, the IRS is attempting to simplify the rules and eliminate uncertainty for businesses and individuals.

Although some of the proposed changes would add clarity, the current law will inevitably leave widespread confusion among employees and businesses. Therefore, Secretary Geithner and I ask that Congress act to make clear that there will be no tax consequence to employers or employees for personal use of work-related devices such as cell phones provided by employers. The passage of time, advances in technology, and the nature of communication in the modern workplace have rendered this law obsolete.

Although the IRS has been aggressively auditing this issue, the combination of IRS Notice 2009-46 and Commissioner Shulman’s short statement indicate a fundamental shift within the IRS regarding this important issue, and serve as acknowledgment that its audit position is arcane and burdensome. This important shift within the IRS may even indicate that the IRS may consider adopting a nonenforcement position (similar to its current nonenforcement position on frequent flyer awards, an equally burdensome and controversial tax compliance issue) and issuing refunds to those taxpayers who have recently paid large assessments related to this issue.

Congressional Repeal – It is important to note that the Notice does not have the effect of removing employer-provided cell phones and PDAs from the onerous definition of “listed property.” In response to a series of audits, Representative Sam Johnson (R-Tex.) and Senator John Kerry (D-Mass.) introduced legislation in 2008 and again in early 2009 to exempt cell phones and PDAs from the listed property recordkeeping requirements. If enacted, the exemption would become effective in 2009. *See* H.R. 690 and S. 144, “Modernize Our Bookkeeping in the Law of Employee’s (MOBILE) Cell Phone Act of 2009.” These bills will likely generate widespread bipartisan support as this is a tax issue that undoubtedly impacts most members of Congress and their staffers. While an immediate legislative fix is the preferred approach, the proposed substantiation methodologies, especially the minimal personal use methodology in the Notice, are important steps forward in developing guidance addressing the personal use of employer-provided cell phones and PDAs.

Morgan Lewis’s Written Comments to the IRS – The IRS and Department of Treasury have requested written comments, including proposals on alternative substantiation methods, by September 4, 2009. Morgan Lewis intends to submit comments on this issue and would welcome client suggestions as to desired solutions and/or substantiation methods. While our primary focus will seek a broad-based de minimis use exclusion, our comments will also address the other methodologies raised by the IRS.

For example, in any case where an employer can prove that an employee’s level of cell phone service has been selected based on proven levels of pure business calls up to the minimum minutes allowed under a designated service band, then any personal calls in that band have no effective cost. The selection of that particular band of service simply avoids the much more expensive per-minute charges that would have been incurred for business calls had a service band with fewer minutes been purchased. Under longstanding IRS rulings and case law, any such proven savings in business cost should support a full deduction of the entire cost of that incremental band of service, even if there was some personal benefit to the employee associated with the expense.

The full text of IRS Notice 2009-23 is available at http://www.irs.gov/irb/2009-23_IRB/ar07.html.
Commissioner Shulman's statement can be found at
<http://www.irs.gov/newsroom/article/0,,id=209795,00.html>.

Morgan Lewis has issued a separate LawFlash on this topic for tax-exempt employers, which can be found at
http://www.morganlewis.com/pubs/TaxExempt_EmployerProvidedCellPhones_LF_15jun09.pdf.

Please contact any of the following Morgan Lewis attorneys if you would like Morgan Lewis to include your comments in its IRS submission, you have questions concerning IRS Notice 2009-23 or Commissioner Shulman's statement as it pertains to your company, or you would like copies of an article written by Rep. Johnson on this controversial topic:

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