Southern AZ Estate Planning Council

Battling the IRS on Compensation & Benefits:

A Survey of Current Audit Developments, Compliance Complexities, and Potential Refund Claims

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A. Summary of Potential Federal Taxes, Penalties, and Interest Triggered By Underreporting Employees' Compensation Income.

1. Penalty Chart Overview.

Description of Tax or Penalty	Tax or Penalty Amount
I. Reporting and Withholding Penalties	
A. Employer liability for underwithheld income taxes (Code §3403).[1]	Currently 25% and 39.6% for supplemental wages over $1M after 2006), but has ranged from 20% to 28.% (and 35% on supplemental wages over $1M).[2]
B. Employer liability for underwithheld employee FICA taxes (Code §§3101 and 3102(b)).[3]	7.65% of unreported income (5.65% in 2011-2012), up to OASDI base $94,200 in 2006, $97,500 in 2007, $102,000 in 2008, $106,800

[1] This is called a "secondary liability" tax, because these income taxes are primarily the employee's liability, but if they are not paid over to the Treasury, the employer is liable for what was not paid (and cannot collect any tax payment it makes from the employee). Accordingly, the employer's tax payment is also not treated as "income" to the affected employees. Importantly, the employer's liability is typically calculated at the applicable "supplemental withholding" rate. However, the employer's maximum exposure to underwithheld federal income taxes can be reduced, if it can be proven that the employee was in a lower rate bracket, either based on the employee's total income, or based on the Forms W-4 on file. *See Internal Revenue Manual* ("IRM") 4.23.8.8, "Computing Income Tax Withholding." The only other way that this "secondary liability" tax can be abated is for the employer to prove that the employee actually paid income taxes on the income reported on Form W-2. Code §3402(d). According to IRM 4.23.8.4.1, this proof of "tax payment by employees" can be based on the filing with the IRS by the employer of Form 4670, "Request for Relief From Payment of Income Tax Withholding," with attached Forms 4669, "Statement of Payments Received," in which the employee attests, under penalties of perjury, that he or she reported the income on Form 1040, and paid the taxes in full. (The December 2014 version of this form has made abatement more complicated.) A Form 4669 must be signed by and filed for each employee involved in the abatement request. The abatement provisions of Code §3402(d) do not affect any applicable penalties, and the structure of the Form 4669 may trigger penalties, since the employer is confessing to knowledge that withholding should have been collected.

[2] Although Reg. §31.3402(g)-1(a)(2)(i) states that the supplemental withholding rate is 20%, the rate was increased to 28% for payments made after 1993, but was decreased to 27.5% for payments made after August 6, 2001 and to 27% for 2002-2003. Section 101(c)(11) of the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16. It was further decreased to 25% in 2003, effective for payments made after July 1, 2003. *See* section 105(a) of the Jobs and Growth Tax Relief Reconciliation Act of 2003, Pub. L. No. 108-27; and Publication 15-T (as revised in July, 2003). The supplemental withholding rate is currently 25% with respect to supplemental wages (in the aggregate for the year) not exceeding $1 million. Treas. Reg. §31.3402(g)-1(a)(7)(iii). Effective January 1, 2005, American Job Creation Act ("AJCA"), §904, increased the supplemental wage withholding rate from the third lowest tax rate for single filers (25%) to the maximum rate in effect (35% then, and 39.6% starting in 2013), after the employee's supplemental wages in the aggregate exceed $1 million. This change effectively increased any employer's tax exposure for executive compensation audits, since the IRS will hold employers liable at the supplemental rate where benefits have been improperly exempted from reporting (or withholding). The final regulations delay this effective date so that the 35% rate applied only to payments after 2006, although some auditing agents have refused to respect this regulatory transition rule. (*See* the effective date, and explanation of why it was adopted, in T.D. 9276, Treas. Reg. §31.3402(g)-1, at 142 Fed. Reg. 42053 (July 25, 2006).)

[3] This is also a "secondary liability" tax, because the taxes are primarily the employee's liability. If the employer is held liable within the employee's statute of limitations period for the employee's share of the FICA tax, which it never withheld from the employee's wages, the employee's obligation to the employer for the underpayment is a "matter for settlement" between the employer and the employee. Reg. §31.6205-1(d)(1) (or, prior to 2009, Reg. §31.6205-1(b)(3)). *See* F.S.A. 200022004, Issue (12) (explaining the employer's ability to recoup from employees any FICA taxes paid during the limitations period when the employee was still liable for the employee share of FICA taxes). If the employer reported the income on Form 1099 and the worker paid SECA taxes on the income, the worker can get a refund of those SECA taxes (if corrected Forms W-2 and 1099 are issued). If the statute of limitations has closed for the employee, the *employer's* liability for underwithheld employee FICA can be offset by the worker's SECA tax overpayment. Code §6521.

Description of Tax or Penalty	Tax or Penalty Amount
	in 2009-2011, $110,100 in 2012, $113,700 in 2013, $117,000 in 2014 and $118,500 in 2015 plus 1.45% (Medicare tax) on excess (plus 0.9% more, for employees with wages over $200K)[4]
C. Employer liability for employer FICA taxes (Code §3111).	7.65% of unreported income, up to OASDI base ($94,200 in 2006, $97,500 in 2007, $102,000 in 2008, $106,800 in 2009-2011, $110,100 in 2012, $113,700 in 2013, $117,000 in 2014, and $118,500 in 2015) plus 1.45%(Medicare tax) on excess.
D. Employer liability for FUTA taxes (Code §§3301 and 3306(a)).	6.2% of unreported income up to $7,000 of total income (state SUI offsets may apply).
E. Penalty for failure to timely deposit withholding and payroll taxes (Code §6656 and Rev. Rul. 75-191). This failure to deposit penalty does not apply where taxes were not withheld (*e.g.*, either in a case where income is not reported, or where no withholding was collected).	10% of underreported employer FICA taxes discussed in C. and D., plus 10% of all income tax withholding and employee FICA taxes that were withheld but not deposited.
F. Penalty for failure to pay employment taxes required to be shown on payroll tax return within 10 days of notice and demand (Code §6651(a)(3)).[5]	25% of total taxes under A., B., C. and D. above (penalty is ½% per month of underreporting, up to 25%); penalty can be avoided by simply paying within 10 days of notice and demand.
G. Penalty for negligence, disregard of rules or regulations, and substantial understatement of tax (Code §6662).[6]	20% of underpayment of employment taxes. Code §6664(c)(1) provides that the penalty may not be imposed with respect to the portion of an underpayment if the taxpayer acted in good faith and there was reasonable cause for the underpayment.
H. Penalties for incorrect or untimely Form W-2.[7]	For pre-2015 returns, $100 per W-2, up to maximum of $1,500,000 for all such failures in the aggregate for the year

[4] The final regulations (as amended in January 2014) governing this tax indicate that employer liability for non-withheld Medicare taxes would be waived for 2013, since they corrected the final regulations as published in December, 2013, which has stated that the withholding requirements imposed by 31.3102(a), (b) and (c) “apply to quarters beginning on or after November 29, 2013.” The amended regulation deleted the preceding sentence that had allowed employers to rely on the earlier proposed regulations for periods before the effective date, implying that employers would NOT be liable for underwithholdings of the AMT in 2013. This transition rule in the corrected final regulations thus may enable employers to avoid liability for nonwithheld 0.9% tax in 2013.

[5] If no return is filed at all, or if taxes are not reported on a filed return, penalties apply under Code §§6651(a)(1) or (a)(2). If penalties are applied to the maximum extent under Code §6656 and 6662, they can total as much as 45% of the taxes not reported.

[6] *See Abbey Carpet Co. v. United States*, 80 AFTR 2d 97-6718, 97-2 USTC ¶ 50,740 (Ct. Fed. Cl. Sept. 26, 1997) (accuracy-related penalty imposed in context of federal employment taxes). Note: Some agents have assessed the 75% fraud penalties for payroll tax deficiencies under Code §6663.

[7] If the Forms W-2 were filed correctly, this penalty does not apply. If the IRS alleges that the forms were not correct, because the taxes reported as “withholdings” were never paid to the IRS or the compensation reported was not correct, the “wrong W-2” penalties could be assessed. Until 2008, the IRS has not applied both the H(1) and H(2) penalties, because the employer and employee Form W-2 information is the same. In recognition of this duplication, the IR Manual implies that only one penalty (*i.e.*, the Code §6721 penalty) per return or payee statement would be assessed. The penalty will be the largest one applicable. *See* IRM 120.1.7.1.5.2. However, starting in 2008, the IRS has been applying BOTH of these penalties in many audits, and has announced that it is revising the IR Manual to instruct agents always to assess both penalties. (The 409A Settlement Program assesses both penalties, too.) Such an increase in penalties obviously doubles the potential penalty cost of payroll tax audits.

[8] These penalties were substantially increased, effective for returns to be filed for 2015 and later years (as is discussed in Section A.2 below), and had been previously increased 5 years earlier, filed after 2010 (i.e., starting with returns for 2010 payments), by P.L. 111-240, enacted in October 2010. Prior to the change, for all taxpayers, regardless of size, the penalties under 6721 were $50 per W-2, up to maximum of $250,000 for all such failures in the aggregate for the

Description of Tax or Penalty	Tax or Penalty Amount
(1) Incorrect Form W-2 to IRS (Code §6721).[8]	($30 per W-2, with $250,000 annual cap if corrected within 30 days of January 31, or $60 per W-2 with $500,000 annual cap if corrected on or before Aug. 1) or, in case of intentional disregard, greater of 10% of underreported amount or $250 per W-2 (with no annual cap). (Lower annual caps apply to small employers with gross receipts under $5M.)
(2) Incorrect Form W-2 to employee (Code §6722).[9]	For pre-2015 returns, $100 per W-2, up to maximum of $1,500,000 for all such failures in the aggregate for the year ($30 per W-2, with $250,000 annual cap if corrected within 30 days of January 31, or $60 per W-2 with $500,000 annual cap if corrected on or before Aug. 1) or, in case of intentional disregard, greater of 10% of underreported amount or $250 per W-2 (with no annual cap).). (Lower annual caps apply to small employers with gross receipts under $5M.)
I. Penalty for willful failure to furnish Form W-2 or willful furnishing of false or fraudulent W-2 (Code §6674).[10]	$50 per W-2.
II. Interest	
Interest is charged on the entire assessment of taxes and penalties, unless the special exception for first time underwithholding mistakes applies. (Code §§6601(a) and (b).)[11] The interest rates, fixed by IRS regulations and rulings, are higher than market rates. (Code §§6601 and 6621.)	8% for the first two quarters of 2007 (or 10% in the case of large corporate underpayments), and varies by quarter thereafter based on 3 percentage points (or 5 percentage points for large corporate underpayments) over the federal short-term interest rate.[12] Despite the low AFRs, these add-on percentages can create substantial interest charges for protracted audits..

year ($15 per W-2, with $75,000 annual cap if corrected within 30 days of January 31, or $30 per W-2 with $150,000 annual cap if corrected on or before Aug. 1) or, in case of intentional disregard, greater of 10% of underreported amount or $100 per W-2 (with no annual cap).

[9] These penalties were also substantially increased by P.L. 111-240. Prior to the change, for all taxpayers, regardless of size, they were $50 per W-2, up to a maximum of $100,000 for all such failures in the aggregate for the year or, for intentional disregard, greater of 10% of underreported amount or $100 per W-2 (with no annual cap).

[10] This penalty is duplicative of the penalties described in Section I.H. and generally is not applied.

[11] A special interest-free adjustment rule exists for employment taxes under Code §6205, however, when these taxes are underpaid in error and the error is "ascertained" at any time within the statute of limitations period for the taxable year of the error and prior to the issuance of notice and demand by the IRS. *See* Rev. Rul. 75-464, 1975-2 C.B. 474. (pre-2009) and Rev. Rul. 2009-39, 2009-52 I.R.B. 951 (applicable after 2008). Effective in 2009, under revised final regulations under Code §6205, if an issue has ever been "raised on audit" (even apparently if the employer won a favorable appeals settlement), the regulations and ruling indicate that this interest-free adjustment is not available.

[12] *See, e.g.*, Rev. Rul. 2007-16, 2007-13 I.R.B. 1.

Description of Tax or Penalty	Tax or Penalty Amount
III. Deduction Disallowances	
A. Loss of corporate deduction for Code §274 items (travel, meals, entertainment and "listed property" such as cars, planes and computers (but no longer car phones)) that are *not* reported as wage income on Form W-2 and as a "compensation" deduction on the originally filed Form 1120.[13]	35% (or corporate tax rate).
B. There appears to be no longer any need (at least since 2004) to be concerned about potential loss of corporate deduction for Code §83 income (such as stock options, restricted stock) not reported on Form W-2 or 1099 (unless the income was included by the worker on his Form 1040) (Reg. §1.83-6.) S*ee Robinson v. U.S.*, 335 Fed. Cir. 1365 (2003), cert. den. (2004) (invalidating this regulation).	Zero cost, under *Robinson*, but 35% (if *Robinson* is reversed by as-yet-unproposed legislation, or if the IRS continues to insist, as it has in some audits, that *Robinson* was overridden by *Mayo Foundation v. U.S.*, 131 S. Ct. 704 (2011).
C. If the employee was among the top five employees named in the proxy, and is still an officer as of year-end, possible loss of corporate deduction under Code §162(m) for cost of payment, if the value of the payment in combination with the employee's other compensation exceed $1 million.	35% (or corporate tax rate).
D. If the payment was part of a "golden parachute" payment, possible loss of corporate deduction under §280G.	35% (or corporate tax rate).
E. Possible IRS allegation of deduction loss for "secondary liability" payments, unless the amounts are reported as income on Form W-2.[14]	
IV. Valuation Issues	
Potential Increase in Amount of Reported Benefit. Employers are allowed to use the "special valuation rules" for cars and planes[15] only if these rules are used for income, employment tax and information reporting purposes. Reg. §1.61-21(c)(3)(i). Corrections referencing these special valuation rules are also possible for prior years for any "control employees" if the original reporting error was made in good faith.	Indeterminate amount of increase in value of reportable benefit. *See*, the disputes over car valuation in *BMW of North America v. United States,* 83 A.F.T.R.2d ¶ 99-413 (D.C.N.J. 1998).(unpublished opinion).

[13] *See* Code §274(e)(2)(A) and Reg. §1.274-2(f)(2)(iii); *see also* Notice 87-23, 1987-1 C.B. 467. If the employer voluntarily corrects the Form W-2 before being required to do so by an IRS agent, the IRS typically waives this penalty, even though the amount was not reported on Forms 1120 and W-2 as originally filed. Note: Code §§274(e)(2) and (e)(9) were amended by AJCA §907(a) (as corrected by the Gulf Opportunity Zone Act of 2005, §403(mm)(1)-(3), Pub. L. No. 109-135) to limit deductions for entertainment expenses incurred for or on behalf of "specified individuals" to the amount treated as compensation and as wages in the case of an employee. A "specified individual" is defined by reference to §16(a) of the Securities Exchange Act of 1934. *See* Notice 2005-45, 2005-24 I.R.B. 1228 and Treas. Reg. §1.274-9 and -10 (obsoleting Notice 2005-45, and effective for years starting after 8/1/2012).

[14] *See L & L Marine Service, Inc.*, 54 TCM (CCH) 312, 320 (1987); *cf.* F.S.A. 200025002, concluding that Code §3403 payments are deductible by the payor, as a "ordinary and necessary business expenses under section 162," irrespective of whether the payments are "compensation" to the employees.

[15] The airplane valuation rules are especially useful because they provide values equal to slightly more than first class. The charter rates (which must be used where the special valuation rules do not apply) provide values of 15 to 25 times first class. *See* Reg. §§1.61-21(b)(6)(ii) and (iii). However, per the changes to §274 referenced in Note 13 above, the benefit of these valuation rules is largely lost due to the corporate deduction disallowance.

2. <u>Likelihood of Increased Payroll Audits After 2015 Increase in Information Reporting Penalties</u>.

