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EMPLOYEE BENEFITS: UPDATES TO LAWS, REGULATIONS IN THE TRUPMP ADMINISTRATION

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Agenda: Hot Topics in Fringe Benefit Developments and Payroll Tax Compliance

I. IRS "Campaign" to audit company aircraft.

II. Employer-provided security services, and compliance with IRS rules to make the services tax-free.

III. Recent surprising IRS guidance limiting the relief available under Section 530 worker misclassification relief standards.

IV. Additional common topics in IRS payroll audits (including company cafeterias, and effect of recently filed tax case on company cafeterias), imposition of FICA taxes on RSU income of employees of Controlled Foreign Corporations, and IRS penalties for late deposits of payroll taxes).

V. Surge in state unemployment and payroll tax audits.

VI. Planning for the "ARPA 5" for 2027, under 162(m).

VII. Planning for increased deduction disallowances in 2026 for food, beverages, and certain company cafeterias.

VIII. Deductions for "overtime' pay, and complications for employers both in 2025, and beyond.

IX. Information reporting changes- to increase the $600 limit for most Forms 1099 to $2,000, and to retroactively reinstate the exemption form 1099-K reporting for 200 transactions or $20,000 in payments.

I. IRS Campaign to Audit Executive Personal Use of Corporate Aircraft

IRS Announces New Campaign to Audit Personal Use of Corporate Aircraft

- The IRS announced in February (in IR-2024-46) that the LB&I Division intends to open in spring 2024 approximately four dozen audits relating to the personal use of aircraft that are owned or leased by multinational and domestic corporations and "complex partnerships" operating in several industries.
- These audits may be prompted by the significant increase in private air travel during the COVID-19 pandemic. The entities selected for audits will be identified through "advanced analytics" applied to a database of corporate jet activity that the IRS is developing.
- The IRS Commissioner explained as a part of the rollout that the IRS is concerned that deductions are overstated, and that passengers' personal travel has not been correctly reported as taxable income.
- This area is undoubtedly complex, but prior to these forthcoming audits, the IRS has never issued clear guidance explaining how Congress's changes to the deductibility of "entertainment expenses" in 2017 would affect the deductibility of travel on company-provided aircraft (which has been governed by detailed regulations, issued in 2007, which were not amended by the IRS regulations implementing these 2017 statutory changes).

Exemptions from Disallowance Under IRC 274(e)(2)

- In *Sutherland Lumber-Southwest Inc. v. Commissioner*, the Court allowed a full tax deduction for all airplane costs, even for "entertainment flights," provided that the IRS's special valuation rules applicable to passengers' personal flights had been correctly applied. 255 F.3d 495 (8th Cir. 2001), aff'g 114 T.C. 297 (2000).
- In 2004, Congress enacted certain statutory limitations on aircraft deductions in order to overturn parts of *Sutherland Lumber* and the underlying regulations.
- Under the statutory override, in any case where a top executive or the executive's guest flies for personal entertainment, the aircraft deductions attributable to that flight (including pro-rated fixed and variable costs) are limited to the amount of income imputed for the flight.
- Neither the statutory override nor the regulations state that airplanes are "entertainment facilities" – they simply provide special deduction limitations for airplane travel (exempting "business entertainment flights" and other types of flights from the disallowance rules), as explained below.

Exemptions from Disallowance Under IRC 274(e)(2)

- The regulations explaining these rules enacted in 2004 created several important exceptions, outlined below:
  - Exclusion of "business entertainment air travel," that is directly related either to the active conduct of the taxpayer's trade or business or to entertainment that directly preceding or following a substantial and bona fide business discussion. Reg. § 1.274-10(b)(3).
  - Exclusion of any flights that are "not for entertainment purposes," such as flights to attend family members' funerals, flights for medical purposes, or flights for commuting between home and work.
  - Exclusion of flights where the passengers are guests of a person who is not a "specified individual" (a term defined to include any officers, directors, or over 10% owner of the entity providing the aircraft who is either "subject to section 16(a) of the Securities Act of 1934 in relation to the taxpayer, or an individual who would be subject to section 16(a) if the taxpayer were an issuer of equity securities referred to in that section)."
- Thus, despite these disallowance rules enacted in 2004, many flights to business entertainment events (even by spouses), commuting flights, and flights by non-executives and their guests have remained deductible.

