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IRS Rules that Employer-Provided Clothing Is Not Wages Under Some Circumstances

By William Hays Weissman

In Private Letter Ruling 2010-05014, the Internal Revenue Service (IRS) held that an employer could exclude the value of employer-provided clothing and related accessories from its employees' wages as a *de minimis* fringe benefit. This Ruling provides some clarity on when employer-provided clothing can be excluded from an employee's wages, but employers should be careful to limit this Ruling's holding to its somewhat particular facts.

Background Facts

The ruling was requested by a political subdivision of a state that is divided into numerous departments. Many of the departments provide their employees work-related articles of clothing and accessories, including t-shirts, polo shirts, sweaters, jackets, swimsuits, socks, sweatshirts, coats, pants, jeans, shorts, gloves, hats, fanny packs, belts, clip-on ties, and equipment bags. Most of the items bear the taxpayer's logo, or other information identifying the individual as an employee of the taxpayer. Employees are required to wear the clothing items while performing services for the taxpayer.

Items are ordered from a vendor under a master contract. The pricing may vary considerably from item to item, and the contracts rarely include specific prices. For example, a medium t-shirt may have a different cost than a large t-shirt, or two medium t-shirts made of different grade material may have different costs. Also, due to escalation clauses, the price for the same size t-shirt may vary from year to year.

Items are usually distributed when an employee is hired, and may be replaced on an as needed basis. Also, the number of items received vary based on several factors, such as whether the employee is full-time or part-time and the kinds of services being performed.[1]

The Ruling

Under Internal Revenue Code rules, any compensation, whether cash or property,

provided to an employee for services is treated as wages subject to employment taxes unless there is a specific exclusion.[2] One such exclusion is for *de minimis* fringe benefits. A de minimis fringe benefit is any property or service the value of which is so small (after taking into account the frequency with which the employer provides similar fringes to other employees) as to make accounting for it unreasonable or administratively impracticable.[3] The Ruling addressed all three criteria necessary to establish a *de minimis* fringe benefit: (1) the value of the benefits; (2) the frequency with which the taxpayer distributed the benefits; and (3) whether it was administratively impracticable to require the taxpayer to account for the benefits.

Items Deemed to Be of Low Value

With respect to the value of the items, the Ruling states: "The items identified by Taxpayer are of low value. Using the cost of the items as an approximation of their values, it is reasonable to conclude that the items listed in Taxpayer's ruling request are *de minimis* fringes if Taxpayer can also establish both that the frequency with which the items were distributed does not preclude such a finding, and that it would be administratively impracticable to account for each item's value."[4]

Items Not Distributed Too Frequently

Turning next to the issue of distribution frequency, the IRS noted that items are usually distributed upon hire and then only on an as-needed basis. There were also policies about the maximum number of items that could be received. "We do not consider the provision of the items once, or perhaps twice, annually as so frequent that, given the low value of each item, the provision could not properly be characterized as *de minimis*."[5] Nonetheless, the IRS also pointed out that the "relevant inquiry for purposes of determining employer-measured frequency is not the frequency with which each individual employee actually received the benefits, but the frequency with which all employees collectively received the benefits."[6]

The IRS also addressed the issue of when frequency is determined by employer-based criteria or employee-based criteria. The IRS pointed out that an employer cannot tailor its procedures to make accounting for *de minimis* fringe benefits administratively difficult for the purpose of achieving *de minimis* fringe benefit treatment.[7]

Nonetheless, the IRS found that it was appropriate in this case to determine frequency by an employer-based criteria. Specifically, the IRS found that under the taxpayer's policies it would have to require each department to track the number of items that each employee received, maintain records for each employee, and routinely transmit such records to various fiscal officers. Further, the IRS found that: (1) many departments, particularly those that provide the items on an "as-needed" basis, do not distribute items at regular intervals; (2) many items are provided to volunteers, a population whose receipt of employer-provided items is inherently difficult to track; and (3) not all employees opt to receive all items that they are entitled to receive under departmental policies.[8]