As noted in the chart above, the penalties for information returns have increased dramatically, effective for returns filed for 2015, due to a change made in June, 2015, not in a normal tax bill, but instead as one of several revenue-raisers included in the Trade Preference Extension Act of 2015 (P.L. 114-27, Section 806).[16] The new information reporting penalties (imposed under *each* of Code sections 6721 and 6722)[17] are effective "with respect to returns and statements *required to be filed* after December 31, 2015,"[18] and are increased as shown below:

Type of Penalty	Prior Amount	New Amount
Erroneous or Non-filed W-2/1099/1098 (without "intentional disregard" of filing requirements)	$100 per form, cap of $1.5M per filer	**$250 per form, cap of $3M per filer**
Lowered Penalty for Corrections by March 2	$30 per Form, cap of $250K per filer	**$50 per form, cap of $500K per filer**
Lowered Penalty for Corrections by August 1	$60 per form, cap of $500K per filer	**$100 per form, cap of $1.5M per filer**
"Intentional Disregard" of Filing Requirements	$250 per form (or 10% of amount if greater – no cap	**$500 per form (or 10% of amount if greater – no cap**
Lower Aggregate Caps for Small Payer-Filers (with no "intentional disregard") (applicable to employers/payers with average gross receipts of under $5M during the 3 years before the reporting year)	$500K per filer, lowered to $75K if corrected by March 2, or $200K if corrected by August 1	**$1M per filer, lowered to $175K if corrected by March 1, or $500K if corrected by August 1**

Due to the inconsistent structure of the amount of the increase, this increased aggregate maximum penalty (applicable except in cases of intentional disregard) will apply to entities that file 12,000 forms (i.e., $3M/$250), whereas the prior-law maximum penalty applied to entities that filed 15,000 returns ($1.5M/$100). There is no aggregate cap in cases of intentional disregard.

[16] These same penalties were dramatically increased just five years ago, by P.L. 111-240 (which included this penalty increase as one of the "pay for" provisions to finance the repeal of recordkeeping on cell phones). Prior to the 2010 change (which applied to information returns filed starting in January 2011), for all taxpayers, regardless of size, the penalties under Code sections 6721 and 6722 were limited to $50 per W-2, up to a maximum of $100,000 for all such failures in the aggregate for the year, or, for intentional disregard, the greater of 10% of the underreported amount or $100 per W-2 (with no annual cap).

[17] In practice, the IRS generally does not apply both the penalties under sections 6721 (IRS copy of the form) and 6722 (employee/payee copy of the form), but technically both penalties could apply.

[18] Certainly these new penalties apply to the information returns filed for 2015 payments; it is possible that the new penalties also will apply to corrections of pre-2015 information returns, where the error is discovered after 2015, and the correction of that error is filed after 2015.

Notably, these new penalties apply not only to the information reporting boxes reporting total income (or "gross-proceeds"), but also to other information boxes, and to a wide variety of information returns, including mortgage interest statements, payments subject to FACTA reporting, and information returns required under the Affordable Care Act.

The abatement procedures remain the same under the rules outlined in Code section 6724(a), if it can be shown that the failure was "due to reasonable cause and not to willful neglect." The regulations under section 6724 provide that there is reasonable cause if the filer can establish that (i) there are significant mitigating factors or events beyond the filer's control, and (ii) the filer acted in a responsible fashion. However, the IRS has become increasingly less willing to abate penalties, so this doubling (and even trebling) of the potential penalties certainly increases the risk of large penalties for errors (or non-filing) of information returns.

It remains to be seen whether these changes will increase the accuracy of information returns. Certainly these increases will raise the "worry factor" for return filers, and they will likely also provide an increased incentive for the IRS to expand its information reporting audit program, given the very large potential revenues for the government resulting from these increased penalties.[19]

3. Expansion of Payroll Audits for Erroneous or Missing Information Returns.

In late September, 2015, the IRS released new "interim guidance" on employment tax exams (SBSE-04-0915-0058, dated 9/18/2015), released by Tax Notes as 2015 TNT 186-16. The specific "change" made by this guidance is a requirement for additional notices to be sent to the managers of any IRS examining agents, and the potential expansion of the audit to cover backup withholding and possible penalties, if the IRS agent believes that there may be problems with filing of all "appropriate information returns were filed for any reportable payments (e.g. Form 1099-MISC; Form 1099-K; Form 1099-INT; Form W-2, etc.), or if there are any "Large, Unusual and Questionable (LUQ) items."

[19] The projected revenues shown from this revenue offset were only $136 million over 10 years. (See Tax Notes Document 2015-13872), although practitioners have been projecting that is a surprising understatement of the revenues that likely will be generated from this increase. According to IRS statistics, penalty collections for "non-return penalties" (including information returns, totaled $4.7 billion in 2014 alone, with $2.2 billion in abatements. These per-year statistics belie the accuracy of the revenue estimates.

B. Overview of Special Procedural Rules and Tax Doctrines Governing Fringe Benefit and Other Payroll Tax Audits and Reporting Penalties.

1. The "Confusion Doctrine."

a. Overview.

In *Central Illinois Public Service Co. v. United States*, 435 U.S. 21 (1978), the Supreme Court concluded that, if the employer is to function as the Government's tax collector as opposed to the employees' surety, the tax obligations must be free of vagueness. As the Court stated, "[b]ecause the employer is in a secondary position as to liability for any tax of the employee, it is a matter of obvious concern that absent further specific Congressional action, the employer's obligation to withhold be precise and not speculative." 435 U.S. at 31. The concurring opinions in *Central Illinois* place further emphasis on the need for precision. In his concurring opinion, Justice Brennan states that ". . . additional withholding taxes should not, at least without good reason, be assessed against employers who did not know of increased withholding obligations at the time wages had to be withheld." 435 U.S. 37.

The principle of *Central Illinois* concerning the need for guidance to employers concerning their withholding obligations has been the subject of several cases, leading up to *General Elevator v. U.S.,* 20 Cl. Ct. 345 (1990). *See McGraw-Hill, Inc. v. U.S.,* 623 F.2d 700 (Cl. Ct. 1980); *Marquette University v. U.S.*, 645 F. Supp. 1007 (E.D. Wis. 1985); and *Western Reserve Academy v. U.S.,* 619 F. Supp. 394 (D.C. Ohio 1985), *aff'd*, 801 F.2d 250 (6th Cir. 1986).

In *General Elevator*, the claims Court cited *Central Illinois* and *McGraw-Hill* for the principle that the employer as "deputy tax collector" must have "adequate notice so that it will 'know what the IRS thinks the law is and therefore what actions they have to take.'" The court concluded that the facts in the case did not establish a "precise and clear duty to withhold."

b. Objective vs. Subjective Confusion.

In applying the "confusion doctrine," it is unfortunately not entirely clear whether it must be proved that "the law is confusing," or merely that the "taxpayer was confused." Detailed briefs, and an interim order, in *American Airlines v. U.S.*, 40 Fed. Cl. 712 (1998) (a 1998 Court of Federal Claims case involving per diem payments and gift certificates, which was *aff'd* in part and reversed in part, 204 F.3d 1103 (Fed. Cir. 2000)), addressed the question, under *General Elevator*, of whether "objective confusion" or "subjective confusion" is required to trigger application of this doctrine. Ultimately the court ruled that the test is an objective one – *i.e.*, whether the law (as reviewed by the court, or an impartial third party) is confusing, not whether the taxpayer was confused. A similar test was applied in *IBM v. U.S.,* 87 AFTR 2d ¶2001-389 (Fed. Cir. 2001). *See however, North Dakota State University v. U.S.,* 84 F. Supp. 2d 1043 (D.N.D. 1999) *aff'd* 255 F.3d 599 (8th Cir. 2001)*, nonacq.,* 2001-2 C.B. xv, which in part

applies an objective test, concluding that the taxpayer had overlooked the controlling statute, but also denying that the taxpayer was "confused." The court noted specifically that the University had decided to start exempting payments from FICA taxes because the teachers had complained about these taxes.

c. Possible Limitation to "Secondary Liability" Cases.

As applied in most circuits to date, the confusion doctrine has resulted in the waiver of the employer's liability not only for "secondary taxes" (*i.e.*, FITW and employee FICA) but also liability for the employer's share of FICA. Some circuits do not extend the doctrine to the employer share of FICA taxes, however. *See North Dakota State University v. U.S.* (cited above)*; HB&R v. U.S.,* 229 F.3d 688, 2000-2 U.S.T.C. ¶50,795 (8th Cir. 2000); and *IBM v. U.S.,* (also cited above). (The issue was also raised during oral arguments on February 3, 1999 of the appeal of *American Airlines v. U.S.,* but it was never briefed; a full refund of the per diem employment taxes in dispute was ultimately paid in a out-of-court settlement. This refusal by some courts to allow any refund of employer FICA is troubling, and appears unsound from a policy standpoint, because employer FICA is merely the "matching half" of employee FICA. However, the Supreme Court, in *Fior D'Italia v. U.S.,* 536 U.S. 238 (2002), was not persuaded by the argument that employee FICA taxes on tips must be "matched" by employer FICA taxes on the same tips, and by a wage history. Accordingly it is possible that if the split among the circuits on this issue is ever litigated, it is possible that the "confusion doctrine" will be limited to FITW and employee FICA taxes, thus requiring employers to pay the employer share of FICA, and FUTA taxes, despite proof that the law is "confusing."

d. Limited Application to Refund Cases.

In *Chicago Milwaukee v. U.S.,* 35 Fed. Cl. 447 (1996), *aff'd,* 141 F.3d 1112, 98-1 U.S.T.C. ¶50,330 (Fed. Cir. 1998), the Federal Circuit Court ruled that the confusion doctrine does not apply to refund cases since the employer was sufficiently aware of the law as to deposit the taxes to begin with, then sued for a refund.

e. Possible Application to "Self-Help Refunds" or IRS Reversal of Previously Paid Refund Claims.

No court has addressed the issue of whether the confusion doctrine applies, if an employer makes a mistake on a corrected Form 941-X (*e.g.*, where the employer initially deposited payroll taxes, then revised the deposit by claiming a "self-help refund," and that second position was challenged by the IRS on audit). Arguably, the confusion doctrine should apply to these cases, since as is true in the basic case, neither the employer nor the IRS have the taxes in question – they have been refunded to the employee, arguably because the law was "confusing." Similarly, if the IRS has paid a refund, then subsequently tries to reverse its payment, the confusion doctrine should apply (since the IRS was obviously sufficiently confused by the confusing law as to have paid the claim). (*See*, *e.g.*, *U.S. v. JPS Composite Materials Corp. and JPS Industries,*

2008 TNT 61-19, D.C. S.Car. Greenville Div. 2008) (suit to recoup refunded FICA taxes on severance, after *CSX*, but before *Quality Stores*).

2. Federal Interest-Free Correction Procedures.

Relatively clear-cut procedures apply to permit taxpayers to correct underpayments of employment tax, free of interest, under certain circumstances. *See* Code §6205; Reg. §31.6205-1 (as finalized July 1, 2009); Rev. Rul. 75-464, 1975-2 C.B. 474 and Rev. Rul. 2009-39, 2009-52 I.R.B. 951. The IRS typically applies a corresponding waiver of information reporting penalties, where an error is voluntarily disclosed. Thus, even if there were a recharacterization of the payments as wages, the assessment would be free of interest. When taxes are underpaid "in error" and the underpayment is discovered during an examination of the taxpayer's return and if the issue has not been "previously raised on audit", the error is considered "ascertained" at the latest to occur of the following points during the audit process (and the additional tax may be paid free of interest at that time):

- when the taxpayer agrees to the findings of the IRS agent at the close of the examination, signs Form 2504, and pays the tax within the same period (*i.e.*, the same calendar quarter) in which the error was ascertained;

- if the taxpayer disagrees with the IRS agent's findings and requests review by IRS Appeals, when an agreement is reached and signed with IRS Appeals at the close of the appellate conference and any additional tax is paid immediately; or

- if the taxpayer exercises all of its appellate rights and is unable to resolve the issue with IRS Appeals, when the taxpayer voluntarily pays, before the issuance of a notice and demand, the amount of the alleged underpayment with the intention of filing a refund action in Federal court.

The key to understanding these interest-free adjustment procedures lies with the determination of when the error is ascertained. Reg. §31.6205-1(a)(4) provides that "an error [in underreporting certain employment taxes] is ascertained when the employer has sufficient knowledge of the error to be able to correct it." Once the error has been "ascertained," the employer is obligated to correct it by filing a supplemental return reporting the additional tax on or before the last date prescribed for filing the return for the period in which the error was ascertained.

Note: If an employer concedes an error in any audit cycle, it should immediately correct the same error that may have been continued in later audit cycles, because this "interest abatement" argument will not apply in the later cycles.

Note: Some states – in particular, New York – do not apply these interest abatement rules, which can lead to very significant interest charges due to delays in completion of audits.

3. "Reasonable Cause" for Abating Proposed Penalties for Failure to Deposit under Sections 6656 and 6651(a)(1) and Penalties for Incorrect Forms W-2 and 1099 (under Sections 6721 and 6722).

The penalty for failure to make a deposit of taxes (imposed under Code section 6656) can be abated if it is "shown that such failure is due to reasonable cause and not due to willful neglect." *See* Code §6656(a) and Treas. Reg. §301.6656-2(c). Similar abatement provisions apply to the penalty to file a required payroll tax return and pay the required payroll tax. *See* Code §6651(a)(1) and Reg. §301.6651-1(c). The revised IRS Consolidated Penalty Handbook instructs IRS agents to make waiver determinations "on a case by case basis." (IRM (20)4(70)1(1) (3/21/95).) Case law makes it clear that a taxpayer who makes mistakes despite the exercise of ordinary business care and prudence should not be punished. *See*, *e.g.*, *Cactus Heights Country Club v. U.S.*, 280 F. Supp. 534, 540 (S.D.S.D. 1967); *U.S. v. Boyle*, 469 U.S. 241, 245-46 (1985), and *see also Fisk v. Comm'r*, 203 F.2d 358, 359 (6th Cir. 1953); *Baxter v. Comm'r*, 816 F.2d 493 (9th Cir. 1987); and *Bergersen v. Comm'r*, 70 T.C.M. (CCH) 568 (T.C. 1995), *aff'd*, 109 F.3d 56 (1st Cir. 1997).

The general reasonable cause guidelines on which taxpayers can rely are contained in IRM 20.1.4 (which updates the long-standing Policy Statements P-2-7 and P-1-18), and in section 6656 of the Code and the underlying regulations. According to P-1-18, "[p]enalties support the Service's mission only if penalties enhance voluntary compliance." IRM 20.1.1.2 reconfirms that penalties are designed to "encourage voluntary compliance." In other words, penalties are not intended to raise revenue or to punish for punishment's sake. Instead they are intended to promote voluntary compliance. Accordingly, any employer with both a record of deposit compliance and prompt corrective actions to correct deposit errors should not be subjected to deposit penalties, especially in any case where the error was made following a careful, comprehensive review of the applicable IRS guidance controlling the employment tax deposit requirements.

Similarly, the penalties under both sections 6721 and 6722 are waived, under the rules outlined in section 6724(a), if it can be shown that the failure was "due to reasonable cause and not to willful neglect." The regulations under section 6724 provide that there is reasonable cause if the filer can establish that (i) there are significant mitigating factors or events beyond the filer's control, and (ii) the filer acted in a responsible fashion. (*See*, *however,* Chief Counsel Memo 200846022 (11/14/2008) suggesting that it may be possible for the IRS to impose penalties under section 6662 even in situations meriting an interest-free adjustment. *See also* LAFA 20125201F (11/16/2012), outlining the standards applied by the IRS in imposing penalties under Code section 6662 and abating penalties under Code section 6664.)

Note: These deposit penalties are raised frequently with respect to late deposits of stock options, and other equity compensation, although most of these audits have been settled on favorable terms.

4. Problems Raised if Forms W-2c and 1099s Must be Sent to Workers.

Luckily for employers, the IRS's employment tax audits conducted over the past 20 years have been linked to the corporate tax audit cycle, and, as a result, not "timely" (relative to current individual income returns, or more importantly, to the employees' (or other workers') statutes of limitations. Accordingly, when an employment tax audit concludes (often 4 to 5 years after the return was filed, and pursuant to multiple extensions of the statute agreed to by the employer) the workers' statute of limitations has long since closed. As a result, payroll examiners (and appeals officers) typically do not raise any requirement to "correct the worker's wage history" (by sending Forms W-2 or 1099).

However, SSA has been complaining to the IRS about agents' waiver of W-2 corrections, so at least in situations dealing with "voluntary corrections," and also as the IRS's tax audits become more current, however, many more examining agents have been requiring that Forms W-2c and/or 1099-X be sent to workers. This will create tremendous additional problems for the employers due to:

a. Form 1040 tax return correction expense;
b. possible additional taxes and interest;
c. possible IRS audits; and
d. company benefits that reclassified workers feel they should have received.