Exemptions from Disallowance Under IRC 274(e)(2)

- Further, it is unclear whether transportation to an entertainment event is necessarily part of the "entertainment" itself.
- Notably, in enacting the 50% disallowance rule under IRC 274(n) applicable to both entertainment and food and beverage expenses from 1987 through 2017 (which, like IRC 274(a) as amended by the TCJA, did not contain any exception for "business entertainment"), Congress specifically exempted from the disallowance any "transportation to restaurants" from the definition of "entertainment," and the IRS's guidance under this provision never countermanded that exemption.
- Similarly, the IRS has never specified that airplanes were classified as "entertainment facilities." Instead, Reg. § 1.274-10 simply provides special disallowance rules for airplanes.
- Accordingly, since neither the TCJA legislative history nor any previous or subsequent IRS guidance has indicated that an airplane is an "entertainment facility," it is difficult to see how the IRS could disallow the fixed costs of aircraft operation simply because some passengers may be on business entertainment flights.
- Additionally, given the 1986 ACT legislative history, and lack of any formal IRS guidance characterizing all "transportation" (in a car or a plane) as "entertainment," it is questionable whether, in these forthcoming audits, the IRS could successfully disallow even the operating costs of a "flight to a business entertainment event."

Limitation of Spousal Travel and Gift Deduction Disallowance to Incremental Expenses

- IRC 274(m)(3) disallows any deduction for the payment of travel expenses of a spouse, dependent, or other individual accompanying an employee on business, but the regulations still permit the exclusion from an employee's income of trips by a spouse to a meeting held for bona fide "business entertainment" purposes, and also would apply a deduction disallowance only to the incremental expenses attributable to the trip by the spouse, guest or dependent. Reg. §§ 1.132-5(t)(1), 1.274-2(g), and 1.274-2(f)(2)(iii).
- Although there are other deduction disallowance rules applicable to "spousal travel" (even when it is for business purposes), and to "gifts" (which can be made to directors and other independent contractors), these rules do not require the expenses subject to this disallowance to be determined on the basis of any pro-rata allocation of expenses across all passengers, or flight miles, or flight hours.
- Instead, in the case of travel on a company plane, it is possible that there are only negligible incremental costs associated with an additional passenger's flight – except, of course, where § 1.274-10 limitations apply, to "personal entertainment" flights by top executives.

Inapplicability of IRC 162(m)

- In the case of publicly held corporations whose top executives' compensation in excess of $1 million/year is subject to the deduction disallowance rules under IRC 162(m), there are two applicable exemptions:
  - First, the rules do not apply to any passenger's travel for bona fide business reasons.
  - Second, and even more importantly, even in the case of personal travel by an executive and/or the executive's guests, these IRC 162(m) disallowance rules apply only to compensation deductions.
- Importantly, Reg. § 1.162-25T specifically provides that "if an employer includes the value of any non-cash fringe benefit in an employee's income, the employer may not deduct this amount (i.e., the imputed income) as compensation for services, but rather may deduct only the costs incurred by the employer in providing the benefit to the employee [including] a cost recovery deduction under section 168 or a deduction under section 179."
- Therefore, although this regulation disallows a "compensation" deduction for any amounts of income calculated under the special valuation rules for plane travel, it instead allows a deduction for depreciation and cost recovery deductions (which are deemed by this longstanding regulation not to be "compensation expenses").
- Thus, although deduction disallowances could apply if and to the extent a flight is an "entertainment flight" subject to Reg. §§ 1.274-9 and -10, there should be no additional deduction disallowance applied under IRC 162(m).

IRS's FOIA-Released Training Materials Focus on 280F

- One important initial focus of these IRS aircraft audits (indicated by recently released "training materials" for IRS agents, Tax Notes Doc. 2024-31360) apparently will be any potential violations of IRC §280F, the provision limiting claims for accelerated depreciation under IRC §168 for airplanes (with correlative adjustments to lease costs) when there is excessive personal use of the aircraft by over 5% business owners and their employees.
- These highly expurgated training materials include multiple examples of how auditors should calculate whether the plane has at least 50% "qualified business use," which is required to qualify for bonus depreciation, focusing mostly on flights that were personal, unsubstantiated, or mis-valued.
- Importantly, the IRS's own "training materials" seem to misapply the statute and regulations,
  - by not conceding that personal flights provided to any employees (and their guests) who are *not* either 5% owners (or related persons), which have been properly valued and taxed under the SIFL regulations, must be deemed to be "qualified business use"; and
  - by not clearly reversing the controversial position taken in TAM 200945037 (7/29/2009), in which the IRS had concluded (without statutory support) that even *business flights* provided to a 5% owner or related person on board are excluded from qualified business use,

