

IRS Requests Comments on Proposed Methods for Substantiating the Business Use of Employer-Provided Cell Phones

June 15, 2009

On June 8, the Internal Revenue Service (IRS) issued Notice 2009-46, seeking comments on proposed simplified procedures for substantiating the business use of employer-provided cell phones under Section 274(d)(4).¹ This provision generally requires employees to allocate their personal and business use of employer-provided cell phones and contemporaneously document such use in a business log or diary. The IRS views the value of any such personal use as income to the employee. The Notice is the first step towards future IRS guidance that will better clarify how to substantiate the allocation between employees' business and personal use of their employer-provided cell phones.

In general, the value of an employee's business use of an employer-provided cell phone (or other personal digital assistant device (PDA)) is excluded from taxable income as a working condition fringe benefit. Despite an uneven enforcement track record, the IRS takes the view that in order to meet the requirements of this exclusion, employers must demonstrate such business use in accordance with specific substantiation requirements set forth in Section 274(d)(4), because cell phones (and PDAs) are classified as "listed property" under Section 280F.

For Section 501(c)(3) and (4) organizations subject to the Section 4958 intermediate sanctions rules, if the value of the personal use is not properly substantiated and treated as compensation, there is a risk that the IRS will propose treating use of an employer-provided cell phone by a disqualified person as an automatic excess benefit transaction under Section 4958. Thus, it is particularly important for such organizations to implement and follow an internal policy specifying their expectations of employees' use of employer-provided cell phones, including the circumstances under which an organization treats an employee's use as personal use, and the intent to treat such personal use as compensation.

Notice 2009-46 seeks comments about the following proposed methods for employers to substantiate an employee's business use of employer-provided cell phones:

- **Minimal personal use method:** Under this method (a) an employer could 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

¹ All Section references are to the Internal Revenue Code of 1986, as amended.

for personal purposes during work hours or (b) the IRS would disregard a specified amount of “minimal” personal use (e.g., number of minutes) in determining the amount of personal use of an employer-provided cell phone.

- **Safe harbor substantiation method:** Using this method an employer could treat a set 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%.
- **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 under Section 274(n).

Should the IRS decide to implement one or more of these alternative methods, they would be purely optional. If an employer chooses to use one of the methods, however, the IRS anticipates mandating that the employer implement a written policy that requires employees to carry and use the cell phones in connection with the employer’s trade or business, and prohibits the personal use of employer-provided cell phones, except for minimal personal use. The IRS might also require the employer to have a reasonable belief that the cell phone is not used for personal purposes except for minimal personal use.

It is important to note that the Notice does not have the effect of removing employer-provided cell phones from the definition of “listed property” under Section 280F, which has been the subject of various legislative proposals. However, its proposed substantiation methodologies are a step forward in developing guidance for employers in substantiating the business use of cell phones provided to their employees. The IRS and Department of Treasury also welcome additional proposals on alternative substantiation methods during the comment period. We encourage nonprofit organizations to submit comments as to the practical utility of the IRS’s proposed methodologies and suggestions for other approaches as well. We anticipate that the cellular communications industry and for-profit employers will take an active role in this debate, and that the issuance of the Notice may accelerate industry efforts to remove employer-provided cell phones from items treated as “listed property” or otherwise to ameliorate these potentially burdensome requirements.

The full text of the Notice is available at http://www.irs.gov/irb/2009-23_IRB/ar07.html. All comments must be submitted in writing by September 4, 2009.

Morgan Lewis has issued a separate LawFlash on this topic, for employers other than tax-exempt organizations, which can be found at: http://www.morganlewis.com/pubs/EB_BusinessCellPhones+PDAs_LF_17jun09.pdf.

If you have any questions concerning this IRS Notice as it pertains to your organization, please contact any of the following Morgan Lewis attorneys:

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