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Income Tax Treatment of Fringe Benefits Provided to Pass-Through Entity Owners

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Taxation of fringe benefits is a topic that has long been a source of confusion for both taxpayers and tax practitioners. In some situations, partners of an entity are treated strictly as partners. Consequently, this may make them ineligible for tax-free benefits. In other instances, partners are treated as employees and are eligible to share in the benefit in the same manner as any other employee. Whether or not a partner is treated as a partner or as an employee is dependent upon the type of benefit being provided. Below is a list of the most popular fringe benefits that employers offer and how the partner would be treated if they received such benefits.

Treated as Partners

- Qualified employee achievement award
- Group term life insurance coverage of up to $50,000 per partner (or shareholder)
- Disability insurance coverage
- Medical reimbursement plans
- Premiums for accident, health, and long-term care insurance coverage for the partner (or shareholder), spouse, and dependents
- Meals or lodging furnished for the convenience of the company
- Cafeteria plan
- Qualified transportation fringes
- Qualified moving expense reimbursements
- Qualified adoption assistance program
- Health savings accounts

Treated as Employees

- Qualified educational assistance program
- Qualified dependent care assistance program
- No-additional-cost services
- Qualified employee discounts
- Working condition fringe benefits. These include the business-use portion of a company-provided vehicle, professional dues, company-paid job-related education expenses, company-provided cell phones, and job placement assistance.
- *De minimis* fringe benefits. These include personal use of an employer-provided cell phones or computer maintained exclusively at business establishment, occasional employee cocktail parties or picnics, occasional use of the copy machine, and local telephone calls.
- On-premises athletic facilities
- Qualified retirement planning services

When a partner is treated as a partner, the cost to provide the benefit is treated as a guaranteed payment. Therefore, such costs are deducted by the partnership and reported as taxable income to the recipient partner. However, the payments must be for compensation for services rendered. If services are not provided, benefits are treated as distributions to the partner, not guaranteed payments. When a more than 2% S Corporation shareholder-employee (or an employee treated as such under stock ownership attribution rules) is treated as a partner, the S Corporation's cost to provide the benefit is treated as compensation expense and reported as taxable compensation income to the shareholder. In the case of a C corporation, fringe benefits can be provided tax free to shareholder employees and deducted by the corporation. Therefore, the rules for these fringe benefits are much more favorable for C corporations than for S corporations or partnerships.

For those fringe benefits that allow a partner to be treated as an employee, the partnership or S Corporation can deduct the cost of providing the benefits. Additionally, the benefits are tax free to the recipient partner or shareholder. In the case of a C corporation, these fringe benefits can be provided tax free to shareholder employees as well. This is obviously a much better tax result than when a partner is strictly treated as a partner.

The rules for taxing fringe benefits are complex. However, having at least a general understanding of how your fringe benefits are taxed is extremely important. Otherwise, it would be difficult to know what you're actually earning, what you're paying taxes on, and also complicate tax planning. If you have any questions about how fringe benefits may impact you or your business, contact one of the tax professionals at Zinner & Co to discuss your specific situation.

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