Generous Valuation Rules for Use in Taxing Personal Travel

- The safe harbor valuation rules applicable to personal flights on "employer-provided aircraft," applicable since 1985, are based upon Standard Industry Fare Level (SIFL) statistics published by the Office of International Aviation (Pricing & Multilateral Affairs) of the Department of Transportation (DOT).
- The values determined using the SIFL valuation rules must be imputed for any personal trips by employees, independent contractors, and their guests, and are also the maximum deductible amount for any "entertainment flights."
- When the US Department of the Treasury initially designed the SIFL valuation method, the basic rate applicable to a flight by a top executive or guest was believed to approximate two times first class fares. However, these SIFL valuations have declined over the years, and the highest valuation currently approximates first class commercial fares.
- These regulations value each seat on any particular flight by multiplying the SIFL cents per mile charge by a number called the "Aircraft Multiple" and then adding the SIFL terminal charge.
- There are substantially different values applied for "control employees" and their guests, as opposed to flights by any "noncontrol" employees.
- If the personal travel by the executive is covered by the "security exclusion" (as a result of some specific threat to the executive, and as supported by an independent security study), then any travel by the executive, spouse and dependent children accompanying the executives can be valued at a rate equal to "200% of SIFL," which is slightly more than half the regular SIFL rates.

Predicted Results of IRS Audits

- Certainly, the deduction disallowance rules and valuation (and withholding) rules applicable to travel on company aircraft are extremely complicated.
- However, companies tend to be extremely careful to identify any personal trips that are taxable to company employees and contractors, to value those trips correctly, and, finally, to apply deduction disallowance rules where applicable.
- The identity of the "four dozen" entities that the IRS intends to target in these audits is currently unclear, but we hope that any audited company has properly applied the rules and pays careful attention to the special exceptions and valuation rules discussed herein.
- In preparation for any potential IRS audit, companies certainly should be sure to retain their flight logs (including for foreign travel), passenger manifests, notes on any business reasons for the flights by employees, directors and guests, valuation calculations for flights where income was imputed, and deduction disallowance calculations for any "entertainment flights" by top executives and their families and guests.

II. Employer-Provided Security Services

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Executive Security Working Condition Fringe Benefits

- In General. To be excludable as an IRC 132(a)(3) working condition fringe benefit, all the following must apply:
    - the benefit must relate to the employer's business,
    - the expense would have been an allowable business expense deduction to the employee if the expense had been paid personally, and
    - the business use must be substantiated with records.
- "Employee". All the following are considered employees for purposes of working condition fringe benefits:
    - current employees
    - partners
    - members of the board of directors of the employer
    - independent contractors

Treas. Reg. Section 1.132-1(b)(2).

Overall Security Programs & Independent Security Studies

- Proof of Need for Security. In order for the working condition rules to apply to security protection, the employer must establish the existence of a "bona fide business-oriented security concern," which must be demonstrated by:
  - specific threats to the executive, such as death threats, threats of kidnapping, serious harm to body or property, or a history of violent terrorist activity in an area; or
  - receipt of similar threats by "similarly situated employees." *See* Reg. §§ 1.132-5(m)(2)(i)(A) and (B).

Note: A "generalized concern for an employee's security" will not suffice. *See* Reg. § 1.132-5(m)(2)(i).

- Establishment of "Overall Security Program". An employer can establish an "overall security program" by either: (1) providing 24/7 security (rare, given the invasiveness to the executive and cost to the company), or (2) obtaining an "independent security study," which requires:
  - The study must be performed by an independent security consultant. (To be "independent," the security consultant must be an outside firm or person, as opposed to another employee of the same employer.)
  - The study must be based on an objective assessment of all facts and circumstances. (We recommend updating a security study every 3-4 years or when circumstances concerning executive safety change.)
  - The recommendation of the study is that a 24-hour overall security program is not necessary and such recommendation is reasonable under the circumstances. (Recommendations may include bodyguards during publicly announced events like shareholder meetings, domestic or international air travel by private aircraft, enhanced vehicle security measures while commuting, home security, etc.)
  - The employer applies the specific security recommendations contained in the security study to the executive on a consistent basis.