Administratively Impractical to Account for Items

The IRS noted that while the determination of administrative impracticability is a facts and circumstances test, "one objective guidepost exists where the administrative costs associated with determining the value of the benefit and accounting for it may be more expensive than providing the benefit."[9] Here, the IRS found that, based on objective data, the taxpayer would incur substantial administrative costs to account for the fair market value of each item. Specifically, the IRS found that the vendor does not provide detailed invoices, nor can it do so at this time. Further, given the variables, such as the escalation clauses and differences in sizes and materials, it would be difficult for the taxpayer to determine cost for the items. Also, because the items have the taxpayer's logo, their fair market value might not be readily ascertainable.[10]

In addition, the IRS found that the taxpayer would incur substantial costs to maintain records of the fair market value. "Its necessarily large and bureaucratic structure would, however, make this process costly. Taxpayer has determined that this tracking process would require a storeroom worker to complete a form every time an employee received an item. This form would have to identify the employee, the item received, the date received, and the item's fair market value. Storerooms would have to maintain these records, and routinely (which Taxpayer defines as most likely weekly) prepare reports and transmit copies of the records to their department's fiscal officer."[11]

The IRS went on to note that, while these costs result in part from the taxpayer's large and decentralized structure, "it is notable for the purposes of a de minimis fringe analysis that there is no indication that Taxpayer designed this system with an intent to make it administratively impracticable to track the items' values. Rather, the size and nature of Taxpayer's operations necessitates such an administrative structure."[12]

Therefore, the IRS held that such clothing items were *de minimis* fringe benefits and excluded from an employee's wages.

Words of Caution For Employers

Before employers assume that any clothing they provide to employees is no longer taxable as a *de minimis* fringe benefit under this Ruling, they should carefully consider the specific facts of this Ruling. There are two facts in particular that appear critical to the IRS's analysis. First, the taxpayer was a large and decentralized entity, which made accounting for items administratively impractical. Second, the nature of the vendor contract, with its escalation clauses and inability to articulate standard pricing clearly, was an important factor in the IRS's determination that accounting for the costs or fair market value was administratively burdensome.

Employers that do not have the same kind of large decentralized structure, such that accounting for items would not be so burdensome, likely cannot establish the same criteria as the taxpayer in this Ruling. Further, employers that can clearly track the costs of items purchased, such as from a catalog with specific pricing, also likely cannot meet the criteria that the taxpayer in the Ruling was able to establish. It is unlikely that this Ruling will be applicable to other employers in the absence of these or similar facts.

Nonetheless, if after careful consideration, an employer does not believe it can meet the administrative burdensome criteria, it may still treat employer-provided clothing as a *de minimis* fringe benefit if the value is low, such as $25 (and probably not more than about $50),[13] and the items are infrequently provided, such as once a year at a holiday party. However, employers should always remember that most items provided to employees are treated as wages unless they can find a specific exclusion, which should be narrowly construed.

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[1] Priv. Ltr. Rul. 2010-05014, at 1-6.

[2] I.R.C. § 3401; *United States v. Cleveland Indians Baseball Co*., 532 U.S. 200 (2001).

[3] I.R.C. § 132(e)(1).

[4] Priv. Ltr. Rul. 2010-05014, at 10-11.

[5] *Id*. at 13.

[6] *Id*. at 12-13 (citing Treas. Reg. 1.132-6(b)(2)).

[7] *Id*. at 11 (citing *American Airlines v. United States*, 40 Fed. Cl. 712, 725 (Ct. Cl. 1998), *aff'd*, 204 F.3d 1103, 1112 (Fed. Cir. 2000) (stating that "difficulty caused by the employer's chosen accounting system . . . does not constitute administrative impracticability")).

[8] *Id*. at 11-12.

[9] *Id*. at 13.

[10] *Id*. at 13-15.

[11] *Id*. at 15-16.

[12] *Id*. at 16-17.

[13] In IRS Information Notice 2008-23 (June 27, 2008), the IRS indicated that a gift amount of $50 was used for administrative convenience and therefore qualified as a *de minimis* fringe benefit. The IRS noted that there was no set dollar limit on *de minimis* fringe benefits. The $25 limit is a long-standing rule of thumb that comes from the limit for income tax deductions for gifts made by businesses, often for suppliers and customers. The Information Notice did not actually endorse the $50 limit as any kind of bright line de minimis fringe benefit amount, and thus employers should be cautious about using an amount much higher than $25. Nonetheless, the Information Notice is useful in reiterating that there is no bright-line rule as to what amount constitutes a *de minimis* fringe benefit, and employers should use their best judgment when determining if an amount is *de minimis.*