business limitation may be relaxed under the special grandfather rule of this paragraph (e). Under this special grandfather rule, if, as of September 12, 1984—

(1) An individual—

(i) Was an employee (within the meaning of §1.132–1 (b)) of one member of an affiliated group (as defined in section 1504(a)) (''first corporation''), and

(ii) Was eligible for no-additional-cost services in the form of air transportation provided by another member of such affiliated group (''second corporation''),

(2) At least 50 percent of the individuals performing services for the first corporation were, or had been employees of, or had previously performed services for, the second corporation, and

(3) The primary business of the affiliated group was air transportation of passengers, then, for purposes of applying sections 132(a) (1) and (2), with respect to no-additional-cost services and qualified employee discounts provided after December 31, 1984, for that individual by the second corporation, the first corporation is treated as engaged in the same air transporation line of business as the second corporation. For purposes of the preceding sentence, an employee of the second corporation who is performing services for the first corporation is also treated as an employee of the first corporation.

(f) *Special rule for qualified air transportation organizations.* A qualified air transportation organization is treated as engaged in the line of business of providing air transportation with respect to any individual who performs services for the organization if those services are peformed primarily for persons engaged in providing air transportation, and are of a kind which (if performed on September 12, 1984) would qualify the individual for no-additional-cost services in the form of air transportation. The term ''qualified air transportation organization'' means any organization—

(1) If such organization (or a predecessor) was in existence on September 12, 1984,

(2) If such organization is—

(i) A tax-exempt organization under section(c)(6) whose membership is limited to entities engaged in the transportation by air of individuals or property for compensation or hire, or

(ii) Is a corporation all the stock of which is owned entirely by entities described in paragraph (f)(2)(i) of this section, and

(3) If such organization is operated in furtherance of the activities of its members or owners.

(g) *Relaxation of line of business requirement.* The line of business requirement may be relaxed under an elective grandfather rule provided in section 4977. For rules relating to the section 4977 election, see §54.4977–1T.

(h) *Line of business requirement does not expand benefits eligible for exclusion.* The line of business requirement limits the benefits eligible for the no-additional-cost service and qualified employee discount exclusions to property or services provided by an employer to its customers in the ordinary course of the line of business of the employer in which the employee performs substantial services. The requirement is intended to ensure that employers do not offer, on a tax-free or reduced basis, property or services to employees that are not offered to the employer's customers, even if the property or services offered to the customers and the employees are within the same line of business (as defined in this section).

[T.D. 8256, 54 FR 28606, July 6, 1989]

§1.132–4T Line of business limitation—1985 through 1988 (temporary).

(a) *In general*—(1) *Applicability*—(i) *General rule.* A no-additional-cost service or qualified employee discount provided to an employee must be for property or services that are offered for sale to customers in the ordinary course of the same line of business in which the employee receiving the property or service performs substantial services. Thus, an employee who does not perform substantial services in a particular line of business of the employer may not exclude the value of services or employee discounts received on property or services in that line of business.

(ii) *Property and services sold to employees rather than customers.* Since the property or services must be offered for

sale to customers in the ordinary course of the same line of business in which the employee performs substantial services, the line of business limitation is not satisfied if the employer's products or services are sold to employees of the employer, rather than to customers. Thus, for example, an employer in the banking line of business is not considered in the variety store line of business if the employer establishes an employee store that offers variety store items for sale to the employer's employees.

(iii) *Performance of substantial services in more than one line of business.* An employee who performs services in more than one of the employer's lines of business may only exclude no-additional-cost services and qualified employee discounts in the lines of business in which the employee performs substantial services.

(iv) *Performance of services that directly benefit more than one line of business*—(A) *In general.* An employee who performs substantial services that directly benefit more than one line of business of an employer is treated as performing substantial services in all such lines of business. For example, an employee who maintains accounting records for an employer's three lines of business may receive qualified employee discounts in all three lines of business.

(B) *Significantly interrelated minor line of business.* The employees of a minor line of business of an employer that is significantly interrelated with a major line of business of the employer who perform substantial services that directly benefit both the major and the minor lines of business are treated as employees of both the major and the minor lines of business. Employees of the minor line of business who do not perform substantial services which directly benefit the major line of business are not treated as employees of the major line of business. A minor line of business is significantly interrelated with a major line of business when, for example, the activity of the minor line of business is directly related to but is a minor part of the major line of business (such as laundry services provided at a hospital).