Executive Auto Travel

- If an employer provides an executive with a vehicle that is specially designed for security for commuting due to bona fide business-oriented security concerns (per a security study), the executive can exclude the additional value of any special security designs from gross income as a working condition fringe. Reg. § 1.132-5(m)(1).
- For example, assume that in response to death threats on CEO's life, Company X provides CEO (per a security study) with the use of a vehicle for commuting that is specially equipped with bulletproof glass and armor plating. Assume further that the value of the specially equipped vehicle is $120,000, while the value of the same vehicle without the security features is $70,000.
- Based on the security protection working condition fringe, the imputed income value of the CEO's commuting benefits (a personal expense) will be based on a $70,000 value. Reg. § 1.132-5(m)(8), Ex. 1.

Executive Private Air Travel

- The personal trip safe harbor valuation rules apply Standard Industry Fare Level (SIFL) rates published by the U.S. Department of Transportation. See Reg. § 1.61-21(g). The regulations value each seat on an aircraft by multiplying the SIFL cents-per-mile charge by the "Aircraft Multiple" and then adding the SIFL terminal charge.
- Different values apply for "control employees" and their guests compared to flights by "noncontrol" employees.

Max Certified Take-off Weight	Aircraft Multiple for Control Employees	Aircraft Multiple for Noncontrol Employees
Over 25,000 lbs.	400%	31.3%
10,001 to 25,000 lbs.	300%	31.3%
6,001 to 10,000 lbs.	125%	23.4%
6,000 lbs. or less	62.5%	15.6%

Flight Distance	SIFL Rate per Mile (1st Half of 2025)
First 500 miles	$0.2869/mile
Miles 501 to 1,500	$0.2187/mile
Miles in excess of 1,500	$0.2103/mile
Plus: $52,44 terminal charge	

- An executive's personal trip (including spouse and dependent children) that is covered by the "security exclusion" is valued at 200% of SIFL cents per mile plus 100% of the terminal charge. For example, a personal flight for an executive from Boston to Phoenix (2300 Statute miles) compares:
  - No Security Study: ((500 miles X $0.2869 + 1,000 miles X $0.2187 + 800 miles X $0.2103) X 400%) + $52.44 = $2,198
  - With Security Study: ((500 miles X $0.2869 + 1,000 miles X $0.2287 + 795 miles X $0.2103) X 200%) + $52.44 = $1,131

Executive Family Travel

- No security study is needed for an executive’s spouse or dependents, provided they are on same flight (or in the same vehicle) with the executive who is covered by such a security study.
- All would fly at 200% SIFL on any plane (or have imputed for any other transportation whatever price would have been paid but for the security concerns).
- However, if a spouse or dependents fly or ride separately, separate studies (plus proof of need for security) is needed for each of them in order for the 200% multiple to apply.
- In the absence of such a study, spouses and dependent air travel without the executive will result in imputed income valued at the 400% multiple.

Reg. § 1.132-5(m)(3).

Non-travel Security Services

- Home Security Services & Systems.
  - In the case of home security services, the exclusion should apply to exclude the value of such security services. See Reg. § 1.132-5(m)(2)(iii)(A) ("guards, metal detectors, alarms, or similar methods of controlling access to the employee's workplace and residence").
  - In the case of home security systems, the FMV of the system may be taxable if the executive is allowed to retain the home security system after the bona fide business-oriented security concern ends, or after the executive terminates employment. *See* PLR 7752010 and PLR 8141011.
- Chauffeurs & Bodyguards. A chauffeur's or bodyguard's salary may be excluded from the executive's income upon showing that:
  - there would be no chauffeur but for the security concerns, and
  - the chauffeur is trained in evasive driving techniques.

Reg. §§ 1.132-5(m)(5) and (8), Ex. (2).

Potential Effect of Security Studies on Commuting Benefit Deductions

- The IRC 274(l) commuting expense deduction disallowance rules include an important exemption that permits a deduction for any commuting trips "necessary for ensuring the safety of the employee." Final Reg. § 1.274-14(b) provides:

  > The disallowance for the deduction for expenses incurred for providing any transportation or commuting in paragraph (a) of this section does not apply if the transportation or commuting expense is necessary for ensuring the safety of the employee. The transportation or commuting expense is necessary for ensuring the safety of the employee if unsafe conditions, as described in § 1.61-21(k)(5), exist for the employee.

- Given that the Preamble of the final regulations indicates that the reference to Reg. § 1.61-21(k)(5) was intended to "expand" the conditions under which commuting reimbursements would be deductible, it appears that this exception applies not only to the types of security protections covered by Reg. § 1.61-21(k) (which is part of a special valuation rule covering transportation for relatively low-paid non-exempt (hourly-wage) employees who either live or work in areas with histories of crime), but also any other situations where the commuting trips are provided by the employer "to ensure the safety of the employee."
- It is possible that since the commuting disallowance regulations no longer specifically cross-reference Reg. § 1.132-5(m) that the disallowance might apply even if the "security risk" and "security study" conditions are not met, but most companies have been continuing to obtain these studies for working condition fringe wage exclusion purposes, and also to strengthen the validity of any claimed commuting expense deduction.

