

## **Employee Discounts: Do You Know the Rules?©**

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Like most practices, yours probably offers discounts to employees on veterinary services and products. Although the amount of the discount varies widely from practice to practice, this is a very common fringe benefit in the industry. Many owners offer discounts as a way to provide a valuable benefit to their employees, and since most practice employees have pets, no doubt this is truly appreciated by those employees. Seems logical, doesn't it?

But like many other good ideas with tax implications, this one is full of traps. What's set forth below is one of the least known tax rules, and one which is not widely understood in the veterinary profession. But here is what our current tax law says about employee discounts. In order for the discounts not to result in taxable income to the employee (with resulting payroll taxes for both the employee and the employer), these discounts *cannot exceed* the following amounts.

- For services, 20% of the price you charge clients for the same service
- For sales of products, your average gross profit percentage for the prior year times the price you charge clients for the same products.

What's a gross profit percentage? If a product costs you \$10, and you charge your clients \$25 for it, then your gross profit is \$15 (\$25 sales price minus \$10 cost) and your gross profit percentage is 60% (\$15 gross profit divided by \$25, the sales price). If you had the same gross profit percentage on all your product sales in the prior year, then the maximum discount you could offer an employee is 60%, or \$15, which is 60% of \$25. A much simpler way to think of this (though when was our tax law ever simple?) is that basically you can sell products to employees at cost, or \$10 in our example.

- You must offer the same discount to all of your employees, or at least to a group that is large enough not to favor highly compensated employees. Anyone who owns more than 5% of the practice is automatically a highly compensated employee, as are employees who earned over \$110,000 in the prior year (based on 2010 rules). You can ignore that second test if the employee was not in the top 20% of employees (ranked by pay) in the prior year.

I know you're now saying one (or more) of the following:

- That's ridiculous!
- But everybody gives employees bigger discounts than that!

- Why didn't anybody ever tell me this before?
- If we work on employees' pets when we're not busy, why does the IRS even care?
- If the IRS doesn't limit the discounts I give my clients, why do they want to control employee discounts?

If you view this from the IRS's perspective, without such a rule employers could choose to pay employees less salary or smaller wages and then give them sizable discounts on goods and services, with the net effect that employee wages would be less, the employee's income taxes would be less, and both the employee and the practice would pay less in payroll taxes. These rules don't just apply to veterinary practices – they apply to all businesses.

So what happens if the discount given to employees exceeds these guidelines? The discounts become taxable wages which must be included in the employees' W-2s at year end, and payroll taxes must be withheld from the employees and matched by the employer as with any other compensation.

Here's how the rules work. For any discount or other fringe benefit to be excludable from an employee's wages, it must fall in one of a handful of specific categories in the tax law. For purposes of this discussion, the relevant categories are:

- **Services provided to your employees at no additional cost to you.** The example generally given is excess capacity services, such as airline, bus, or train tickets for transportation workers or hotel rooms for hotel employees. At first blush, you would think you could treat employee pets during slow periods and exclude the value of the services under this rule. But there are a couple of problems. First, highly compensated employees as discussed above are automatically not eligible for this benefit. Second, the IRS counts any lost revenue as a cost. Therefore, they could argue that the time spent treating employee pets was time not available for treating other patients, and it would be up to you to prove that there was no lost revenue. Could you prove that? Finally, the rules also say that you are considered to incur substantial additional costs if you or your employees spend a substantial amount of time in providing the service, even if the time spent would otherwise be "idle" or if the services are provided outside normal business hours. Ugh.
- **De minimis (minimal) fringe benefits.** These are described as property or services that have so little value (taking into account how frequently you provide similar benefits to your employees) that accounting for them would be unreasonable or administratively impractical. Examples include use of the practice's copy machine (as long as at least 85% of the use is for business), occasional company parties or picnics, occasional typing of personal letters by a company employee, etc. It seems highly unlikely that veterinary products or services could be squeezed into this category with any success.

- **Working condition benefits.** These rules apply to property and services you provide to employees to enable them to do their jobs. Examples include use of a company car for employees who travel on company business (if adequate documentation is provided) and attendance at work-related classes paid by the employer for training which maintains or improves job skills or is required to maintain the current position. Providing services and selling products for employees' personal pets don't fall in this category.

Because these rules are so stringent, far and away the safest and simplest approach is to offer employees no more than a 20% discount on services and require them to pay at least the practice's cost of any products which they buy. In addition, the practice's employee manual should state these rules in some detail and they should be applied uniformly among all employees. Finally, the practice should track the amount of the employee discounts using a separate code in the practice management software for discounts on services and another code for discounts on products. This would provide evidence to the IRS that the discounts have been limited as defined in the law and still allow practices to track and manage the dollar amounts they are investing in the health of their employees' pets.

Alternatively, if you want to offer larger discounts to employees than these rules allow, you can certainly do so. You must, however, include the value of those discounts in the employee's wages for payroll tax purposes and include them on Form W-2 for each employee for the year. You are, however, given some flexibility in terms of when you treat these wages as being paid. It can be done as infrequently as once a year, although to avoid penalties for failure to deposit, the related payroll taxes must be deposited in the same deposit period as the one you chose for the wages.

In case this discussion hasn't been depressing or alarming enough, you can read more about this topic in *Publication 15, Circular E, Employee's Tax Guide* published by the IRS every January and sent to all employers. There's a more complete discussion in *Publication 15-B, Employer's Tax Guide to Fringe Benefits* available at <http://www.irs.gov/pub/irs-pdf/p15b.pdf>.

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