If this reporting were limited to FICA wages, it would not be either surprising or particularly troubling (since FICA tax payments are creditable to employees' accounts, and are, in fact, "wages" to employees, unless the employer obtains refunds, by check or withholdings, of any employee-share FICA that it pays within the employees' statutes of limitations). It is an extremely troubling development, though, when W-2Cs or Forms 1099-X are required to be sent, reporting back-years' income. Notably, any income tax withholdings paid by the employer are NOT "creditable" to the employee under Code section 31(a) (*but see Whalen v. Comm'r*, T.C. Memo 2009-39), so the IRS is effectively collecting the taxes twice, unless the employer, after settling its audit, applies for a refund of any income tax withholdings that it paid.

The detailed concurring opinion in *John J. McLaine v. Comm'r*, 138 T.C. 228 (2012) (which was accepted as correct in *Dixon v. Comm'r,* 141 T.C. No. 3 (2013), nonacq., 214-38 I.R.B. 346, AOD 2014-010 (September 14, 2014)) addresses the issues of (a) whether an employer's payment of income tax withholdings might be creditable to employees; (b) whether the IRS as a matter of policy or practice does "collect taxes twice," and (c) whether, if an employer's payment of previously underwithheld income taxes actually or effectively were to stop an audit of the employee for the same taxes, the

employer's payment of taxes should be treated as "effective income" to the employees (thus triggering a gross-up, as happens for example, when an employer pays §409A taxes on its employees' behalf, pursuant to Announcement 2007-18). (Years ago, the IRS has concluded that an employer's tax payment was income to employees, in G.C.M. 39577 (Dec. 1, 1986) and PLR 8635004 (3/17/1986), each of which had concluded that where an employer "as a matter of practice, paid the additional income and employment tax liability of [its] employees, so as to maintain goodwill." However, the IRS changed this position in FSA 20022004 concluded instead that where an employer has no right to collect the taxes from the employees, and no historic practice of paying employees' taxes, that its payment under Code section 3403 is not "income" to the employees.)

The most recent Tax Court case to address these issues was *Dixon v. Comm'r* (cited above), which concluded that an employer's payment to the IRS of previously unwithheld income taxes were NOT "withholdings," but they could be "designated" as a payment on behalf of the employee, and the IRS was required to give the employee credit, in order that the taxes not be collected twice. (This case did not address whether the employer's payment might be characterized as income to the employees; it appears from the facts of the case that no such income was triggered.)

5. Deductibility by Company of Taxes, Penalties and Interest.

Very few closing agreements structure the tax payments made by employers as "nondeductible penalties." Accordingly, many employers simply deduct these "secondary liability" payments, in addition to the "primarily liability" payroll taxes as "compensation-related expenses." There are few recorded cases or rulings to date addressing this issue. *See* P.L.R.s 9127021 and 8408011 (permitting a deduction of §3509 taxes, which are a derivative type of §3403 and §3102(b) taxes). *See* P.L.R. 8653004 (permitting a deduction where the taxes are treated as employee compensation.) *Cf. L&L Marine Services, Inc.,* 54 T.C.M. 312, 370 (1984). The interest payments (if they have not been avoided under Section B.2. above) are similarly deducted. The penalties for incorrect information returns and late deposits are subject to prohibitions on deduction of penalties. (This nondeductibility of penalties provides additional reasons for employers to have the penalties abated, wherever possible.).)

6. Delays in Meetings with Appeals.

Due to the significant numbers of retirements among IRS Appeals officers over the past 4 years, there is a huge backlog in IRS processing of Protests, particularly those on payroll tax issued. Many protests filed in these data collection audits have not been considered in even a first meeting with Appeals, even though the Protests were filed 12 to 24 months earlier. These significant delays in IRS processing of the Appeals is at striking odds with the fact that the IRS Examining Agents are often unwilling to provide ANY extension of the 30-day deadline for filing the Protest. It is also at odds with the IRS's new procedures for enforcing taxpayers' responses to delinquent IDRs (issued, in 2013, and extended to all LB&I employment tax audits per a decision by LB&I on 5/1/2014, which was announced on September 2, 2015, SBSE-04-0914-0065). The

memorandum explaining these new procedures to force faster taxpayer responses is available on the irs.gov website at http://www.irs.gov/Businesses/Large-Business-and-International-Directive-on-Infomration-Document-Requests-Enforcement-Process.

7. IRS Alerts to States of Payroll Adjustments and Voluntary Confessions.

Depending upon the size of a particular adjustment, the IRS may send an alert to the principal state of an employer's operations, triggering a follow-on state audit. For this reason, it may be advisable to consider participation in the "voluntary disclosure" programs offered by many states.

C. Hot Audit Topics for Compensation and Fringe Benefits.

1. Approach in 2010: Audits of Wide Range of Employers.

a. Background.

Reviving audit tactics from the "Taxpayer Compliance Measurement Program" ("TCMP") audits from the 1970s, the IRS announced in late 2009 that it planned to examine 6,000 taxpayers across the next three years, in audits that IRS spokespersons indicated would be "invasive."[20] Ultimately (after the IRS dealt with objections from IRS employee's labor union about excessive work requirements), under 2,000 employers were audited, including under 100 large companies. The major focus of these audits was on small companies, governmental entities, and tax-exempt entities.

> Note: The IRS had hoped to use these results to prepare an extrapolated report on "business tax compliance" with all the issues under audit. However, in a Study dated May 17, 2011, the Treasury Inspector General for Tax Administration determined that the sample results (and, in particular the audit sample of large taxpayers) was "too small of a sample to provide meaningful compliance estimates." Accordingly, the IRS was required to re-start these audits, focusing in the second round on larger companies.

> Note: Possible State Referrals. Not only are these IRS audits painful processes, but given increased coordination between the IRS and state tax agencies, it is possible that audit findings will be coordinated with state tax authorities. Many states have longer statutes of limitations – some extending two or three years after the employer pays taxes to the IRS at the conclusion of the IRS payroll tax audit (which leads to painful delays, and problems with data retention). Notably, if the employer does not

[20] These audits were initially viewed as creating so much additional work for IRS agents that the employee's union entered into a "Memorandum of Understanding" about the training and scope of the audits.

"confess" to the state (or states) its payment of Federal payroll taxes, the states' SOL may never run. (This is the rule in California, for example.)

b. Five areas identified for attention during original round of executive compensation examinations.

(i) Fringe benefits (likely to include use of company cars, planes, home computers, spousal travel, corporate apartments, prizes and awards, tax return preparation, meals, life insurance, and various de minimis items);

(ii) Reimbursed expenses (§62(c) compliance).

(iii) Executive compensation (including deferred compensation and stock-based awards, such as qualified and nonqualified stock options, restricted stock, and various phantom stock programs, and for larger companies, issues under sections 162(m) and 280G issues);

(iv) Payroll tax compliance overview. These questions will focus on W-4/W-9 collections (including investigations of employees who have claimed "exempt status" or too many exemptions), information return compliance (including inquiries about individuals who have received both Forms W-2 and 1099-MISC) and timing of payroll tax deposits (with a focus on stock options and RSUs).

(v) Worker classification/independent contractors. The IRS has designed a detailed new IDR to collect facts about worker classification, starting with inquiries about workers who received both Forms 1099-MISC and W-2, either in the same year, or even in different years. The focus of these audits has been, ultimately, to collect solid revenue estimates for an expected proposal to repeal §530 of the 1978 Revenue Act. There has also been concern that employers may try to avoid covering workers under the Affordable Care Act, by classifying them as independent contractors.

Note: Many of the listed issues related to areas where the published guidance has been issued in final form and only relatively recently (*e.g.*, golden parachute, split dollar life insurance, nonqualified deferred compensation, ISOs, ESPPs, and certain fringe benefits).

(vi) Note: To provide incentives for employers to reclassify workers, the IRS announced a "VSCP" program in Ann. 2011-64, 2011-41 I.R.B. 503 (and related FAQs), superceded by Ann. 2012-45, 2012-I.R.B. 725, as temporarily expanded by Ann. 2012-46, 2012-51 I.R.B. 724. The VSCP program provided an even better deal than the CSP program, for employers not yet under audit, but not many employers have signed up.

c. Withholding and Reporting for Settlement Damages.

As part of many of these payroll audits, the IRS also has recently increased its review of litigation settlements. In 2008, the IRS issued detailed guidelines for its field agents to use in reviewing settlement, to determine whether damages (including both damages paid to plaintiffs, and amounts paid to attorneys) were correctly reported, and subjected to withholding taxes. *See* Program Manager Technical Assistance 2009-035 (October 22, 2008) (including a detailed chart explaining the forms to use in reporting various types of settlement); and "Lawsuits, Awards and Settlements: Audit Technique Guide," Tax Notes Doc. 2011-22273, and Chief Counsel Memorandum 20133501F (Aug. 30, 2013).

2. Discounted and Backdated Stock Options.

a. Background.

In late 2006, after a number of companies announced charges to earnings for their stock options, the IRS started audits of many of these companies, alleging violations of Code sections 162(m) (the $1M limit on top executives' compensation, 409A (deferred compensation rules applicable to post-2005 vested options), and 421 (the ISO regulations, which had not been finalized until 2005).

b. 409A Audits.

Audits under section 409A do not involve "withheld" taxes (unless the employer has failed to tax the compensation completely, which did not happen in the case of most nonqualified stock options audits. However, the IRS attempted, through a 2006 settlement program, to require employers to pay taxes on employee's behalf (on a gross-up basis). One audit is still continuing at the state level.

c. ISO Audits.

Several audits have dragged on for years of ISO plans that were allegedly "backdated." As a technical matter, these audits can actually *generate refunds* for the employer companies, since if the company failed to claim deductions with respect to options that were believed to be ISOs, the IRS's challenge can yield corporate deductions with respect to exercises of the "disqualified" ISOs.

3. Gift Cards and De Minimis Fringes.

a. IRS's Challenge of "Gift Cards" as "Cash Equivalents."

As set forth in Treas. Reg. §1.132-6(e)(2), there are certain benefits that can never qualify as de minimis fringes. These include cash, except as specifically provided in the regulations (*i.e.*, occasional meal money or local transportation fare and reimbursements for public transit passes provided to employees before 1993[21]) and certain other high ticket-items such as *season* tickets to sporting events. A cash equivalent fringe benefit is also never excludable even if the same property or service acquired (if provided in kind) would be excludable. *See* Treas. Reg. §1.132-6(c); *see also American Airlines v. United States*, 204 F.3d 1103 (Fed. Cir. 2000), *aff'g* 40 Fed. Cl. 712 (1998). In *American Airlines,* the U.S. Court of Federal Claims held that American Express gift certificates with a face value of $100 were not de minimis, because they were cash-equivalent benefits.

In TAM 200437030 (April 30, 2004) the IRS ruled that a $35 employer-provided gift coupon redeemable at grocery stores for a holiday gift is not excludable from gross income and wages as a de minimis fringe benefit. In this TAM, the IRS reasoned that gift coupons could not qualify for the exception because "cash and cash equivalent fringe benefits like gift certificates have a readily ascertainable value, [and therefore] they do not constitute de minimis fringe benefits because these items are not unreasonable or administratively impracticable to account for." Particularly troubling is that the IRS reached this conclusion despite the fact that: (1) the listed grocery store reserved the right not to accept the coupon; (2) the coupon could only be used once with any unused portion of its value forfeited; and (3) the coupon was issued to specific employees requiring them to sign their name on the back of a coupon (similar to a check).

See also TAM 200502040, in which the IRS proposes to tax employees on dependent insurance that they actually bought with after-tax dollars, only some of them paid under the Table I rates. This dependent coverage had a face amount of $5,000 per child and either $15,000, $30,000, or $45,000 for spousal coverage. The employees all paid the same flat rate for such coverage, regardless of the number of children or age of the spouse covered. The IRS stuck with the rule in Ann. 89-110, saying the insurance is taxable simply because the amount of the insurance exceeds $ 2,000, without applying any of the general rules on the difficulty of tracking, etc. Essentially, the IRS simply does not believe that anything is hard to track.

Arguably, limited use gift cards do not constitutes cash equivalents. *See e.g.* Prop. Treas. Reg. §1.274-8(c)(2) (and its pre-1987 predecessor regulation, Treas.

[21] After 1993, separate exclusion rules apply to transportation benefits, but the de minimis regulations cite the pre-1993 exclusion limit (of $21 per month) to warn taxpayers that this limit ($252 per year) should not be assumed to be a de minimis "safe harbor." This exclusion has been complicated by the fact that the metro-pass/commuting transportation exclusion periodically reverts to under half the amount of the parking exclusion, and then is retroactively extended, creating enormous problems for employer refunds. This recurring problem will likely be repeated in 2015-2016.

Reg. §1.274-3(b)(2)(iv)), for purposes of the employee length of service/safety awards, this regulation provides that a "gift certificate" will be treated as an effective substitute for the employee award that could be purchased with the certificate (instead of as a substitute for cash), provided that the gift certificates are non-negotiable, not transferable, and not able to be used to receive cash or a reduction of a balance due on the employee's account with the issuer of the gift certificate.

b. Permissible "De Minimis Fringes" (Per Treas. Reg. §§1.132-6(e)).

(i) occasional typing of personal letters by a company secretary;

(ii) personal use of copying machine (provided at least 85% of the machine's use can be shown to be for business purposes);

(iii) prior to 1993, monthly transit passes provided at a discount not exceeding $21; $21 per month worth of tokens or fare cards; or, by technical correction, $21 per month in cash reimbursements to cover commuting. 1986 Act, S. Rept. No. 99-313 at 1026 and H. Rept. No. 99-841 at II 852; Treas. Reg. §1.132-6(d)(1). (Prior to July 1, 1991, the limit was $15.)

The Energy Policy Act of 1992, Pub. L. No. 102-486, and several subsequent inflation-indexing statutes have created a statutory exclusion for "qualified transportation fringe" benefits (Code §§132(a)(5) and (f)), including, *inter alia*, monthly transit passes, in amounts that have been increased gradually from $60 per month, through $100 per month, (indexed for inflation), to (in 2009-2013) $250 per month (reverting to $130 per month in 2014, but then increased by statutory change at year-end back to the higher limit just for 2014). *See* Notice 2015-2; 2015-4 IRB 334. The rate is $130 per month in 2015, although extender legislation is pending.

Note: The de minimis fringe exclusion for transit passes is not supposed to be used as a guideline to set a general limit on de minimis fringes, *i.e.*, as a benefit "with a value equal to or less than $252 [per year]" *i.e.*, $21 per month for 12 months. *See* Treas. Reg. § 1.132-6(d)(3). (Note: Treas. Reg. §§1.132-6(d)(1) and (d)(3) have not been updated to reflect post-1991 law changes to the limit).

(iv) occasional cocktail parties, group meals, or picnics;

(v) occasional supper money or taxi fare because of overtime work;

Note: Supper money, taxi fares and pre-1993 transit discounts are the only instances in which cash (or use of a credit card) can be excluded as a de minimis fringe. *See* Treas. Reg. §1.132-6(c).

Note: Treas. Reg. §1.132-6(d)(2) clarifies the definition of "occasional," for purposes of applying the de minimis fringe to occasional meals or taxi fares home while working overtime, as not "on a regular or routine basis," but the regulation does not attempt to set a maximum limit to such meals and commutes of a certain number of times a month. (For example, "four times per month" had been suggested, and dropped, as the definition of "occasional.") Moreover, the regulations warn that just because use of an employer vehicle "more than one day a month" is listed as an example of a benefit that is not excludible as a de minimis fringe, per Treas. Reg. § 1.132-6(e)(2)), it should not be assumed that commuting use of the vehicle up to 12 times per year is automatically excludable as a de minimis fringe. *See* Treas. Reg. § 1.132-6(d)(3).

Note: In an Industry Specialization Program (ISP) coordinated issue paper issued to all industries on April 15, 1994, the IRS addressed meal allowances provided as "overtime meals" and concluded that the meals were not provided "occasionally" and thus were not excludable as de minimis fringes. However, in *IBM v. United States,* 87 AFTR2d 2001-536 (Fed. Cl. Jan. 9, 2001), the Court of Federal Claims held that there was no specific frequency test for former Temp. Reg. §1.132-6T and that there was no express limitation to the frequency with which meals could be provided.

Note: Two different special valuation rules apply to taxis provided in "unsafe" locations for either employees working overtime or for hourly employees, but the compensation caps and other limits on use of these rules make them difficult to apply. *See* Treas. Reg. §§ 1.132-6(d)(2)(iii) and 1.61-21(k).