III. Recent IRS Guidance Concerning Section 530 Worker Misclassification Relief Standards

Federal Payroll Tax Relief: Section 530 Relief

- Section 530 (a non-Code provision enacted as Section 530 of the Revenue Act of 1978) was designed to eliminate the need for the courts and the IRS to engage in the balancing of complex factual issues in determining whether an individual is an independent contractor or an employee under the common law.
- The IRS describes Section 530 as a "safe harbor provision" that prevents the IRS from retroactively reclassifying "independent contractors" as "employees" if specific statutory rules are met. Section 530 does not make or validate workers as independent contractors but rather classifies them as "non-employees" for federal employment tax purposes.
- Reduces the employer's federal employment tax exposure to zero for **<u>all past and future years</u>**.
- Employer-only relief and only for employment taxes.
- If these tests are met, companies can continue treatment of the workers as independent contractors for payroll tax and information reporting purposes.

Federal Payroll Tax Relief: Section 530 Relief

- Substantive Consistency. The service recipient must have treated the workers, and any similar workers, as independent contractors.
- Reporting Consistency. The service recipient must have timely filed all required federal tax returns (including information returns) consistent with the treatment of each worker as a non-employee (i.e., the compensation must have been consistently reported for all years on Forms 1099, not Forms W-2).
- Reasonable Basis. The service recipient must have had a reasonable basis for not treating the workers as employees, such as:
  - Reasonable reliance on a worker classification court case or a ruling issued to the service recipient by the IRS; or
  - The service recipient was audited by the IRS at a time when the service recipient treated similar workers as independent contractors and the IRS did not reclassify those workers as employees; or
  - The service recipient treated the workers as independent contractors because the service recipient knew, and can substantiate, that was how a significant segment of the service recipient's industry treated similar workers; or
  - The service recipient relied on some other reasonable basis (e.g., reliance on the advice of a lawyer or accountant who knew the service recipient's facts).
- Once a taxpayer makes a *prima facie* showing that all three Section 530 requirements have been satisfied, the IRS then bears the burden to rebut that *prima facie* showing by a preponderance of the evidence.

Federal Payroll Tax Relief: Section 530 Relief

- Section 530(b) prohibits the IRS from publishing any "regulation or revenue ruling … with respect to the employment status of any individual for purposes of the employment taxes."
- Section 530(d) provides that section 530 does not apply in the case of "an individual who, pursuant to an arrangement between the taxpayer and another person, provides services for such other person as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work."
- In response to enormous taxpayer opposition to the enactment of Section 530(d), the IRS in Notice 87-19 agreed not to apply the "technical service specialist" exclusion beyond the job categories specifically listed in the statute and, much more importantly, conceded that Section 530 protections continued to apply both to the companies hiring tech service specialists from third parties, and to companies that hire individual tech service specialists directly (i.e., not through any third party or LLC).
- In the case of "technical service specialists" who work either for their own companies or for leasing companies, worker classification will be determined based on the common law worker classification rules.

Tax Court Jurisdiction Under IRC 7436

IRC 7436 provides the U.S. Tax Court with jurisdiction to review IRS employment tax determinations when the following conditions are satisfied:

1. an examination in connection with the audit of any person;
2. a determination that –
   a. one or more individuals performing services for such person are employees of such person for purposes of subtitle C, or
   b. such person is not entitled to relief under section 530(a) with respect to such an individual;
3. an "actual controversy" involving the determination as part of an examination; and
4. the filing of an appropriate pleading in the Tax Court.

Federal Payroll Tax Relief: Section 3509 Relief

- Provides an opportunity for reduced employment tax assessments if service recipient issued Forms 1099.
- Section 3509 does not provide any relief regarding the employer's portion of FICA taxes nor the FUTA tax.
- The effective IRC 3509(a) rate is 10.68% for both FICA and FITW for the compensation paid to reclassified workers on wages up to the annual Social Security wage cap. On wages above the annual Social Security wage cap, the IRC 3509(a) tax rate is 3.24% (or 3.42% if wages exceed $200K).
- If Forms 1099 were not filed, the effective IRC 3509(b) rates are 13.71% on wages up to the Social Security wage base, then 5.03% on additional wages up to $200K, and 5.39% on wages over $200K.
- A service recipient will owe full rates if any failure is attributable to "intentional disregard." *See* IRC 3509(c).
- FUTA taxes are also owed.

