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## Create Tax-Free Fringe Benefit Deductions for Your Smartphone

How do you operate your business? As a proprietorship? A corporation? A partnership? (Note that your LLC falls into one of the categories.)

Your business entity makes a big difference when it comes to the personal tax benefits you as a small business owner can realize on your personal costs for a smartphone such as an Android phone or an iPhone.

And depending on how you operate your business, you can achieve the tax benefits without keeping any tax records on your smartphone usage. For this added and delightful benefit, say thanks to the IRS and your lawmakers.

If you have employees or independent contractors, you can bless them by paying for their smartphones and not requiring them to keep any phone usage records.

This article sets out the relatively new and certainly improved smartphone rules that you will actually like. (How's that for a tax law?)

### ***Who Is an Employee, and Why Ask?***

The definition of an "employee," for working condition fringe benefit purposes such as this smartphone benefit, is broader than you would think, and includes<sup>1</sup>

- your current employees (this includes you if you are an employee of your corporation),
- partners in your partnership performing services for your partnership,
- directors (if you operate as a corporation), and
- independent contractors performing services for you.

Note that this list does not include you if you're a sole proprietor. But not to worry: proprietors also got a break from the changes in the law, as we discuss later.



## ***How the Smartphone Tax Break Works***

When a business provides an employee or a partner with a smartphone or similar telecommunications equipment primarily for non-compensatory business reasons, the following great things happen:<sup>2</sup>

1. The employee's or partner's business use is a working condition fringe benefit that is excludable from income.
2. The employee's or partner's personal use is excludable from income as a de minimis fringe benefit.
3. The employee or partner does not have to keep records of business use.
4. The tax code nondiscrimination requirements do not apply. This means the business can pick and choose who gets the smartphone benefits. (This could be you only.)

## ***Non-compensatory Reason***

To qualify for this tax-favored treatment, the business must grant this smartphone benefit to the employee or partner primarily for "non-compensatory business purposes" such as the following (and you are going to love these):<sup>3</sup>

1. The employer needs to be able to contact the employee at all times in case of work-related emergencies.
2. The employer requires that the employee be available to speak with clients when away from the office.
3. The employee needs to speak with clients located in other time zones at times outside of the employee's normal workday.

If you operate your business as a corporation or partnership, you should have no problem satisfying one or more of the three criteria above.

**Beware.** Your business does not meet the non-compensatory test if it offers the smartphone to<sup>4</sup>

 promote goodwill or a particular employee's morale,

- attract a prospective employee, or
- provide additional compensation to an employee.
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## ***Similar Equipment***

The smartphone (known as a “cell phone” in IRS Notice 2011-72) includes other similar communications equipment.<sup>5</sup> According to the IRS audit manual, similar equipment includes tablet devices such as iPads.<sup>6</sup>

## ***Mechanics***

Although it could, the business does not need to buy the smartphone and its calling plan for the employee or partner. Instead, the business could pay the employee a cash allowance and/or reimburse the actual plan use.<sup>7</sup>

**Example.** You pay a flat monthly fee for your smartphone service. That fee includes the cost of your phone. You operate your business as an S corporation. Your corporation can reimburse you for the entire monthly fee even though you use the phone for both personal and business calls.<sup>8</sup>

The IRS audit manual states that the reimbursements are not income if<sup>9</sup>

1. the employee maintains smartphone coverage that is reasonably related to the needs of the business;
2. the reimbursement is reasonably calculated not to exceed expenses actually incurred in maintaining the phone; and
3. the reimbursement does not really represent a substitute for the employee’s regular wages.

Note that there are no accountable plan rules for the reimbursement. You simply need a reasonable calculation, or better yet, you can simply reimburse based on the phone bill.

## ***Smartphones for the Sole Proprietor and the Single-Member LLC***

The IRS’s no-hassle smartphone break applies to your employees, but not to you if you are a sole proprietor or the owner of a single-member LLC.



If you are in the out-of-favor group, you deduct your monthly business-related smartphone costs the same as any other business operating expense, such as rent or utilities. You depreciate or expense the cost of the smartphone itself, just like any other capital property, such as computers.

Your sole piece of good news comes from the change in the law, not from the IRS. Smartphones are no longer listed property. That makes things easier.

But unlike those who own corporations, you are required to offer proof of your percentage of business use. If you use the smartphone 75 percent for business and 25 percent for personal, your proprietorship deduction for expensing, depreciation, and monthly charges is based on your 75 percent business use.

To prove the 75 percent, you need to keep track of your calls. One easy method is simply to tally the business and personal calls that show on your smartphone bill as proof of your business and personal use.<sup>10</sup>

You don't necessarily have to go through every smartphone bill for the entire year and categorize each and every call. If you make about the same number of calls every month, you can use a sampling method for, say, three months.<sup>11</sup>

If you hate the idea of checking off the calls on your phone bill, consider acquiring two phone numbers for your smartphone: one for business and one for personal use. Technology now makes this possible.<sup>12</sup>

## ***Independent Contractors***

The IRS grants independent contractors tax-free, tax-favored employee status for smartphones given to them or reimbursed to them by their employers (clients, brokers, etc.).<sup>13</sup>

This favored-employee status does not apply to independent contractors who are not reimbursed for smartphone use by an employer. Unreimbursed independent contractors are proprietorships for the purposes of smartphone use and thus are subject to the prove-your-cell-phone-use rules discussed above.

## ***Takeaways***

If your business is taxed as other than a sole proprietorship, you can have your corporation or partnership pay or reimburse 100 percent of your smartphone expenses, even when you use the smartphone for both business and personal purposes.

The corporation or partnership can pick and choose which employees or partners get the fringe benefit. There are no limiting discrimination rules.

And this gets better: neither you nor your chosen employees need to keep records on smartphone use.

The general rules for this fringe benefit are that it cannot represent compensation to the employee or partner and that there needs to be a business reason for the smartphone.

These rules work for all employees and partners, but not for sole proprietors or single-member LLCs taxed as sole proprietors. The sole proprietor has to keep basic business records on personal and business use and can deduct only the business use. But there's a silver lining here: the smartphone is no longer listed property that requires those onerous records.

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- 1 Reg. Section 1.132-1(b)(2); IRS Publication 15-B, Employer's Tax Guide to Fringe Benefits (2017), p. 21.
- 2 Notice 2011-72; Reg. Section 1.132-8(a); IRM Section 4.23.5.13.3.1.
- 3 Notice 2011-72.
- 4 Ibid.
- 5 Notice 2011-72.
- 6 Internal Revenue Manual 4.23.5.13.3.1.
- 7 IRS Memorandum for All Field Examination Operations, Sept. 14, 2011.
- 8 Ibid.
- 9 Internal Revenue Manual 4.23.5.13.3.2.
- 10 Umit Tarakci, T.C. Memo. 2000-358.
- 11 Reg. Section 1.274-5T(c)(3)(ii)(C), Example 1.
- 12 For some ideas on how to have two lines on one phone, Google "one smartphone, two phone numbers."
- 13 IRS Regulation 1.132-1(b)(2)(iv).