(C) *Examples.* The rules provided in this paragraph are illustrated in the following examples:

Example (1). Assume that employees of units of an employer provide repair or financing services, or sell by catalog, with respect to retail merchandise sold by the employer. Such employees may be considered as employees of the retail merchandise line of business under this paragraph (a)(1)(iv).

Example (2). Assume that an employer operates a hospital and a laundry service. Assume further that some of the gross receipts of the laundry service line of business are from laundry services sold to customers other than the hospital employer. Only the employees of the laundry service who perform substantial services which directly benefit the hospital line of business (through the provision of laundry services to the hospital) will be treated as employees of the hospital line of business. Other employees of the laundry service line of business will not be treated as employees of the hospital line of business.

Example (3). Assume the same facts as in example (2), except that the minor line of business also operates a chain of dry cleaning stores. Employees who perform substantial services which directly benefit the dry cleaning stores but who do not perform substantial services that directly benefit the hospital line of business will not be treated as employees of the hospital line of business.

(2) *Definition*—(i) *In general.* An employer's line of business is determined by reference to the Enterprise Standard Industrial Classification Manual (ESIC Manual) prepared by the Statistical Policy Division of the U.S. Office of Management and Budget. An employer is considered to have more than one line of business if the employer offers for sale to customers property or services in more than one two-digit code classification referred to in the ESIC Manual.

(ii) *Examples.* Examples of two-digit classifications are general retail merchandise stores; hotels and other lodging places; auto repair, services, and garages; and food stores.

(3) *Aggregation of two-digit classifications.* If, pursuant to paragraph (a)(2) of this section, an employer has more than one line of business, such lines of business will be treated as a single line of business where and to the extent that one or more of the following aggregation rules apply:

(i) If it is uncommon in the industry of the employer for any of the separate

lines of business of the employer to be operated without the others, the separate lines of business are treated as one line of business.

(ii) If it is common for a substantial number of employees (other than those employees who work at the headquarters or main office of the employer) to perform substantial services for more than one line of business of the employer, so that determination of which employees perform substantial services for which line of business would be difficult, then the separate lines of business of the employer in which such employees perform substantial services are treated as one line of business. For example, assume that an employer operates a delicatessen with an attached service counter at which food is sold for consumption on the premises. Assume further that most but not all employees work both at the delicatessen and at the service counter. The delicatessen and the service counter are treated as one line of business.

(iii) If the retail operations of an employer that are located on the same premises are in separate lines of business but would be considered to be within one line of business under paragraph (a)(2) of this section if the merchandise offered for sale in such lines of business were offered for sale at a department store, then the operations are treated as one line of business. For example, assume that on the same premises an employer sells both women's apparel and jewelry. Since, if sold together at a department store, the operations would be part of the same line of business, the operations are treated as one line of business.

(b) *Grandfather rule for certain retail stores*—(1) *In general.* The line of business limitation may be relaxed under a special grandfather rule. If—

(i) On October 5, 1983, 85 percent of the employees of one member of an affiliated group (as defined in section 1504 without regard to subsections (b)(2) and (b)(4) thereof) were entitled to employee discounts at retail department stores operated by another member of the affiliated group, and

(ii) More than 50 percent of the current year's sales of the affiliated group are attributable to the operation of retail department stores,

then for purposes of the exclusion from gross income of a qualified employee discount, the first member is treated as engaged in the same line of business as the second member (the operator of the retail department stores). Therefore, employees of the first member of the affiliated group may exclude qualified employee discounts received at the retail department stores operated by the second member. However, employees of the second member of the affiliated group may not exclude any discounts received on property or services offered for sale to customers by the first member of the affiliated group.

(2) *Taxable year of affiliated group.* If all of the members do not have the same taxable year, the affiliated group must designate the 12-month period to be used in determining the ''current year's sales'' (as referred to in this paragraph (b)). The 12-month period designated, however, must be used consistently.