(vi) traditional birthday or holiday gifts of property with a low fair market value. (*See* Rev. Rul. 59 58, 1959 l C.B. 17, covering Christmas hams and turkeys; *but see Leschke v. Comm'r*, T.C. Memo. 2001-18 ($61 gift nut baskets given to employees held to be taxable to the employees, and therefore deductible by the employer; although a potential exclusion under Code section 132(e) was not addressed, presumably because the employer's counsel believed the case was easier to win if it were conceded that the nut baskets were "income" to the employees));

(vii) occasional tickets (not season tickets) to the theater or sporting events;

(viii) coffee, doughnuts, and soft drinks;

(ix) "group meals" (an undefined, but potentially very useful term);

(x) local telephone calls;

(xi) flowers, fruit, books, or similar property provided under special circumstances, such as illness, outstanding performance, or family crisis; and

(xii) the commuting use of an employer-provided automobile no more than one day a month.

Note: None of these listed benefits is subject to any dollar limit (as even the IRS has admitted, in Information Letter 2008-0023). However, some agents, on audit, have adopted creative new readings of the list above, indicating that it applies only to "occasional tickets to Little League games and second-run movies, and to flowers from Wal-Mart, single pieces of fruit, and paperback books." Indeed, in one audit, an agent has insisted upon taxing a $35.00 movie ticket gift card entitling the bearer to movie tickets at a particular theater chain, because "the Taxpayer has not provided any support for the assertion that the [movie theater gift cards] could only have been used for tickets to the movies." The agent stated during the audits that the card-holders "could have bought popcorn." Obviously, the IRS is adopting an absurdly narrow view of excludable fringes.

Note: In enacting Code sections102(c)(to repeal any exclusion for "gifts" to an employee) and 74(j) (providing an exclusion for certain length-of-service and safety achievement awards), the 1986 Act "clarified" that the de minimis exclusion can apply to "employee awards of low value" not

excludable under Code section 74(c), or to “traditional awards (such as a gold watch) upon retirement for an employer.” 1986 Act Blue Book at 33 and 37 38; Prop. Treas. Reg. §1.274-8(d)(2). (Unfortunately, this proposed regulation is not scheduled to be finalized. *See* Notice 92-12, 1992-1 C.B. 500.)

4. Cell Phone/Blackberry/ Computer Recordkeeping.

a. Background.

Over the years 2005-2010, the number of cellular phone audits by the IRS increased dramatically, in part because the IRS National Office has instructed agents who audit both executive compensation, or conduct payroll audits, to cover “fringe benefits” generally, including “employee use of listed property.” (*See* “Executive Compensation - Fringe Benefits Audit Techniques Guide,” published at 84 BNA Tax Reporter G-1 (5/3/2005), at page 6 of 10.) Some of these audits also included blackberries and other hand-held computers (although the IRS's audit instructions refer generally only to “computers used off business premises”). These audit instructions for computers did specifically state that “There are no recordkeeping exceptions like ‘no personal use’ available for computers,” but they do not contain a similar warning that company policies limiting personal use do not work for cell phones. Perhaps because the IRS itself is rumored to have a version of a “no personal use” policy for computers, many IRS agents have appeared willing to accept cellular phone policies that limit personal use, provided that the employer can show that the policies are complied with (*e.g.*, by producing proof that some percentage of the phone bills – *e.g.*, 5% - is audited each year). However, the vast majority of employers audited with respect to this issue have either no policies, or have cellular phone policies that do not adequately substantiate or document employees’ business use of their cellular phones. The IRS historically had been accepting settlement offers ranging from 25% to 50% of deemed personal use (and therefore the employers have been required to pay the employment taxes on the value of that deemed personal use), but then Congress (responding to constituents’ complaints) enacted legislation designed to stop the audits.

b. 2011 Legislation Provided Partial Relief.

After literally years of delay, and a dozen legislative proposals that were never enacted, in 2010, Congress finally enacted legislation (in the Small Business Jobs Act of 2012, P.L. No. 111-240, §2043), that removed cell phones and blackberries (but not computers generally) from the list of “listed property” subject to onerous recordkeeping and substantiation requirements. However, this property remain subject to some sort of proof that the property was used for “business reasons,” so even after the statutory change, taxpayers have been waiting for guidance (finally announced this month), although it remains unclear what exactly the IRS will do in future audits of blackberries and cell phones.

c. Cell Phone Guidance.

(i) Release of Guidance.

On September 14, 2011, the IRS released Notice 2011-72 and related guidance to IRS examining agents (Control No. SBSE-04-0911-083), providing welcome relief that eliminates all recordkeeping requirements in connection with employer-provided cell phones and "other similar telecommunications equipment" that are provided to employees primarily for business purposes. Unfortunately (and probably intentionally), the Notice does not address cash reimbursements for cell phone use – that guidance was provided in a "Field Exam Memo" which instructs agents to GENERALLY apply similar relief to cash reimbursements. This relief is generally being relied upon by employers. However, nothing was done to change, pursuant to "substantial authority," the rule in Reg. §1.132-6(c) prohibiting cash (and cash reimbursements) from ever being a "de minimis fringe" – except in limited situations that do not involve cell phones. (Notice 2011-72 cites Reg. §1.132-6(c), warning again that cash fringes are not de minimis fringes, although the Field Exam Memo (which has a stated expiration date of September 19, 2012) states that "agents should not *necessarily* assert that the employer's reimbursement [for cell phone use after 2009] results in additional income on wages to the employee" [Emphasis supplied].) There is widespread reliance on this Field Exam Memo, despite the fact it is not "substantial authority," and the fact that is expired a year after its issuance.

(ii) General Relief.

Pursuant to Notice 2011-72, employee use of cell phones and other similar telecommunications equipment (such as PDAs, blackberry, smart phones and the like) (and related calling/data plans) (collectively referred to as "cell phones") provided "primarily for non-compensatory business purposes" is a:

(a) Deductible expense, that is also

(b) Excludable from the employee's income as a working condition fringe benefit and

(c) Any personal use will be excludable as a de minimis fringe benefit, without the need for any recordkeeping.

As for reimbursements for cell phones, employers should avoid:

(i) reducing salaries and substituting phone reimbursements;

(ii) paying for coverage not needed by the employee (*e.g.*, international coverage for employees with only U.S. clients); and

(iii) "significant" increases in the reimbursed amounts.

(*See* the MLB Lawflash available at: http://www.morganlewis.com/pubs/EB_LF_Employer-ProvidedCellPhonesPDAs_19sept11.pdf .)

(iii) Likely Reasons for Relief.

Both before and after the legislation was enacted, the IRS and Treasury Department were considering possible regulatory changes to the existing rules that would provide a more streamlined substantiation process for cell phones. *See* IRS Information Letter 2008-0012 (April 24, 2008) and Notice 2009-46 (soliciting public comments). *See also*, the MLB Lawflash:

http://www.morganlewis.com/pubs/EB_BusinessCellPhones+PDAs_LF_17jun09.pdf

Note: MLB argued in a lengthy submission to the IRS (dated Sept. 4, 2009) that it could reasonably be argued that personal calls are free from information reporting tax if the employer can show that business calls exceeded the minimum number of minutes a particular band of calls, thereby effectively converting into "free calls" any additional personal calls in that band. (TEI also submitted a long thoughtful comment on Aug. 26, 2009.) The IRS nonetheless had generally taken the position that "personal use" of cell phone includes not only any charges for individual personal calls, but also a pro-rata portion of the monthly service charges, unless the employer can prove (based on itemized phone records) that the employee had only "minimal personal use of the cell phone," in which case no income will be imputed. (*See* IRS Information Letters 2007-0025 and 2007-0030.)

Note: More to the point, MLB had repeatedly discussed with Treasury and IRS agents the fact that the cell phones that the federal government provides to its own employees are never taxed. Also, it's likely that the political appointees at Treasury realized the firestorm of controversy that would be created, had the guidance blatantly attempted to tax any portion of cell phone use like the unpopular "tax 25% rule" (that had been proposed in Notice 2009-46).

5. Company Cafeterias and Other "Eating Facilities."

Company cafeterias are one of the fringe benefit items being examined during the current round of data-collection audits. The issues being raised include:

a. whether the eating facility's revenues at least equaled the facility's "operating costs," in compliance with Code section 132(e);

b. if the Code section 132(e) test is not met, whether the eating facility is operated "for the convenience of the employer" under Code section 119;

c. if the eating facility is also not a section 119 cafeteria, whether the 50% disallowance under Code section 274(n) applies to meals. This disallowance can be avoided if:

   (i) the meals are excludable under section 132 and are in fact provided in an "eating facility." (Some IRS agents have refused to agree that "non-traditional" eating facilities satisfy the regulatory definition);

   (ii) the meals (including many snacks) qualify as "de minimis" fringes, apart from the direct operating cost/operating revenue test of Code section 132.

Note: All the above-outlined issues are affected by the Tax Court's decisions in Boyd Gaming (involving Las Vegas casino cafeterias). In the first *Boyd Gaming* case, 106 T.C. 343 (1996), the Tax Court ruled that if all the cafeteria meals are excludable under Code section 119, the cafeteria costs are exempt from the 50% disallowance. (This decision was codified by TRA '97, effective for 1998). However, in the second *Boyd Gaming* case, at T.C. Memo 1997-45, the Tax Court held that only 55% of the meals in this taxpayer's cafeterias were excludable under section 119, thereby requiring the employer to apply the 50% disallowance to all the meal costs, and to pay retroactive payroll taxes on all the taxable meals. This decision was partially overridden by Code section 119(b)(4), enacted with retroactive effect in 1998. Under the revised statute, if over 50% of the meals at a cafeteria satisfy Code section 119, all the meals will satisfy section 119. However, except for cafeterias in prisons, hospitals, and ships, and cafeterias in the casino, entertainment and hotel industries (which have been eligible for a generous industry-specific amnesty offer, provided by Ann. 98-78), the IRS has continued its audits on this issue, and routinely denies the existence of any Code §119 exclusion. (*See e.g.*, T.A.M.s 9502001 and 9143003. *See also BOC v. United States*, (a 1999 company cafeteria case filed in New Jersey District Court, which was ultimately conceded by the Justice Department).)

Note: On August 26, 2014, the IRS released the "Department of the Treasury 2014-2015 Priority Guidance Plan," noting that there are now 317 projects (representing updates and changes from the guidance on the

plan for the 2013-2014 year) which the IRS intends to work on actively over the next year. One new item is in Section B (entitled, generally: "Executive Compensation, Health Care and Other Benefits, and Employment Taxes") – under item 3, providing, in full, as follows: "3. Guidance under §§ 119 and 132 regarding employer-provided meals." On July 31, 2015, the IRS issued its 2015-2016 Priority Guidance Plan, which refers to this project as: "3. *Regulations* under §§ 119 and 132 regarding employer-provided meals." (Emphasis supplied.) It thus appears that the IRS intends to issue regulations (presumably correcting the regulations that were overridden by statutory changes in 1978).[22]

6. FICA Taxes on Tipped Employees' Wages.

Until 2008, the IRS had conducted surprisingly few audits of employers with tipped employees, even after winning the Supreme Court case addressing the IRS's ability to impose only the employer half of FICA taxes on estimated underpayments of tips by tipped restaurant employees. (*See Fior D'Italia v. U.S.*, 122 U.S. 2117 (2002)). The scarcity of audits has in large part been due to the many "TRAC" and "TDRA" agreements between the IRS and employers in the restaurant, casino and cosmetology industries. However, since 2008, the IRS has been conducting more of these audits (focusing on establishments parts of larger chains that were not signed up for TRAC), and expanding them to impose penalties on employees, after the "tip rate" has (allegedly) been determined by the agent.

7. Valuation and Deduction of Meals, Airplanes, Travel Costs, etc.

a. Car Plans. These audits focus on:

(i) reimbursements for use of employees' cars, either under "cents-per-mile" plans, "FAVR" plans, or "zone payment" plans, including whether adequate documentation was collected; and whether excess amounts were paid; and

[22] Floor statements by Senator Dole and Congressman Cotter in 1978 criticized the IRS for its unduly narrow application of the Code §119 exclusion. In his statement, Senator Dole specifically referenced the concept of "substantial noncompensatory business reason," explaining that he was "… concerned that the IRS has attempted to narrow the meaning of the broad term "convenience of the employer,." and further stating that the "… existing regulations, in essence, provide that meals are regarded as furnished for the convenience of the employer if there is a substantial noncompensatory employer business reason irrespective of the presence of a compensatory reason. That principal remains intact." (*See* 124 Cong. Rec. at 23883-84 (Aug. 2, 1978).) Representative Cotter, who offered the amendment to Code §119 in 1978 clarifying the tax status of meals received in employer subsidized cafeterias, made a more pointed observation: "Again the IRS was auditing major companies in order to tax individual employees for the subsidized part of cafeteria meals. It is incomprehensible to me that the IRS believes that the Congress wanted it to go after subsidized cafeteria meals. These cafeterias are for the most part serving the convenience of the employers and are well within the exemption of section 119." (*See* 124 Cong. Rec. at 19365 (June 28, 1978).)

(ii) provision of "test cars" to employees by companies and dealerships. (*See* T.A.M. 9801002 (Jan. 2, 1998) - requiring phenomenally detailed recordkeeping, before an exclusion is allowed.) *See also BMW of North America, Inc. v. United States*, Docket No. 96-4360 (JCL), 83 A.F.T.R.2d ¶99-413 (D.C.N.J. 1998).)

b. Per Diem Plans.

At first, audits of per diem plans were industry-specific (only for airlines and trucking companies), but now cover many industries, including particularly the "travel nursing" industry (which has attracted over a dozen audits). These audits, which have been raised in significant numbers after the expiration of a quasi-moratorium which extended through 2006,[23] typically focus on some or all of the following issues:

- whether the per diems were "sliced out of wages" in violation of the guidelines outlined in Rev. Rul. 2012-25, 2012-37 I.R.B. 337 (a ruling which, predictably, ignores the lack of clear regulations preventing such wage recharacterization, and also ignores the substantial contrary authority that authorizes properly structured plans);

- whether excessive per diems were paid (in violation of Rev. Rul. 2006-56, 2006-2.C.B. 874) (including possibly providing lodging in kind in addition to lodging per diems);

- whether employees had "tax homes," or were only itinerant workers (and whether the employer collected information proving the tax home, pursuant to the limited guidance in Rev. Rul. 71-551, 1971-2 C.B. 354);

- whether employees had travelled far enough away from their tax homes to justify incurring "away from home overnight" expenses;

- whether the employer paid per diems for days when it was not logical to expect that the employees incurred meal or lodging expenses (either because they had gone back to the tax homes on days off from work, or, in the case of truckers, that they slept in their trucks);

[23] In a news release accompanying the release of a 2006 revenue ruling warning against the payment of excessive per diem allowances, the IRS stated that it was instructing agents not to apply this revenue ruling to years prior to 2007, "in the absence of intentional noncompliance." (See I.R. 2006-175, 2006 TNT 218-13, (Nov. 9, 2006); see also Field Guidance SBSE -04-1106-049 (April 23, 2006) (providing guidance to examiners for purposes of auditing "excess per diem plans" and LMSB -04-0608-037 (July 2, 2008) (explaining the accountable plan rules for "tool and equipment plans").

- whether the employees had been traveling (or expected to travel) to one location for more than a year (in violation of Code section 162(a) and Rev. Rul. 93-86, 1993-2 C.B. 71);

- whether employees have avoided application of this "one-year rule" either by traveling to various different locations, or by having a "break in service" (an undefined term referenced in several Chief Counsel Advisory opinions, e.g., CCA 200026025 (May 31, 2000));

- whether any of the employer's lodging per diems are eligible for the effective moratorium provided by Notice 2007-47, 2007-1 C.B. 1393, which provides that, until further notice, the IRS will not challenge local lodging reimbursements or the provision of other in-kind lodging in the area of the employee's home, so long as the lodging is temporary, necessary for the employee to participate in a bona fide business function of the employer and the expense would otherwise be deductible by the employee under Code § 162(a)), *i.e.*, the working condition fringe test under Code § 132(d). (Proposed regulations were issued in 2012, amending this effective moratorium, but the moratorium continues until that proposed guidance is finalized); and

- whether the employer properly applies to all of its M&IE per diems the 50% disallowance of Code section 274(n) (or, whether the employers have passed on the burden of the disallowance to their clients, pursuant to the procedures outlined in Rev. Rul. 2008-23, 2008-18 I.R.B. 852 and Treas. Reg. §1.274-2(f)(2)(iv) (effective for taxable years beginning after August 1, 2013)).

c. Moving Expenses.

Audits of moving expense plans typically focus on: the amounts of reimbursements; reporting and withholding issues on amounts over deduction limits and on mortgage interest reimbursements; and, the deductibility of home sale losses. The number of moving expense audits might have increased if there had ever been a decision in *Gallo Winery v. U.S.,* but that case was settled without a decision. The taxpayer won its home sale loss deduction case in *Amdahl Corporation v. Comm'r*, 108 T.C. 507 (1997), on the grounds that the employer never took title to the house. When the same defense was raised in *Gallo Winery*, the government counterclaimed for payroll taxes on the loss (and home sale expenses) reimbursed to the employee.

