"Control Employee" Changes and the Commuting Valuation Rule

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Bio:
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The commuting valuation rule is a "special valuation rule" provided for under the Internal Revenue Code and Treasury Regulations for noncash fringe benefits. The commuting valuation rule only applies where the employee is not a "control employee" under the Code and Regulations.

This article examines whether a government employer can change how it determines who qualifies as a "control employee" on a year to year basis. The author submits that the answer is "yes."[2]

A. Special Valuation Rules for Employer-Provided Vehicles

Treasury Regulation 1.61-21 addresses how noncash fringe benefits are to be valued by employers and employees for federal tax purposes. In general, noncash fringe benefits are to be valued based on the fair market value of the benefit received. Treas. Reg. § 1.61-21(b)(1). The fair market value of the noncash benefit is included in the employee's gross income. Id.

The rule provides certain "special valuation rules," however, for valuing certain types of noncash benefits. Treas. Reg. § 1.61-21(c). These special valuation rules "may be used under certain circumstances" as set forth in the rule. Id. at (c)(1).

If an employer uses a certain special valuation rule to value a noncash benefit, the employee can only use that specific special valuation rule when calculating gross income. Id. at (c)(2). However, the employee always has the option of using "fair market value" when valuing noncash benefits for purposes of calculating gross income. Id.

In this way, the "special valuation rules" are best understood as exceptions from the general rule of using the fair market value of noncash fringe benefits to determine the amount included in an employee's gross income.

Special valuation rules for employer-provided vehicles are set forth in sections (d), (e), and (f) of Treasury Regulation 1.61-21. Subsection (d) addresses the "lease valuation" rule; subsection (e) addresses the "vehicle cents-per-mile" rule; and subsection (f) addresses the "commuting valuation" rule. This article only addresses the commuting valuation rule.

B. "Control Employees" and the Commuting Valuation Rule

The commuting valuation rule allows employers to calculate the value of an employer-provided vehicle at $1.50 per one-way commute. Treas. Reg. § 1.61-21(f)(3)(i). This valuation rule can only be used if the conditions set forth in subsection (f)(1) of the regulation are met.

One of the conditions set forth in subsection (f)(1) is that the employee using the vehicle cannot be a "control employee of the employer." Treas. Reg. § 1.61-21(f)(1)(v). The term "control employee" is defined in subsection (f)(6) for government employers. Government employers are therefore subject to the rule at subsection (f)(6) for determining who a "control employee" might be.

Treasury Regulation 1.61-21(f)(6) provides two "default" definitions of which employees constitute a "control employee" of a government employer. These default definitions describe control employees as either: (i) elected officials, or (ii) employees "whose compensation equals or exceeds the compensation paid to a Federal Government employee holding a position at Executive Level V, determined under Chapter 11 of title 2, United States Code, as adjusted by section 5318 of title 5 United States Code." Treas. Reg. § 1.61-21(f)(6)(i)-(ii) (emphasis added).

Subsection (f)(6) also provides a third, optional way for government employers to determine who the control employees are in the employer's organization. This alternative method, which can be used in lieu of the default definitions described above, allows the employer to define control employees as "highly compensated" employees as that term is defined elsewhere in the regulations. Treas. Reg. § 1.61-21(f)(6)(ii).

The employer has the power to choose whether to use the "default" control employee definitions for purposes of the commuting valuation rule, or whether to use the "highly compensated" employee option instead. Id. This "optionality" has been confirmed by the IRS

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in non-binding informational advice. See IRS Office of Chief Counsel, Information Letter 2008-0031 (Sept. 26, 2008) (whether elected officials are control employees depends on whether the employer chooses to apply the default definition or the highly compensated employee definition).

Under the rule, government employees that are not elected officials can therefore be analyzed as "control employees" under either the "Executive Level V" benchmark or the "highly compensated employee" benchmark.[3]

C. Can the Employer Change its Choice of "Control Employee" Definition?

A government employer has the freedom to choose which benchmark it will initially use to determine who qualifies as a control employee. But after this initial choice, can the employer change how it defines control employees under subsection (f)(6)? This issue has not been directly addressed by any publicly available IRS guidance or judicial decision.[4]

The author submits that the structure of the regulation and related concepts indicate that the employer should be able to change its "choice" of how it defines control employees on a taxable year basis.

The concepts at issue are as follows:

1. No IRS Notification Required for Special Valuation Rule Election

The employer is under no obligation to "notify" the IRS when it elects to use a special valuation rule for a noncash fringe benefit. This "no notification" rule was specifically codified in 1993 for elections occurring prior to that year. Treas. Reg. § 1.61-21(c)(3)(i). Instead of notification, the employer is "deemed" to have applied a special valuation rule when the rule is applied. Id.