(3) *Definition of* ''*sales*''. For purposes of this paragraph (b), the term ''sales'' means the gross receipts of the affiliated group, based upon the accounting methods used by its members.

(4) *Retired and disabled employees.* For purposes of this paragraph (b), an employee includes any individual who was, or whose spouse was, formerly employed by the first member of the affiliated group and who separated from service with the member by reason of retirement or disability if the second member of the group provided employee discounts to such individuals on October 5, 1983.

(5) *Increase of employee discount.* If, after October 5, 1983, the employee discount described in this paragraph (b) is increased, the grandfather rule of this paragraph (b) does not apply to the amount of the increase. For example, if on January 1, 1985, the employee discount is increased from 10 percent to 15 percent, the grandfather rule will not apply to the additional five percent discount.

(c) *Relaxation of line of business requirement.* The line of business requirement may be relaxed under an elective grandfather rule provided in section

4977. For rules relating to the section 4977 election, see § 54.4977–1.

[T.D. 8063, 50 FR 52301, Dec. 23, 1985, as amended by T.D. 8256, 54 FR 28600, July 6, 1989]

§ 1.132–5 Working condition fringes.

(a) *In general*—(1) *Definition.* Gross income does not include the value of a working condition fringe. A ''working condition fringe'' is any property or service provided to an employee of an employer to the extent that, if the employee paid for the property or service, the amount paid would be allowable as a deduction under section 162 or 167.

(i) A service or property offered by an employer in connection with a flexible spending account is not excludable from gross income as a working condition fringe. For purposes of the preceding sentence, a flexible spending account is an agreement (whether or not written) entered into between an employer and an employee that makes available to the employee over a time period a certain level of unspecified non-cash benefits with a pre-determined cash value.

(ii) If, under section 274 or any other section, certain substantiation requirements must be met in order for a deduction under section 162 or 167 to be allowable, then those substantiation requirements apply when determining whether a property or service is excludable as a working condition fringe.

(iii) An amount that would be deductible by the employee under a section other than section 162 or 167, such as section 212, is not a working condition fringe.

(iv) A physical examination program provided by the employer is not excludable as a working condition fringe even if the value of such program might be deductible to the employee under section 213. The previous sentence applies without regard to whether the employer makes the program mandatory to some or all employees.

(v) A cash payment made by an employer to an employee will not qualify as a working condition fringe unless the employer requires the employee to—

(A) Use the payment for expenses in connection with a specific or pre-arranged activity or undertaking for which a deduction is allowable under section 162 or 167,

(B) Verify that the payment is actually used for such expenses, and

(C) Return to the employer any part of the payment not so used.

(vi) The limitation of section 67(a) (relating to the two-percent floor on miscellaneous itemized deductions) is not considered when determining the amount of a working condition fringe. For example, assume that an employer provides a $1,000 cash advance to Employee A and that the conditions of paragraph (a)(1)(v) of this section are not satisfied. Even to the extent A uses the allowance for expenses for which a deduction is allowable under section 162 and 167, because such cash payment is not a working condition fringe, section 67(a) applies. The $1,000 payment is includible in A's gross income and subject to income and employment tax withholding. If, however, the conditions of paragraph (a)(1)(v) of this section are satisfied with respect to the payment, then the amount of A's working condition fringe is determined without regard to section 67(a). The $1,000 payment is excludible from A's gross income and not subject to income and employment tax reporting and withholding.

(2) *Trade or business of the employee*—(i) *General.* If the hypothetical payment for a property or service would be allowable as a deduction with respect to a trade or business of an employee other than the employee's trade or business of being an employee of the employer, it cannot be taken into account for purposes of determining the amount, if any, of the working condition fringe.

(ii) *Examples.* The rule of paragraph (a)(2)(i) of this section may be illustrated by the following examples:

Example (1). Assume that, unrelated to company X's trade or business and unrelated to employee A's trade or business of being an employee of company X, A is a member of the board of directors of company Y. Assume further that company X provides A with air transportation to a company Y board of director's meeting. A may not exclude from gross income the value of the air transportation to the meeting as a working condition fringe. A may, however, deduct such amount under section 162 if the section 162 requirements are satisfied. The result would be the