November 2005, the IRS finally released long-awaited guidance (after years of lobbying by the Employee Relocation Council) addressing expenses associated with assisting relocating employees from a payroll tax perspective, to determine WHEN the benefits and burdens of ownership would be deemed to shift from the employee to the

employer. Rev. Rul. 2005-74, 2005-51 I.R.B. 1153, addresses the use of relocation arrangements in three fact patterns and bases its analysis on whether the benefits and burdens of ownership shift from the employee to the employer. There have been surprisingly few audits after the release of this guidance, but starting in late 2013, examining agents began raising questions again.

d. Employer-Provided Cabs and Limos for Commuting Employees.

These audits all focus on the operation of the de minimis exclusion, and on the proper valuation of these commuting trips. Unfortunately, the IRS rules on "commuting" are tremendously confusing. The principal guidance is Rev. Rul. 99-7, 1991-1 C.B. 361, governing the limited conditions under which daily transportation expenses might be deductible under Code section 162(a)).[24] Any daily transportation expenses between a taxpayer's residence and a "regular place of business" will always be a nondeductible personal expense.[25] The fact that the residence and "regular place of business" are a significant distance apart does not change this result because the IRS presumes that an individual's decision to reside a significant distance from his "regular place of business" is for personal, rather than business, purposes.

A "regular place of business" is any location where an employee performs services on a recurring basis for more than a year and where he performs services for more than 35 workdays (or partial workdays) during the calendar year.[26] In other words, a location may become a "regular place of business" if employment at the location is expected to exceed more than 1 year and the employee travels to that location for more than 35 workdays (or partial workdays) each year. (This rule is derived from the general rules issued under Code section 162(a) and Rev. Rul. 93-86, governing travel away from home for more than a year.)

If the taxpayer has a qualifying home office, his residence can be his principal place of business, and in such instances, the taxpayer may deduct daily transportation expenses incurred in going between the residence and another work location in the same trade or business, regardless of whether the work location is regular or temporary. However, if the taxpayer does not have a home office, daily transportation expenses between his residence and another regular place of business are never

[24] Rev. Rul. 99-7 was the third in a series of IRS rulings that significantly changed the rules on deducting commuting trips. See also Rev. Rul. 90-23, 1990-1 C.B. 28, as modified by Rev. Rul. 94-47, 1994-2 C.B. 18. Effective starting in 1990, these rulings changed the prior rule (contained in Rev. Rul. 55-109, 1955-1 C.B. 261, which had allowed deductions for trips beyond the general area of a taxpayer's tax home, and also generally allowed deductions for trips exceeding the mileage of the taxpayer's normal commute). The later rulings were designed in order to narrow the circumstances in which a commute could be deductible. *See Burleson v. Commissioner*, T.C. Memo 1994-364 (in which the Tax Court prevented the IRS from applying the narrowed position in Rev. Rul. 94-47 retroactively to a particular taxpayer).

[25] *See* Treas. Reg. §§ 1.162-2(e) and 1.262-1(b)(5). In contrast to this rule, however, transportation expenses between two business locations, whether the locations are "regular" or "temporary," are always deductible. \

[26] *See* IRS CCA 200026025 (April 30, 2000), 20010156 (June 4, 2001) and 20040063 (Oct. 20, 2003).

deductible, even when work is performed during the trip.[27] Further, a proven health problem will not justify a business deduction (or exclusion) for commuting (although in certain very limited circumstances it may justify a medical expense deduction).[28]

For this reason, in audits of travelers, the IRS agents continually attempt to identify "commuters," and to disallow deductions (and exclusions) for reimbursements applicable to commuting expenses. Unfortunately, too, this is an area of law where the Service has indicated that it will not issue rulings making it impossible for individual taxpayers to obtain guidance based on their individual facts and circumstances.[29] In fact, this has been a "no rule area" since 1988.[30]

e. Taxation of Local Lodging Expenses.

Final regulations were issued September 30, 2014 under Treas. Reg. §§1.162-31 and 1.262-1(b)(5) (finalizing proposed regulations issued April 24, 2012), which create a special limited deduction (or, for employer-provided benefits, an exclusion) for local lodging (i.e., lodging in the area of the worker's tax home) provided to employees or independent contractors for periods that does not exceed five days and does not occur more frequently than once per quarter, where the lodging is not "lavish" and is necessary for the individual to participate in business meetings, or be available for some other bona fide business function of the provider of the lodging. (If the individual is an employee, the employer must have required the employee to stay at the business function overnight).

These are useful regulations, which both clarify and limit the seemingly broader, but confusing, relief that had been provided under Notice 2007-47, 2007-1 C.B. 1393. That Notice had provided that an exemption from income would be applicable to any lodging of an employee not incurred while the employee is traveling away from home that an employer provides to the employee, or requires the employee to obtain, "temporary lodging" (an undefined term) in the area of the employee's tax home, where the "lodging is necessary for the employee to participate in or be available for a bona fide business meeting or function of the employer" and where the expenses "would be deductible if paid by the employee." Importantly, too, Notice 2007-47 had imposed a moratorium on any audit of temporary local lodging, promising that "This issue will not be raised in any taxable year ending on or before publication of the [final regulatory] guidance." This Notice was obsoleted by the proposed regulations, effective as of April 25, 2012. However, the effective date of the proposed regulations was the date of

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[27] *See* H. Rept. No. 98-861 at 1025, 1984 Blue Book at 566-67; *Commissioner v. Flowers*, 326 U.S. 465 (1946); *Fillerup v. Commissioner,* T.C. Memo 1988-103; IRS Pub. 463.

[28] *See* IRS Information Letter 2001-0266 (October 2, 2001) (citing cases that have allowed, but mostly disallowed, medical deductions for commuting expenses).

[29] *See* § 4.01(11) Rev. Proc. 2004-3, 2004-1 I.R.B. 114.

[30] *See*, e.g. § 5.08 of Rev. Proc. 88-3, 1988-1 C.B. 579 and each subsequent annual revenue procedure.

issuance of final guidance. Accordingly, it remains unclear whether this moratorium on audits of local lodging expenses remained in place for lodging expenses incurred through April 15, 2012, or possibly also for lodging expenses incurred through September 30, 2014 (the effective date of the final regulations). The final regulations do not resolve this ambiguity about the effective date of the obsolescence of Notice 2007-47, because they do not mention the Notice at all.

8. Bonus Accrual Audits.

a. Background.

Under the accrual method of accounting, a liability can be taken into account in the taxable year in which:

(i) The fact of the liability is established;

(ii) the amount of the liability can be determined; and

(iii) economic performance has occurred.

The only additional limitation is that the amounts accrued for tax purposes must be paid within 2.5 months after the year-end. Further, under the case law, so long as employees collectively have a right to receive the bonus, the bonus is accruable. Thus, if there is a pre-established bonus formula, and a commitment to pay the employees in the aggregate, which is communicated to employees, the bonus should be accruable. Knowing the identity of the individual recipients of the bonus is simply not a requirement.31

b. IRS Challenges.

On audit, the IRS is looking for ANY possible reason the employer might have reduced bonuses, collectively or individually, whether by adopting a "work to the pay date" rule, or including a tiny-type disclaimer somewhere in the plan indicating that the company has the right to amend the plan. First, in the case of audits of companies with plans requiring employment on the bonus pay date, the IRS has contended that, despite the literal language of Rev. Rul. 2011-29, it "never intended to reverse" its opposition to work-to-pay date requirements, which are explained in C.C.A. 200949040 and C.C.A. 201246029. Second, in the case of plans with revocation provisions, in FSA 20134301F (dated 10/25/2013, released November 4, 2013), the IRS has taken the

[31] *See, e.g., Washington Post v. U.S.*, 405 F.2d 1279, 1284 (Ct. Cl. 1969), *U.S. v. Hughes Properties*, 476 U.S. 593, 604 (1986); *Massachusetts Mutual Life Insurance v. U.S.*, 103 Fed. Cl. 111, 128 (Ct. Cl. 2012); and *Burnham v. U.S.*, 878 F.2d 86 (2nd Cir. 1989)). *See also* Rev. Rul. 61-127, 1961-2 C.B. 36 (concluding that bonuses were accruable where the employer advised its employees that it would pay bonus in the aggregate amount of "not less than 2% of profits.") and Rev. Rul. 2011-29, 2011-49 I.R.B. 824 (revoking the IRS's prior nonacquiescence in *Washington Post* announced in Rev. Rul. 76-346, 1976-2 C.B. 134), and concluding that the "fact of the liability" to pay bonuses can be established even if individual employee's bonuses are payable only if the employee works until the bonus pay date).

controversial position that simply because an employer has reserved the right to amend a bonus plan, that means that the entire plan is merely an "illusory" promise, which is not accruable. This IRS position disregards (without citing) many authorities which conclude that a promise to pay compensation cannot be retracted after the service-provider performs the required services.

c. Taxpayer Responses.

Some taxpayers are appealing the IRS's harsh position – particularly in audits where the IRS has proposed penalties, or is refusing to fairly apply the accounting method change rules outlined in Rev. Proc. 2002-18, 2002-1 C.B. 678. One company expects to file a case shortly in the Tax Court.

9. Compensation Deductions for SubS Company Executives.

In a surprising 2014 audit of a closely held California company, the IRS proposed to disallow deductions for over half the compensation paid to two top executives, on grounds that the compensation was "unreasonable" (even though the executives were not the owners of the company). The taxpayer proved that there had never been any unreasonable compensation case in which the IRS successfully challenged compensation paid to officer-shareholders (or their family members) who did not maintain majority control over the corporation; and further proved that the net revenue pick-up for the IRS, after protective refund claims were filed by the executive, was not significant.

10. Audits of Expatriate Employees.

As part of many payroll audits, IRS examining agents recently have been inquiring about the wage withholding collected from the expatriate employees. Although the Code section 911 exclusion covers part of these wages, the exclusion typically is inadequate to protect all the wages from withholding for all but a few employees. Many employees file Forms W-4 claiming sufficient exemptions to minimize their U.S. withholdings. However, other employees file Forms W-4 claiming "exempt status," which have either been completed incorrectly (in some instances, because exemptions were claimed at the same time that "exempt status" was claimed), or because any Form W-4 claiming "exempt status" is deemed to expire on Feb. 15 of the next year.

In reviewing and challenging these Form W-4 claims, the IRS agents often also mis-compute the Code section 911 exclusion (significantly understate the available exclusion). Disputes also arise over application of the FITW exclusion provided under Code section 3401(a)(8)(A)(ii) (and the underlying regulations), which provide a wage withholding exemption for remuneration paid for services by a U.S. citizen employee in a foreign country if the employer is required by the law of a foreign country to withhold income tax upon such remuneration. Per the language of the statute, a withholding exemption applies even if taxes were not in fact withheld, so long as it can be shown that, if tax were imposed, the foreign tax would otherwise qualify for credit (if elected) under

Code section 901. (*See* P.L.R. 8129013.) However, many IRS agents insist on detailed explanations (and translations) or foreign laws, plus proof that withholding in fact occurred, before applying this exclusion.

After calculating the alleged amount of underwithholding liability, most IRS agents insist that the only way for an employer to abate its liability for underwithheld income taxes is to collect "originally signed" Forms 4669 from each affected employee (even though the Internal Revenue Manual does not limit Form 4669 as the exclusive method by which an employer can "show that the tax … has been paid," and even though IRS District Counsel has agreed that faxed or PDF copies of these forms should be adequate). The agent uniformly reject employers' attempts to prove (e.g., by attestations by the accounting firms that prepared the tax returns) that the employee in fact paid taxes on the income, even though, according to Treas. Reg. § 31.3402(d)-1, an employer should be relieved of its liability for payment of the tax required to be withheld if it "can show that the tax … has been paid."

11. Audits of Impatriate Employees.

Code section 861 provides only a limited exclusion (for under $3,000 of income, and for work of under 90 days) for services performed in the U.S. The $3,000 exclusion amount (dating to the 1950s) is not adequate to protect most travelers, particularly since, in determining the fraction to use in allocating income to U.S. source, the IRS counts even a minute of a calendar day as a full day, even though the regulations indicate that the calendar day test is a "general" rule (implying that exceptions exist).

Luckily, the inadequacy of the Code section 861 exclusion is offset for many expatriates who are traveling to the U.S. from one of the 60 countries with which the U.S. has an income tax treaty, since those treaties often provide a general exemption from U.S. income taxes for amounts received by nonresident aliens who travel to the U.S. for study, research, or business or technical training (which is precisely why many B-1 visa-holders travel to the U.S.). However, these treaty exemptions do not apply to persons actually working in the U.S. (e.g., employees traveling on L-1, TN, or H-1B visas).

> Note: Some IRS agents examine even employees on B-1 visas, attempting to prove that the visas were obtained in error, and that the employees are ineligible for treaty protections.

For these nonresident alien workers, whose income and period of stay likely exceeds the Code section 861 exclusion limits, many employers arrange to pay their U.S. taxes (even though the foreign entity pays their wages), typically depositing the taxes on a quarterly basis, and then following through with tax return preparation. However, in some audits, the IRS has alleged that the U.S. employer's payments of taxes are late-deposited, thus triggering FTD penalties under Code section 6656 (even though the U.S. employer never in fact paid the wages). This penalty is hard to justify, since the U.S. employer in many instances did not pay the wages in the first instance, and no FTD

penalties should be applied to an employer that has not withheld (and, as a practical matter, has not even paid the wages). But, agents nevertheless are raising the penalty issue.

In other audits, examining agent insist that certain taxes were underpaid, or underwithheld. These assessments are particularly unfortunate when raised for FICA/FUTA taxes (which is possible, since the exemption in Code section 3121(b) for employees of "non-American employers" applies only to work performed outside the U.S.), because many of these NRA workers will never qualify for social security or unemployment benefits. Nevertheless, the IRS ignores the basic unfairness of imposing these social taxes, where no benefits will be received.

For employees whose wages likely exempt under section 861 or a treaty, where no payroll taxes are paid, the IRS has announced in several audits that it intends to audit the foreign affiliate, even though:

- the U.S. has no jurisdiction over the foreign employer;
- the U.S. affiliate cannot be held liable for underwithheld taxes, except for certain government contractors affected by Code seciton 3121(z); and
- It is very hard to obtain the information, given strict procedures for seeking and obtaining foreign records, and limitations on information exchanges (on top of IRS budget limitations on traveling to the foreign countries).

It is possible, in opening audits of these foreign affiliates of U.S. employers, that the IRS is only trying to collect unpaid employment taxes (for workers with compensation not exempt under Code section 861 or a treaty). However, it is also possible that the IRS is trying to determine visa violations, which it could report to US immigration authorities. Alternatively, it also is possible that the IRS is trying to prove that the foreign affiliates have created a "permanent establishment" in the U.S. Unfortunately, the IRS's motives are not as yet very clear, since most of these foreign affiliate audits are in early stages (and the IRS examining agents have dropped the issue completely in some audits).

Additional problems arise when NRA employees (or green card holders) move back overseas and exercise option or receive other equity compensation (e.g., RSUs), since at least FICA withholding, and possibly also income tax withholding, applies to that compensation attributable to U.S. services, irrespective of the fact that the employees are working for non-American employers at the point the compensation is ultimately received. In sourcing income from options and other equity compensation, the U.S. generally applies the grant-to-vest method (although auditing agents frequently make mistakes in their computations of U.S. taxable income). *See* Treas. Reg. § 1.861-4(b)-(d). However, this is not the exclusive method, as source-of-income allocation must turn on the specific facts and circumstances of the particular case. Accordingly, some

employers apply grant-to exercise; others allocate income based upon the taxpayer's residence during the period of significant appreciation in the underlying stock.

12. Tax Return Preparation for Expatriates and Company Executives.

a. Background.

As a general matter, the "working condition fringe" exclusion applicable under Code section 132(d) to benefits provided to employees that would be deductible by the employees, if paid for directly, does not apply to itemizable deductions, such as financial counseling, that are deductible under Code section 212. *See* Treas. Reg. §1.132-5(a)(1)(iii); Code §212; Rev. Rul. 73-13, 1973 1 C.B. 42; PLR 8547003 (7/31/85) and FSA 200137039 (6/19/01) (tax return preparation paid by employer). (Notably, although examining agents uniformly cite these authorities, they are generally distinguishable from the facts applicable to most employers' reimbursements. Particularly the "cash option" explained in PLR 8547003 is inapplicable to most employers' facts.)

b. Potential Ground for Exclusion.