This provision was adopted in the context of the IRS eliminating the notification requirements that were previously required for employers to use special valuation rules. T.D. 8457, 57 F.R. 62192-01, § 1 ("[T]his Treasury Decision amends the regulations [§ 1.61-21(c)] by eliminating the [rule's previous] notification requirements[.]").

No notification provision was added for post-1993 elections.

Therefore, the IRS does not require employers to notify the IRS when a special valuation rule is used. The use of the rule is the election itself.[6]

2. No Notification Required for Special Accounting Rule

In 1985, the IRS provided guidance on reporting and withholding on taxable noncash fringe benefits. IRS Ann. 85-113, 31 I.R.B. 31 (Aug. 5, 1985). This guidance is still current, as it is incorporated by reference into the current Treasury Regulation on valuation of noncash fringe benefits. See Treas. Reg. § 1.61-21(c)(7) (referencing IRS Ann. 85-113). See also PLR 201415011, "Ruling 8" (Jan. 13, 2014) (private letter ruling from 2014 referencing IRS Ann. 85-113 as current law); IRS Publication 5137: Fringe Benefit Guide, p. 3 (Jan. 2014) (same).

In Announcement 85-113, the IRS provided that employers can elect to use a "special accounting rule" for noncash fringe benefits. This rule allows employers to treat such benefits provided in the last two months of a taxable year as if they had been paid during the subsequent calendar year. IRS Ann. 85-113, § 5(a).

The "general rule" is that the value of the noncash fringe benefits has to be determined for the calendar year. Id. Therefore, this "special" accounting rule is an exception to the generally applicable calculation period.

The employer does not have to inform the IRS about this election. Instead, the employer elects the special accounting rule by using it. IRS Ann. 85-113, § (5)(b).

The same notice allows the employer to treat benefits as paid at any point in the calendar year, regardless of when the benefits were provided. No notification is required for the employer's election. Again, the employer's use of a particular period is treated as the election itself. IRS Ann. 85-113, § 1.

Moreover, the employer can change its election at any time "for appropriate administrative reasons" without approaching the IRS for approval. IRS Ann. 85-113, § (5)(b). The caveat is that for the "changed period," the appropriate amount of income must be reported and the appropriate amount of tax must be withheld and deposited. Id.

3. Application to the "Control Employee" Determination

The concept underlying the lack of a notification duty for employers using special valuation rules or the special accounting rule is that the employer has the discretion to determine what rules will apply to a given employee.

This discretion applies to determining what "control employee" test a government employer will use. Treas. Reg. § 1.61-21(f)(6). This choice is not reported to the IRS. Instead, the choice is made through the employer's use of the test that it deems appropriate. See id.

In light of the discretion granted to the employer, it would not make sense that an employer electing to determine control employees based on the "default" method would be "locked in" to that method for all subsequent taxable years.

Instead, it makes more sense that the employer could choose, on a year to year basis, how to determine what employees count as control employees for each taxable year.

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Conclusion

This article presents an argument that it is more likely than not that government employers can change how they determine who qualifies as a "control employee" from year to year for purposes of the commuting valuation rule. Further commentary on this issue is invited and welcomed.

(Endnotes)

1 The author thanks Benjamin Taylor, law clerk at Ausley McMullen, for his research and editing assistance.

2 This article only examines the issue for government employers. In this context, "government" means "any Federal, state or local governmental unit, and any agency or instrumentality thereof." Treas. Reg. § 1.61-21(f)(6)(ii).

3 The methods for calculating these benchmarks are outside the scope of this article.

4 The author would be very glad to be shown any guidance that was overlooked. This would especially be the case if the overlooked guidance comes to a different conclusion.

5 Though the author is confident in this article's analysis, a taxpayer would be strongly advised to seek a Private Letter Ruling on this issue.

6 Employers must keep records sufficient to substantiate their valuation of employer-provided vehicles. Treas. Reg. § 31.3501(a)-1T, Q/A-8 (an employer may not include any amount related to an employer-provided vehicle in an employee's gross income unless the employer keeps "adequate contemporaneous records" substantiating the valuation).

7 Because the "highly compensated" employee method of determining control employees must be applied to all employees, it makes sense that any "switch" could only occur on a taxable year basis. See Treas. Reg. § 1.61-21(f)(6) (an employer using the highly compensated employee method must treat "all and only" such employees as control employees). Consistency should be achieved within the taxable year reporting period.

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