Despite the IRS National Office's generally adverse position about tax return preparation, the working condition exclusion should apply if and to the extent the financial counseling is deductible under Code section 162 (*e.g.*, advising the workers generally about the company's benefit plans). A PLR request was submitted on this issue in 1988, requesting a segregation of the counseling provided into Code section 162 and 212 components, but the IRS was unwilling to rule on the factual questions presented. (*See* letter from Richard Skillman to IRS in Tax Notes Highlights, February 10, 1988.) More recently, in at least one audit, an Appeals Officer agreed that the employer's additional cost of tax-return preparation for expatriates was excludable from the employee's incomes, so long as the employer had imputed at least the reasonable "fair market value" of preparation of a domestic tax return. In some audits, even the examining agents have agreed that income imputation would be limited only to the value of tax-return preparation (generally \$350 to \$500, as estimated annually by the IRS and separately by the National Society of Accountants), and not to many ancillary services (including computation of tax-equalization payments). Other agents have been willing to exclude the cost of benefits exceeding those that would have been incurred if the employee had not been traveling. (*See* Rev. Rul. 630144 (Q&A 31), *Doak v. Comm'r,* 234 F2d(1956), and *Teeling v. Comm'r,* 42 T.C. 671 (1964), *acq*. 1965-2 C.B. 6 (all allowing deductions for personal meals and entertainment expenses, where it is clearly shown that the taxpayer was incurring costs exceeding those that would have been incurred for personal expenses).

c. Continuing National Office Opposition to Exclusion.

In PLR 199929043 (April 22, 1999), the IRS ruled that the fair market value of financial counseling services provided to families of terminally ill employees and survivors of deceased employees are not excludable from income under Code

§132(a)(3), but instead must be included in the terminally ill employee's income or, alternatively, in the survivors' income.

d. Difficulty of Obtaining Refunds or Credits for Overpaid Tax Equalization Payments.

Another emerging audit issues in payroll audits is whether the IRS will grant refund claims for overpaid tax equalization taxes – particularly FITW taxes, where the regulations generally limit refunds where amounts were withheld from employees' wages. However, certain FICA refunds are available, and even FITW and Additional Medicare Tax refunds (or credits) should be paid, particularly when the amounts have been deposited in January or February after the year in which the wages were paid, but the IRS is nevertheless resisting the claims – with the unfortunate result that the IRS is effectively overcollecting taxes that were never owed on the expatriates' incomes.

D. Possible Active Future Audits.

1. Tax Consequences of Early Retirement Vesting Provisions in RSUs, Restricted Stock: FICA Tax Audits.

a. Background.

Perhaps because of reviews of plans for potential Code section 409A and 162(m) issues, many employers have realized that vesting-at-termination guarantees that apply to RSUs or restricted stock may trigger FICA taxes on the RSU in the year of vesting, or early taxation of the restricted stock. With FICA taxes and RSUs in particular, this failure to tax is surprisingly widespread. As a general matter, this failure to impose FICA taxes on vested RSUs has not bothered IRS agents, since the IRS reserves the right to FICA-tax at the point of distribution any compensation that had not been appropriately FICA-taxed at the point of "vesting." Thus, in a rising market, and further taking into account the interest-free adjustment available (under Rev. Rul. 75-464), if a payroll tax underpayment error is corrected within the statute of limitations, the IRS on audit has very little incentive to require a company to go back to correct a FICA underpayment on RSUs - particularly since it has a continuing ability, even beyond the time that the statute of limitations has run on the vesting year, to collect FICA from the ultimate payment. However, in a falling market, the IRS *does* have a potential ability to collect more FICA taxes, by mandating that the employer go back to correct a FICA underpayment at the point of "vesting." In addition, under Rev. Rul. 75-464, it must be shown that the employer made some reasonable "mistake" - instead of simply blatantly avoiding the law - in order to qualify for interest-free adjustment. The IRS may not be equally generous with restricted stock, however, because the income tax rules do not provide the IRS with optional dates on imposing taxes, so, even in a rising market, technically the IRS would be required to tax the restricted stock at the date the early-retirement conditions were met. Also, the IRS may raise significant taxes, if the restricted stock tax-timing is accelerated, if the officers holding the restricted stock had

other compensation over $1M, and if the restricted stock was not eligible for any performance exemption from Code section 162(m).

b. GCM 38739.

It may have been possible to argue for exemption from early FICA taxation of RSUs, or early income taxation of restricted stock, if the vesting guarantee to early-retirees was limited to pro-rata vesting, based on GCM 38739 (an old ruling that is still "substantial authority" at least under Treas. Reg. §1.6662-4(d)(3)(iii) (which permits reliance on GCMs issued after March 12, 1981)). Under the odd facts in this GCM, it appears that if vesting in restricted stock is prorated over a period of time (*e.g.*, 1/3 per year after the employee reaches age 55), but no stock distribution is made until the end of the stated "vesting period" (or on termination of service), the point of taxation might be delayed until the property is 100% vested. Not all plans would qualify to rely on this GCM, and it is also not clear that the IRS would still agree with its conclusion. However, it's the only extant authority for claiming that pro-rata vesting might not trigger early taxation.

c. Code Section 3121(v) Issues.

In any case where RSUs are subject to the special FICA/FUTA tax timing rules applicable under Code § 3121(v) (as for any other nonqualified deferred compensation ("NQDC")), it is possible to delay the imposition of tax until the end of the year (the "rule of convenience" or until quarter one of the next year ("lag method")). These exceptions may help avoid any penalty on RSUs for late-paid FICA (as might the discussion in *Davidson v. Henkel Corp.* 2015 B.L. 1384 (E.D Mich. Jan. 2015), a class action by executives angry FICA was not imposed under the timing rules, in which the Court concluded that the 3121(v)(2) treatment was elective, but that the employer had promised employees to impose FICA early).

> Note: If the company did impose FICA at the vesting date, the refund/credit regulations do not allow retroactive changes, in a falling market, to delay the point of taxation, (*cf.* proposals for retroactive FICA refund claims which were wrongly suggested in December, 2008, by several accounting firms).

> Note: In order to avoid the substantial increase in Medicare taxes under the Health Reform legislation, it is likely that most companies will be seeing to *accelerate* the point of FICA taxation, under many existing plans, while taking care NOT to trigger any problems with Code § 409A.

2. IRS Payroll Audit Training Materials: An Alphabetical Approach to Future Tax Audits.

In 1993-94, the IRS prepared a booklet (and videotape) for employment tax examiners, to alert them to "The Basics" of payroll tax audits. These materials

included instructions on the fundamental principles of payroll tax examinations, as well as an *alphabetical* list of potential items that could be addressed in any payroll tax audit. That list (only part of which are so far being covered routinely, in large corporate audits) appear below:

- automobile allowances
- awards or prizes
- back pay awards
- bonuses (cash or noncash)
- cafeteria plans
- chauffeur service
- communications equipment (such as car phones)
- company owned or leased aircraft
- company owned or leased vehicles
- company free long distance phone line (personal use)
- country club memberships
- dependent care assistance programs
- disability payments
- discounts on property or service
- discounted airline passes
- educational reimbursements
- executive dining rooms
- estate planning
- financial counseling
- financial seminars
- free or subsidized lodging
- frequent flyer tickets used for personal purposes
- golden parachute payments
- group-term life insurance over $50,000
- holiday gifts
- home security systems
- income tax preparation
- legal counseling
- loans (low-interest or interest-free)
- local transportation for commuting
- luncheon-club memberships
- meal money because of overtime
- meal allowances/reimbursements (not away overnight)
- memberships in athletic facilities
- moving expense reimbursements
- nonqualified stock bonus plans
- nonqualified stock option plans
- outplacement services

- parking
- personal computers allowed to be taken home
- personal liability insurance
- physical examinations and/or use of health/medical facilities
- qualified stock options
- reimbursements of expenses on sale of personal residence
- retirement gifts
- safety or length of service awards
- severance pay
- scholarships or fellowships
- sick pay
- spousal travel
- uniform allowances
- use of recreation vehicles or boats
- use of vacation homes
- vacations (all expense paid or discounted)
- whole-life insurance

The IRS has subsequently expanded this list, and its explanation, in Publication 15-B ("Employer's Tax Guide to Fringe Benefits"), so it is possible at some point that at least some agents will revert to this prior technique of issuing IDRs with lengthy similar questions about the types of benefits provided by any employer. As is always the case with any summary of the tax rules, Publication 15-B omits many special exceptions, and oversimplifies the statutory and regulatory exclusions. Because of its simplicity, however, it has become an audit tool for many employment tax specialists in their identification of potentially taxable fringe benefits. Accordingly, employers may want to review this Publication, to determine if any of its summaries are at odds with their tax treatment of the various fringe benefits that are covered.

3. Whistleblower Audits.

a. Background.

A surprising number of recent audits of workforce-wide never-taxed benefits have arisen due to "whistleblower" complaints – often driven by disgruntled employees, former contractors, or business competitors – who hope to benefit from the increased rewards payable to whistleblowers. These increased rewards were part of a provision in a December 2006 tax bill, which increased the awards to informants who report perceived "tax abuses" by other taxpayers from the prior law reward levels of 1% to 15% (capped at $10M) to 15% to 30% of what the IRS collects. (The reward percentage is 10% if the information is based principally on specific allegations disclosed in public information sources.) The new provision (in Code section7623(b)) applies increased benefits to any returns of individuals with gross income over $200,000, if the additions to tax, plus taxes, penalties, interest and other amounts in dispute exceed $2M. (*See* W.S.J., "Legislation Raises the Rewards for Tips Uncovering Big Fraud," Dec. 20,

2006 at D-2.) There are tax law firms (*e.g.*, the Ferraro Law Firm in D.C.) whose practice centers around assisting whistleblowers file these complaints.

b. Recent Increased Collections.

Historically, the IRS has paid only approximately 8% of the informants who came forward with specific information about tax evaders. Between the late 1960s and the 2006 statutory increase in the award levels, the IRS had received 258,000 reward claims (of which 20,000 claimants received rewards totaling $89M). The new legislation was intended to increase the incentives for people to become informants, and it appears that it has done exactly that (including attracting reports from persons having inside knowledge of the transactions they are reporting, who have come forward with extensive documentation to support their claims). In its annual report for fiscal 2013 submitted to Congress and posted to the IRS website (Tax Notes Doc 2014-8277, 2014 TNT 66-60), the IRS Whistleblower Office reported the following information on claims (which often involve more than one claimant, per case):

Fiscal Year	2007 + 2008	2009 + 2010	2011 + 2012	2013 alone
Claims Received	6,455	20,154	17,322	9268
Claims Still Open	2,433	8,278	5,403	5417
Number of Awards Paid	447	207	225	122
Number of Awards over $2M	20	14	16	6
Amount of Awards Paid	$124.6M	$24.6M	$133.4M[32]	$53.0M
Total Amounts Collected	$338M	$670.7M	$640.5M	$362.0M

Several GAO reports have concluded that the IRS has had significant difficulties in processing claims and is extremely slow in paying rewards. In response the Whistleblower Office has modified its information system to provide additional information of its reason for closing claims, and better explanation for reasons for delay. On August 20, 2014, the IRS Deputy Commissioner for Services and Enforcement provided a list of "key principles for improving the timeliness and qualify of action on whistleblower submissions," which largely echoed, but improved upon, the principles announced in a prior report from June 2012. (2014 TNT 162-15.)

One reason that awards under the 2006 statute have been delayed is that the IRS has been waiting not only until the whistleblower audits were concluded, but also until the two-year statute has expired on any refunds, before making payments. Another

[32] These figures are skewed by the $104M award in September 2012 to former USB banker Bradley Birkenfeld. Similarly, the 2013 figures are skewed by a single payment of $38M near the end of calendar 2012 to a single whistleblower. (*See* 2014 TNT 66-5.) The IRS was criticized for being so slow in paying these claims. (*See* W. S. Journal 9/10/2011 "IRS Whistleblower Program Faulted.")

contentious issue between the IRS and practitioners and lawmakers has been the definition of "collected proceeds" used in determining the award. The IRS's Internal Revenue Manual provisions covering Code section 7623, indicates that "collected proceeds" do not include offsets, application of net operating losses, refunds, or other amounts that might reduce a tax liability. Another controversial issue is that the IRS actually applied backup withholding to the award it has distributed (even though such withholding is not required, or even permitted, when the payor has the payee's T.I.N.). Finally, some whistleblowers have been concerned about maintaining their confidentiality, logically if they were required to sue for collection of their perceived proper reward.

Note: It is not known how many of these whistleblower audits involve employment taxes, but, notably, the point of contentions about offsets for NOLs and refunds is less likely to apply to limit such refunds.

Note: U.S. Tax Court held in 2010 that it had jurisdiction to review the IRS Whistleblower Office's decision to deny an award. (*See William Prentice Cooper III v. Comm'r*, 135 T.C. 70 (2010).) However, the Tax Court has also concluded that it lacked jurisdiction when the IRS has not determined whether the whistleblower's information had lead to an action against the affected taxpayer. (*See Whistleblower 22231-12 v. Comm'r,* T.C. Memo. 2014-157 (August 4, 2014).)

Note: In *Whistleblower 14106-10W v. Comm'r*, 137 TC M.15, the Tax Court allowed a whistleblower to suppress his identity by expurgating all identifying information from the pleadings and the ultimate decision in a case filed under Code section 7623(b) over when an award should be denied.

4. State Payroll Audits of Travelers.

Completely apart from the IRS audits discussions throughout this presentation, companies with peripatetic workforces—employees and contractors working in, and moving among, many different states, either in a single year or over the course of the vesting period for bonuses, stock options, restricted stock, or other equity compensation—have special problems due to myriad state laws governing the taxation of residents and non-residents. Some states provide thresholds before withholding is triggered, based on days worked, dollars earned, or some combination of the two. (See map in Attachment A.) For example:

- NY – reasonable expectation that employee will work 14 days or less in NY
- GA – 23 days a quarter, or GA-allocated wages exceeding 5% of total compensation

- CT – 14 working days a year;
- ND – 20 working days a year

Note: Although Federal legislation has been pending for over 6 years that would limit states' ability to tax travelers who spend under 30 days in a state, is unclear whether this Congress (or the next) is going to enact this legislation, or, if it is enacted, whether it will exempt executive and other high-earners.

As with any payroll audits, it is simpler for state/local tax officials to audit employers, holding them liable for non-withheld income taxes where allocated wages exceed the state's personal exemption, because that is more efficient than finding and auditing individual employees. If employers have neither reported nor withheld on the income, it is extremely unlikely that any non-resident of a state would have voluntarily paid income taxes (thereby enabling the employers to abate their liability for nonwithheld income taxes). However, it is nearly impossible for employers to keep track of day-counting income allocation rules (or with 183+ days residency tests). Moreover, some states have poorly explained rules on income allocations, and historically many states were not aggressive in auditing non-residents or conducting payroll audits. however, as states become more aggressive, many employers are considering participating in programs operated by various states (e.g., NY) which provide effective amnesty for prior years, per "Voluntary Disclosure Agreements" which encourage employers to voluntarily confess their withholding/reporting errors

E. Pending Cases in U.S. Courts on Payroll Taxes and Benefit Deductibility.

1. Per Diem Taxation Audits.

The tax treatment of per diems is still an issue that the IRS challenges in audits of truckers, nurses, and airline employees (as is discussed in Section C.1 above). Several of these cases may have to be litigated, since the IRS is generally refusing to enter into any reasonable settlement.

Note: American Airliens filed a petition in Tax Court with respect to the payroll taxation of per diems of non-resident alien flight attendants, but the case was promptly settled after the Court ruled that it had jurisdiction to decide the case. *See American Airlines v. Comm'r* , Docket No. 15957-11.

2. Pending Refund Claims for Railroad Retirement Taxes on Moving Expense Reimbursements.

BNSF settled its refund claims, instead of waiting for the remand ordered in *BNSF Railway Co v. U.S.*, 745 F.3. 774 (5th Cir. 2014); and a similar refund claim was filed in August 2014 in *Union Pacific Railroad Co. v. U.S.*, Docket No. 8:14-cv-00237-

JFB-TDT (D.C. Neb). Both cases involve interpretations of limited terms in the Railroad Retirement Tax Act, one of which provides a limited exception for Railroad Retirement Taxes for advances or reimbursements for "bona fide and necessary business expenses."

3. Limited Tax Court Jurisdiction over Payroll Taxes.

One controlling (but infrequently noticed) theme to all the court cases involving payroll taxes is that there are very few Tax Court cases included on these lists. This is because, until 1997, the Tax Court had no jurisdiction over FITW, FICA or FUTA cases. Per the enactment of Code section 7436 in 1997 (and its subsequent technical correction in 2000), the Tax Court was granted very limited jurisdiction to resolve the issues of: (i) whether a particular worker is or is not classifiable as an "independent contractor" or an "employee" for purposes of Subtitle C; (ii) whether the person, if in fact an employer, is entitled to relief under section 530 of the Revenue Act of 1978; and (iii) the correct amounts of employment taxes which relate to the IRS's determination concerning worker classification. (*See* the Community Renewal Tax Relief Act of 2000 ("CRTRA"), Pub. L. 106-554, sec. 314(f), (g), amending the Taxpayer Relief Act of 1997, Pub. L. 105-34, sec. 1454(a).) Very few payroll tax cases have been brought to Tax Court, because:

a. The Tax Court generally has considered only cases that are certified by the IRS as ones involving worker classification; (*See* Notice 2002-5, 2002-1 C.B. 320, modifying and superseding Notice 98-43);

   Note: However, the Tax Court disregarded the instructions in Notice 2002-5, in *SECC Corp v. Comm'r,* 142 T.C. No. 12, concluding that the Tax Court has jurisdiction to hear any case in which there has been a "determination" as to employment status (or, alternatively a "dispute" over application of Section 530 relief), and that the issuance of a formal "Notice of Determination of Worker Classification" was not required in order for the Tax Court to hear the case. A similar victory for taxpayers' procedural rights to litigate in Tax Court was granted in *American Airlines v. Comm'r*, 144 T.C. No. 2 (1/13/2015). (The IRS had not wanted to have this case litigated in the Tax Court, in light of the extremely pro-taxpayer precedents on the substantive issues; after Tax Court jurisdiction was granted, the IRS settled the case.)

b. Even in these certified cases, the Tax Court initially concluded that it had no jurisdiction to resolve the amount of taxes in dispute, or the related penalties (*See Henry Randolph Consulting v. Comm'r*, 112 T.C. 1 (1999) and 113 T. C. 250 (1999)), although its jurisdiction was expanded by the CRTRA, to include resolution at least of the taxes and penalties in dispute, in *Evans Publg. Inc. v. Comm'r*, 119 T.C. 242, 244 (2002) and *Charlotte's Office*

Boutique v. Comm'r, 121 T.C. 89 (2003); and

c. Code section 7436 is so confusingly drafted, it is not clear whether the remaining issues in a tax cases (not directly involving the classification issue) would be procedurally blocked from litigation in another court, after the Tax Court resolves the classification issue.

For these reasons, most payroll tax cases have been filed only in District Courts and in the Court of Federal Claims.

F. **Typical Miscomputations in Exam's Payroll Tax Proposed Assessments.**

Note: Irrespective of the type of payroll tax audit, there are many mistakes or overly aggressive proposed assessments which are common to nearly all of these audits. This section outlines various common errors, which should be challenged even before any employer appeals the underlying proposed assessment.

1. Imposition of FICA Taxes on Employees Whose Wages Cleared the OASDI Wage Base.

FICA taxes (imposed pursuant to Code §§3101(a)-(b) and 3111(a)-(b)) are comprised of two elements: old-age, survivor and disability insurance ("OASDI" or "Social Security" taxes) and hospital insurance ("HI" or "Medicare" taxes). "Wages subject to social security taxes do not include amounts paid to an employee that are in excess of the taxable wage base." I.R.M. 4.23.8.6(1). While the HI portion of FICA is uncapped, employers and employees only pay OASDI taxes up to annual wage limits. During the audit years, the OASDI wage limits equaled $106,800 (in 2011), $110,100 (in 2012), $113,700 (in 2013) and $117,000 in 2014. *See* IRS Publication 15; I.R.M. Exhibit 4.23.8-2. The collective employer-employee OASDI tax rate during 2011 and 2012 equaled 10.4%, and in 2013 and 2014 equaled 12.4%. *Id*.

In proposing any FICA tax assessment, examining agents should exempt from Social Security taxes all employees whose earned wages in excess of the annual wage limit (and also should take into account employees whose wages might have been near the wage cap – a separate problem, discussed in item F.2 below). Failure to make this adjustment can result in substantially overstated proposed OASDI tax adjustments, which in turn carries over to any proposed penalties.

2. Imposition of FICA Taxes on Employees Whose Wages, Plus the Proposed Wage Adjustment, Would Exceed the OASDI Wage Base.

The second FICA tax computational error made by many examining agents is that they impose excessive Social Security taxes upon employees whose other wages are already only slightly below the Social Security wage base, so that when any proposed adjustment, when added to existing wages, would result in the proposed

assessment of Social Security taxes on wage that exceed the annual Social Security wage cap. The computation of this excess amount requires computations for each affected employee, but those computations should be performed, so as to ensure that Social Security taxes are applied only to that portion of the proposed additional wages that are sufficient for each employee to reach the annual Social Security wage caps.

3. Computation of FITW Liability at a Flat 25 Percent.

Another extremely common error made by examining agents is the imposition of Federal Income Tax Withholding (FITW) taxes at a flat rate of 25 percent. Admittedly, as a general matter, I.R.M. 4.23.8.8(1) instructs that in calculating an employer's Code section 3402 liability, "supplemental wage withholding rates" should be used. During 2011-2014, the supplemental wage withholding rate (on "regular wages") has been 25 percent. *See* Treas. Reg. § 31.3402(g)-1(a)(7)(iii). However, there is an important exception to this general rule (which may *reduce*, but not increase withholding computed under the supplemental wage withholding rates), which applies "where the employer can establish the employee's allowable number of exemptions from the Form W-4, Employee's Withholding Allowance Certificate, on file for the employees during the audit years [in which case] the computation can be made based on the laws and regulations in existence during those years." I.R.M. 4.23.8.8(2) and Treas. Reg. §31.3402(f)(2)-1(e). Stated more simply, Federal income tax withholding ("FITW") deficiency computations start with the supplemental wage withholding rates, but any determined deficiency should be reduced if the employer can demonstrate that application of the regular withholding method (i.e., using an employee's Form W-4 on file) results in an amount of withholding lower than the amount calculated under the supplemental wage withholding method. Most agents reject these suggestions, but most IRS Appeals Officers understand that any assessment of withholding on the employer should not exceed the amounts that would have been withheld, under Treas. Reg. §31.3402(g)-1 (the supplemental withholding regulations, which provide employers the option of withholding at the W-4 rate, if it is lower than the 25% supplemental rate).

4. Exclusion of Non-Employee Benefit Recipients.

If there are a substantial number of non-employees (e.g., independent contractors, or company guests, who received the fringe benefit in question, and further if the company has the SSN of these individuals (so that backup withholding is inapplicable), then the benefits allocable to those individuals also should be exempted from any alleged FICA or FITW taxes.

5. Income Tax Abatement if Employees Paid Taxes on the Benefits.

Any employer's liability under Code section 3403 for non-withheld FITW taxes can be abated, pursuant to Code section 3402(d), if "the tax against which such tax may be credited is paid." According to Treas. Reg. §31.3402(d)-1, "the employer will not be relieved of his liability unless he can show that the tax … has been paid." One potential method of proof is the collection of Form 4669 (attesting that the income was

reported, which must be signed by the employee under penalties of perjury), but other method of proof should be available, particularly since the Internal Revenue Manual does not provide that Form 4669 is the *exclusive* method of proving tax-payment by the employee, and alternative methods of proving tax payment have been recognized in numerous court cases. Unfortunately, some agents not only insist that Form 4669 is the exclusive method of proof, but also require that the Forms be "originally signed," and not PDF'd or faxed (although IRS District Counsel has disagreed with these positions in at least one audit, confirming that other methods of proof may be available, and also confirming that electronically signed Forms 4669, and PDF copies of these forms, would be acceptable).

6. Overstated Penalties.

Accuracy-related penalties under Code section 6662(c) are only applicable when a taxpayer underpays taxes due to "negligence or disregard of rules or regulations." Similarly, FTD penalties under Code section 6656 are applicable only when an employer fails to timely and properly remit employment taxes, and only if it cannot be shown that deposits were not required (because the employer had sound support for its filing position), or that the penalty is otherwise abatable on equity grounds.[33] Unfortunately, examining agents in nearly all instances have been proposing penalties, apparently for "trading" purposes, which is unfortunate.[34]

G. IRS Amnesty Offers.

1. Worker Classification Settlement ("CSP" and "VSCP" Programs).

In March 1996, the IRS established an optional settlement program that is designed to resolve, early in the administrative process, disputes with businesses over how their workers should be treated for Federal income tax withholding and FICA (Social Security and Medicare) tax purposes. The Classification Settlement Program ("CSP") was initially intended to be a pilot program designed to offer eligible businesses under IRS examination the opportunity to settle their worker reclassification disputes at what may be a big discount. The program was so successful that it was extended indefinitely. (Notice 98-21, 1998-15 I.R.B. 14.)

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[33] Per Rev. Rul. 75-191, 1975-1 C.B. 376, the FTD penalty does not apply where taxes were not withheld (e.g., either in a case where income is not reported, or where no withholding was collected). For this reason, NOPA DT7-6 is restricted to applying this penalty only to the employer share of FICA taxes. But, as discussed above, this penalty should not be applied at all.

[34] *See, generally,* M. B. Hevener, "More carrots, fewer sticks: why employers should be offered in payroll tax and executive compensation audits all the protections of Rev. Proc. 64-22," 29 Virginia Tax Review 187 (Fall 2009) (which discusses penalty abatement rules, as part of a series of articles in the same issue, all evaluating the continuing relevance of the sound principles of tax administration outlined by Commissioner Mortimer Caplin in Revenue Procedure 64-22, 1964-1 C.B. 869).

Under CSP, businesses that filed all required Forms 1099 with respect to the workers treated as independent contractors, are eligible for a special discount on the income tax withholding and FICA tax liability assessed for failure to treat the workers as employees.[35] An eligible business that is under audit or in IRS Appeals on this issue will be offered a settlement that is either 25% or 100% of the taxes at issue (computed using the Code section 3509 rates) for the most recent audit year (a substantial savings compared to the "full rate assessment" computed under the rates shown in section I.A.-D. of the chart in Section A.1. above).

The amount of the discount under CSP depends on how well the business complied with the following three requirements for getting relief from the payment of payroll taxes under section 530 of the Revenue Act of 1978: (1) filing Forms 1099 for all workers ("the reporting consistency requirement"), (2) consistently treating similarly situated workers as independent contractors ("the substantive consistency requirement"), and (3) having a "reasonable basis" for not treating the workers as employees ("the reasonable basis requirement"). Section 530 gives employers retroactive and prospective relief from federal employment taxes in cases in which the IRS has reclassified workers as employees. (If an employer can satisfy the IRS or a court that it fully meets all of the conditions of section 530, the employer is not liable for employment taxes and does not need CSP.)

To participate in CSP, a business must meet the section 530 reporting consistency requirement (that is, all Forms 1099 required to be filed must have been filed) but is not required to meet fully both of the other requirements. If the business fails to meet one or both of the other two section 530 requirements, the IRS agent is instructed to settle the case for 100% of the proposed assessment for the most recent calendar year under audit (still a benefit because several years may be closed by the settlement). If the business meets the reporting consistency requirement and has "a colorable argument" that it meets the other two requirements, the IRS offer will be for 25% of the employment tax assessment (computed under Code section 3509 rates) for the most recent calendar year under audit. It should be noted that CSP only permits either a 25% settlement or a 100% settlement based on the most recent audit year. An IRS agent is not permitted to negotiate a settlement percentage that is between 25% and 100%. In exchange for the settlement, the business must agree to classify its workers as employees in the future, beginning with the first calendar quarter following the date of the CSP agreement. Importantly, the settlement, which is calculated on the assessed employment tax liability for the most recent calendar year under audit, covers not only all the years currently under audit but also any intervening years.

The IRS does not require employers settling worker reclassification disputes under CSP to issue Forms W-2 recharacterizing the amounts previously reported

[35] IRS Fact Sheet 96-5 (3/5/96), TNT Doc 96-6663*; see also* TNT Doc 96-14207 and Stratton, "IRS Officials Clarify Scope of Worker Classification Initiatives," TNT Doc 96-11393. Federal unemployment ("FUTA") taxes cannot be settled under the CSP program.

as income on Form 1099-MISC. The CSP procedures do, however, instruct IRS examiners to tell employers to notify workers of the reclassification. The IRS usually has not been inclined, except in limited circumstances, to assert deficiencies against individual workers for additional tax liability that could result from a worker's reclassification as an employee. Because CSP fails to address the issue of the workers' exposure to individual audits, this administrative matter is left to the discretion of the individual IRS districts. Unfortunately, no formal steps have even been taken by the IRS National Office to advise its examiners to waive auditing the workers, except in the most egregious cases.

Under Code section 401(a)(2), a qualified plan's assets must be held for the exclusive benefit of employees and their beneficiaries. If a plan covers purported employees who are reclassified as independent contractors, the plan is in violation of this "exclusive benefit" rule. Although the IRS has in some instances expressed concern about the ramifications of worker reclassification on employers' pension plans, it long ago decided not to pursue a follow-up program that would have dealt with the pension plan consequences and would have provided a structured settlement program for those problems as well. (*See* Statement of Mary E. Oppenheimer, Assistant Chief Counsel (Employee Benefits and Exempt Organizations) at an ALI-ABA benefits course. Daily Tax Report at G-3 (October 7, 1996). *See also* P.L.R. 9546018 addresses the consequences of worker reclassification in a Code §401(k) plan and a defined benefit plan.)

> Note: An even better percentage settlement – of only a 10% settlement, based on the Code §3509 rates - is available for employers not otherwise under audit, per the "VSCP Program", as announced in Ann. 2011-2011-41 I.R.B. 503 (and related FAQs), superceded by Ann. 2012-45, 2012-I.R.B. 725, as temporarily expanded by Ann. 2012-46, 2012-51 I.R.B. 724. However, despite extensive IRS promotions of this program, it is not clear that many employers have signed up, mostly due to employer's concerns about potential consequent exposure to significant increases in payroll taxes, and in pension and benefit costs.

2. Cafeteria Amnesty (Industry Specific).

In 1998, the IRS announced an unusual (but temporary) amnesty offer for the casino, hotel and hospitality industry, to protect their cafeterias from payroll taxes and deduction disallowance. *See* Ann. 98-78 1998-34 I.R.B. 30, and the associated proposed training materials in Anns. 98-77 and 98-100. This settlement initiative was terminated per Ann. 99-7, 1999-2 C.B. 243, after the IRS decided not to appeal its loss of *Boyd Gaming v. U.S.*, 177 F.3d 1096 (9th Cir. 1999), reversing T.C. Memo 1997-445, and instead agreed to resolve cafeteria meal cases on the basis of their "particular facts." Unfortunately, most agents maintain that *Boyd Gaming* only provides relief for casino cafeterias.

3. IRP "Mass Error" Closing Agreements.

a. IRP Closing Agreement Procedures.

At the April 1998 meeting of IRPAC, the IRS released a draft version of the "Information Reporting Program ("IRP") Closing Agreement for Understatement of Income on Forms 1099 by a Payer". This program was subsequently updated, and is explained in IRS Manual under "Exhibit 8.13.1-12, Form 906 – Pattern Information Reporting Program (IRP) Closing Agreement for Understatement of Income on Form 1099 by a Payer." As initially proposed, this "Information Reporting Program ("IRP") Closing Agreement for Understatement of Income on Forms 1099 by a Payer" was intended to be a written agreement between the IRS and a payer when a error affecting numerous Forms 1099 has been made, and the error only involves a de minimis amount of understated reportable income for each Form 1099. The de minimis level originally was $50, but it was expanded to $100 in the recent Internal Revenue Manual explanation of the program. (Notably, too, in some instances the IRS has been willing to enter into closing agreements recently where the *average* error was under $100, even though some individual employees may have had larger errors.)

As originally proposed, these IRP closing agreement procedures were not intended to apply to Forms W-2, because of IRPAC's assumption that any corrections in wages would have had to have been coordinated with the Social Security Administration. For several years, the IRS was also willing to extend these closing agreement procedures to similar-sized errors in Forms W-2, but after 2008 it has become almost impossible to negotiate such W-2 settlements, because of a stated "need to coordinate the accurate reporting of wages with the Social Security Administration." However, there has been no indication that the IRS is backing off this program as applied to Form 1099 errors.

The actual closing agreement form is typically "IRS Form 906" - called "Closing Agreement on Final Determinations Covering Specific Matters," which is prepared and filed in triplicate, pursuant to Code §7121). Oddly, it is <u>not</u> available to general public and not accessible through their website or any other public website - it is an internal IRS form.

b. Requirements and Benefits of the IRP Closing Agreement.

The details of what payers will be required to do in order to avail themselves of an IRP closing agreement have never been entirely clear, but per the Manual guidelines, required that: (1) the payer must bring the error to the Service's attention on a voluntary basis; (2) the payer cannot make the same or similar errors repeatedly, and repeatedly request or be granted an IRP closing agreement; (3) the dollar amount of the underreported income with respect to each payee must be de minimis, which has been defined, by the IRS as $100; (4) the payer must provide a payee-specific listing of the amounts actually reported and the amounts that should have been reported, but the individual Taxpayer Identification Numbers of the payees do not need to be provided; and (5) a compliance fee must be paid by the payor, which, in cases of

underreported income, is based on the backup withholding rate of 28 percent. This payment would be considered a payment in lieu of tax, interest, and any potential IRP penalties.

The benefits of this direct-pay procedure, if the IRP proposal is accepted, would be:

(i) it does not affect the returns of individual payees, who would not ever even need to know there was an error on their Form 1099-MISC;

(ii) the payments are made interest-free, and typically penalty-free as well (although the penalty waiver is not guaranteed - *see* IRS Chief Counsel Memorandum 200844022, discussing the interrelationship between an interest-waiver and a penalty waiver);

(iii) the payor's payments under the program are not treated as income to the affected payees, and thus do not trigger a gross-up requirement; and

(iv) the payment is deductible.

H. Miscellaneous Hot Topics. (Frequent Flyer Miles).

1. Background.

Although the IRS has solicited public comments on the proper way to value and report frequent flyer ("FF") miles paid for use of credit cards, or as promotions or bonuses (*See* 50 Fed. Reg. 52333 (12/23/85), and has opened several "study projects" on this issue, it has had an official "moratorium" in place since 2002, for certain types of FF awards. However, this remains an extremely sensitive issue, as is shown by the controversy generated in late January, 2010, when the LA Times and Tax Notes ran articles complaining about Citibank's decision to report (on a Form 1099-MISC) the miles awarded as promotion bonuses for opening bank accounts. (*See* discussion in H.I.3. below.)

2. IRS Moratorium in Place since 2002.

a. Announcement 2002-18.

In Ann. 2002-18, 2002-10 I.R.B. 621 (issued two months after a change in the Federal employee compensation rules permitting government workers to accrue frequent flyer miles), the IRS announced that:

> "Questions have been raised concerning the taxability of frequent flyer miles or other promotional items that are received as the result of business

travel and used for personal purposes. There are numerous technical and administrative issues relating to these benefits on which no official guidance has been provided, including issues relating to the timing and valuation of income inclusions and the basis for identifying personal use benefits attributable to business (or official) expenditures versus those attributable to personal expenditures. Because of these unresolved issues, the IRS has not pursued a tax enforcement program with respect to promotional benefits such as frequent flyer miles.

Consistent with prior practice, the IRS will not assert that any taxpayer has understated his federal tax liability *by reason of the receipt or personal use of frequent flyer miles or other in-kind promotional benefits attributable to the taxpayer's business or official travel*. Any future guidance on the taxability of these benefits will be applied prospectively.

This relief does not apply to travel or other promotional benefits that are *converted to cash*, to compensation that is paid in the form of travel or other promotional benefits, *or in other circumstances where these benefits are used for tax avoidance purposes* " (Emphasis supplied.)

b. Comments on Relief Provided in Announcement.

(i) Benefits covered. This relief certainly applies to the FF miles awarded for travel on airlines; it also applies to the FF miles awarded for use of credit cards (provided that those miles are not convertible to cash). It has long been presumed that the reference to the "promotional benefits" that are covered by this Announcement would include, for example, rental cars and hotels provided in addition to FF miles.

(ii) FF Miles and Promotional Benefits Not Covered. The first italicized clause in the quote above from Ann. 2002-18 concludes with a reference to amounts "attributable to the taxpayer's business or official travel." Thus, it certainly does not apply to promotional benefits NOT attributable to travel. Also, per the second two italicized clause, it does not apply to either FF miles or promotional benefits "converted to cash," or "used for tax avoidance purposes." *See, e.g., Charley v. Comm'r*, T.C. Memo. 1993-558, *aff'd*, 91 F.3d 72 (9th Cir. 1996), 96-2 U.S.T.C. ¶ 50,399 (taxpayer embezzled from employer by obtaining reimbursements for first-class fare on trips purchased with frequent flyer coupons). After *Charley* was decided, in late 1996 and early 1997, federal grand juries indicted several NBA referees for tax fraud for practices not unlike those

engaged in by the taxpayer in *Charley*. Pursuant to a collective bargaining agreement, NBA referees are permitted to downgrade from first class to coach the airline tickets provided to them by the NBA for business travel and to pocket the difference. The difference is includible in the referee's income, but apparently at least three of them did not report it. The referees were not found guilty of tax fraud, but were found liable for taxes on the amounts they failed to report as income. By the same token, if an employer "bought back" FF miles from employees, this would clearly be not covered by the moratorium, since this is a "conversion to cash." (*See also* PLR 9340007 (June 29, 1993), which addresses information reporting of frequent flyer miles by a small airline, but which also briefly discusses conditions under which payments to employees under employer sponsored frequent flyer programs might be treated as fringe benefits. And also see PLR 199920031 (Feb 22, 2000) (the FF awards distributed by a mutual fund to investors for purchasing shares will be an adjustment to each investor's purchase price for fund shares, thus resulting in an adjustment to basis).

(iii) No Concession by IRS that these FF miles are "De Minimis Fringes." Notably, though the IRS in this Announcement did *not* characterize these FF benefits as "de minimis fringes." Instead, it simply announced that it is not going to assert on audit that their distribution is taxable.

c. Previous IRS Attempts to Address the Tax Treatment of FF Miles.

(i) Controversial 1995 TAM. The Office of Chief Counsel issued a Technical Advice Memorandum (TAM 9547001 (7/11/95)) addressing the effect that employee retention of frequent flyer miles earned on business travel has on an employer's air travel reimbursement arrangement. Under the express terms of the employer's travel policy, employees were allowed to retain FF awards earned on employer-paid business travel and use them for personal travel. The TAM concluded that this provision rendered the employer's arrangement a "nonaccountable plan" because it allowed employees to retain amounts in excess of substantiated business expenses, thereby contravening IRC § 62(c)(2). As such, the IRS reasoned, *all* amounts paid under the employer's arrangement were includible in employee gross income.

(ii) Public Reaction to TAM. Public reaction to the TAM was swift and unfavorable. Press reports revealed that approximately 90% of corporate America allows employees (usually informally) to keep FF miles on the premise that it is small recompense for the inconvenience of traveling on business. More importantly, the TAM failed to consider the overwhelming practical problems that would be created for employers with otherwise accountable plans. For example, old travel records for all years open under the statute of limitations would have to be reviewed to determine the cost of each employee's business travel. Not only would the employer face a huge administrative burden in trying to determine how many frequent flyer miles or free tickets each employee had kept, but the employer would be liable for income tax withholding and Social Security taxes, would have to file corrected Forms 941 and W-2 for all the affected employees, and would be exposed to large potential penalties for underpayment of payroll taxes. Compounding these problems was the fact that it is virtually impossible to separately track business and personal FF miles, many of the latter having been generated by affinity card programs.

(iii) IRS Response in 1995 to Controversy. Within two business days, the IRS issued a statement to the press, emphasizing that the TAM only applies to the taxpayer under audit and that there are ways (unrevealed in the TAM) for employers to avoid tax problems over the treatment of FF miles. The IRS reiterated that there is "no special enforcement program for frequent flyer miles" and revealed that it "is considering the analysis" set forth in the TAM.

(iv) Ultimate issuance of Ann. 2002-18. Although many people at the IRS believed that SOME adjustment should be made for FF mile awards (particularly because, even if treated as a "nontaxable rebate," under the tax laws applicable to rebated, the receipt of FF trips (used for personal purposes) should result in a decreased deduction for the business trips that were deducted). Nevertheless, ultimately the IRS caved to public pressure.

3. Controversy about Information Reporting of FF Miles Awarded for Opening Bank Accounts.

a. Reporting by Citibank of Miles Awarded in 2011.

A large controversy was generated in early 2011, in response to Citibank's decision to report the FF miles it awarded as promotions for opening bank accounts. See:

(i) http://www.latimes.com/business/la-fi-lazarus-20120124,0,1228880.column

(ii) http://www.latimes.com/business/la-fi-lazarus-20120131,0,1866043,full.column

(iii) (The public comments in response to these articles – also featured after the stories themselves - are a measure of the public outrage that FF miles would EVER, EVER be taxed.)

(iv) *See also* What Is a Frequent Flier Mile Worth? by Mamrie Sapirie, Tax Notes, Feb. 6, 2012, p. 619; 134 Tax Notes 619 (Feb. 6, 2012) (2012 TNT 24-1)

(v) Laura Sanders, Wall Street Journal, February 4, 2012 "Frequent-Flyer Tax Traps"

b. Support for Such Reporting.

Citibank's decision was certainly justified, first because of the above-outlined limitations of the Ann. 2002-18 moratorium, and second because the definition of "interest" in Treas. Reg. §1.6049 is extremely sweeping, particularly as applied to banks.

(i) Specifically, Treas. Reg. §1.6041-5(a)(3) states that whenever banks, S&Ls or other types of financial institutions pay "amounts" … in respect of deposits," that those amounts are *deemed to be interest* "whether or not designated as interest." (Notably, the same rule does not extend to brokerage accounts - since Reg. §1.6049-5(a)(5) does NOT contain this reference to "whether or not designated as interest " – and instead defines "interest" to include "interest on deposits with brokers.")

(ii) Rev. Proc. 2000-30, 2000-2 C.B. 113, also warns that "financial institutions" must "generally" file a return if they pay interest aggregating $10 or more, but although they are not required to report interest of under $10.

(iii) Presumably, any payment "deemed" to be interest under the rules outlined above would have to be reported as such by a bank or other financial institution.

c. Valuation.

The valuation of FF miles is the difficult issue. Citibank reportedly decided to value the FF miles it awarded for opening accounts at 2.5 cents per mile (which has been viewed as too high, per the public comments on the LA Times story). When FF miles are awarded as a "prize" (which happens), some companies value the miles at as low as 0.5 cents per mile. In purchasing FF miles to award with credit card purchases, banks typically pay the airlines about 0.5 to 0.8 cents per mile. The amount charged for "top up" purchased on line when "buying" travel with FF miles, the "price charged" can be 2.5 cents to 3.5 cents per mile. Obviously, the possible valuations cover a wide range.

d. Timing of Reporting the FF Miles.

It appears that the proper timing for the reporting of the miles would be at the time they are awarded, by analogy to the IRS's guidelines for reporting "prize points."[36]

e. Form to Use in Reporting the FF Awards for Opening Bank Accounts?

Citibank reportedly used a Form 1099-MISC (presumably not reporting any FF miles with a value under $600. It's not clear why a Form 1099-INT was not used (which has a $10 reporting threshold).

f. Possibility of any Congressional or IRS Action?

In response to the public controversy over Citibank's reporting of these FF awards, Sen. Sherrod Brown (D-Ohio), chairman of the Senate Banking Subcommittee

[36] In Rev. Rul. 59-58, 1959-1 C.B. 17, the IRS concluded that a distribution of gift certificates and similar items of readily convertible value provided to an employee are includible in the employee's gross income at that convertible cash value. Also, in Rev. Rul. 68-365, 1968-2 C.B. 418, the IRS concluded that the FMV of trading stamps redeemable for merchandise are includible in income when provided to employees, not when the stamps are redeemed. Similarly, in *American Airlines v. U.S.*, 204 F.3d 1103 (Fed. Cir. 2000), *aff'g* 40 Fed. Cl. 712 (1998) the court held that the Amex vouchers were taxable in the year awarded, not in the year redeemed. Additionally, in P.L.R.s 7002040390A (Feb. 4, 1970), and 7945009 (August 1, 1979) the IRS stated that "prize points" were includible in income when paid or otherwise made available to them. *See also* Rev. Rul. 70-331, 1970-1 C.B. 14 and TAM 7945009 (merchandise "credit" to dealers, operated as a prize point program under which points were taxed as they were awarded). Finally, s*ee* IRS Publication 525, also requiring taxation of "prize points awarded to salespersons" at the time they are awarded (without referencing Ann. 85-113, 1985-31 I.R.B. 31, which would indicate that any non-cash fringe benefit provided to an employee or a contractor could be valued and taxed at any time during the calendar year in which it is provided).

on Financial Institutions and Consumer Protection, wrote to Citibank's CEO, Vikram Pandit, calling on him to stop sending miles-related tax forms to customers, saying "The last thing Citibank should be doing is creating baseless fear in middle-class families, or placing a nonexistent tax burden on the backs of families who are already struggling to make ends meet." It's not clear that any additional action will be taken by Congress or (even less likely) by the IRS.

4. Tax Court Case Confirming Taxability of Awards for Opening Bank Accounts, and Continuing Controversy.

In *Shankar v. Comm'r*, 143 T.C. No. 5 (August 26, 2014), the tax court concluded that Citibank's award of "Thank-You Points" for opening a bank account, which were redeemed for a $668.00 ticket, were taxable income to the customer-taxpayer. The court relied on the Form 1099-MISC, plus testimony from a Citibank representative confirming that the points were redeemed in 2009. Mr. Shankar had testified that he "knew nothing about the points and received no award," but he did not make any other arguments as to why the award should not have been taxable, or that the award had been mis-valued, or that the award should have been taxable in another year. (Footnote 2 of the case notes that: "Neither party has addressed, nor do we consider, whether award of the thank you points, itself, may have been the taxable event.")

Notably, this case does not mention (although it is supported by) Treas. Reg. § 1.6049-5(a), which defined "interest" paid by financial institutions which is subject to information reporting (if it exceeds $10.00 per year) to include "Property which the payee receives from the payor as interest (or in lieu of a cash payment of interest) shall be interest for purposes of Code § 6049. The amount subject to reporting is the fair market value of such property." The case also does not mention Rev. Proc. 2000-30, 2000-2 C.B. 113, providing special guidance on so-called "de minimis premiums" paid by "banks and other financial institutions" to their customers, "as inducements to depositors to open new accounts or add to existing accounts." This Revenue Procedure provides that, effective as of 2000, any such "non-cash inducement" with a cost of $10 or less for a deposit of under $5,000, and a cost of $20 or less for a deposit of $5,000 or more would be treated as a "de minimis premium," and would neither be treated as gross income to the depositor (or as a reduction of the depositor's basis in the account), nor be treated as interest for purposes of the information reporting requirements under Code § 6049. Obviously, however, these airline tickets did not qualify for this de minimis rule.

5. Controversy over *Shankar v. Comm'r*.

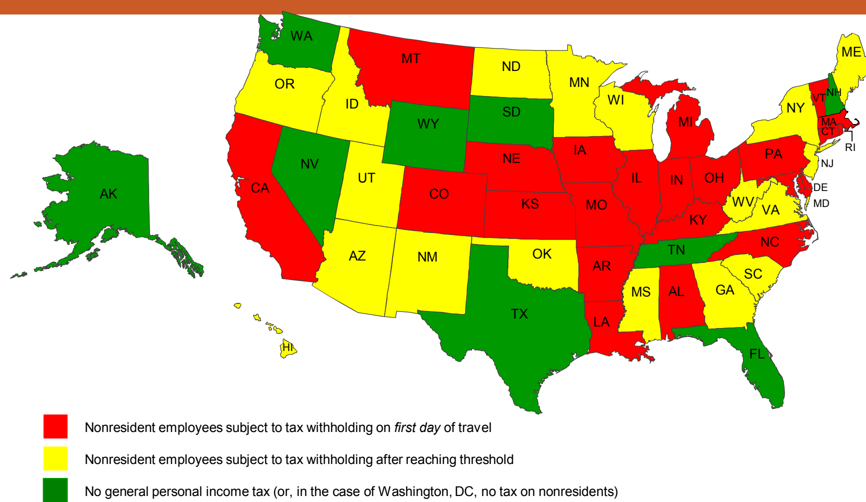
Predictably, this case attracted significant attention (plus an FAA hearing).

a. Forbes (8/27/ 2014), article by K. P. Erb, "Tax Court Sides with IRS in Tax Treatment of Frequent Flyer Miles Issued by Citibank."

b. Law360, New York (September 08, 2014, 2:40 PM ET); Taxation Of Bank Points Still Murky After Citi Case, by Ama Sarfo

Attachment A Overview of State Taxation Thresholds

Overview of Thresholds



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