Rev. Rul. 2025-3

- In January 2025, the IRS updated 40-year-old guidance governing Section 530 relief. Rev. Rul. 2025-3 provides 5 fact scenarios that illustrate whether:
  - Section 530 relief is available (under the IRS's interpretation of the statute); and
  - the IRS should issue a Notice of Determination of Worker Classification (a/k/a recipient 7436 Notice).

<u>Situation 1</u>.

- Facts: Non-employee weekly pay and weekly bonus reported on 1099-NEC; IRS determines that workers are "employees," to which TP asserts that Section 530 relief applies.
- Holding: Section 530 is available because IRS is reclassifying workers as "employees" (if TP can satisfy the 3-part test); if not, IRC 3509 reduced rates apply; IRS will issue 7436 Notice if no agreement is reached during the audit.

<u>Situation 2</u>.

- Facts: Employee weekly pay reported on W-2 and weekly bonus reported on 1099-NEC; IRS determines that bonuses are "wages," to which TP asserts that Section 530 relief applies.
- Holding: Neither Section 530 relief or IRC 3509 reduced rates are available because IRS is not reclassifying workers as "employees"; IRS will issue 7436 Notice if no agreement is reached during the audit.

Rev. Rul. 2025-3

Situation 3.

- Facts: Employee weekly pay reported on W-2 and no reporting of weekly bonus; IRS determines that bonuses are "wages," to which TP asserts that Section 530 relief applies.
- Holding: Neither Section 530 relief or IRC 3509 reduced rates are available because IRS is not reclassifying workers as "employees"; IRS will issue 7436 Notice if no agreement is reached during the audit.

Situation 4.

- Facts: Employee weekly pay reported on W-2 and no reporting of weekly bonus; TP does not assert that Section 530 relief applies.
- Holding: Neither Section 530 relief or IRC 3509 reduced rates are available because IRS is not reclassifying workers as "employees"; IRS will not issue 7436 Notice since TP did not assert entitlement to Section 530 relief.

Situation 5.

- Facts: TP employs workers through a third party that reports weekly pay on W-2; TP directly pays year-end bonus to workers that are not reported; IRS determines that bonuses are "wages," to which TP asserts that Section 530 relief applies.
- Holding: Holding: Neither Section 530 relief or IRC 3509 reduced rates are available because IRS is not reclassifying workers as "employees"; IRS will issue 7436 Notice if no agreement is reached during the audit.

Rev. Rul. 2025-3

The Rev. Rul. 2025-3 scenarios that illustrate when the IRS will and will not issue a Notice of Determination of Worker Classification (NDWC) “ticket to Tax Court” should have little bearing on whether the Tax Court will assert its jurisprudence under IRC 7436. For example, see:

- *SECC v. Comm’r*, 142 T.C. 225 (2014), in which the Tax Court overruled both parties’ motions to dismiss after finding that the Tax Court possessed IRC 7436 jurisdiction even though the IRS never issued a NDWC;
- *AAL v. Comm’r*, 144 T.C. 24 (2015), in which the Tax Court upheld IRC 7436 jurisdiction in the absence of any NDWC; and
- *Reflectxion Resources v. Comm’r*, T.C. Memo 2020-114, in which the Tax Court determined 7436 jurisdiction did not exist (over certain tax periods) despite the IRS having issued a NDWC for the dismissed tax periods.

Rev. Rul. 2025-3

- One bright spot in Rev. Rul. 2025-3 is the first published recognition of "dual capacity" workers since Rev. Rul. 58-505 was published over 65 years ago.
- In footnotes, Rev. Rul. 2025-3 recognizes that in "unusual circumstances" a worker may be both an independent contractor and an employee vis-à-vis a service recipient, but only if the independent contractor services "are completely separate and distinct from the services giving rise to the employment relationship," and the worker is "separately compensated for those services."
- This requires "no interrelation either as to duties or remuneration in the two capacities."
- But in such "dual capacity" arrangements, Rev. Rul. 2025-3 instructs that "the status of the individual as an employee or non-employee, and the application of section 530 [and the application of IRC 3509], will be considered separately with respect to the distinct relationships under which the separate services are provided."
  - *See also* Rev. Proc. 2025-10, at fn 13.

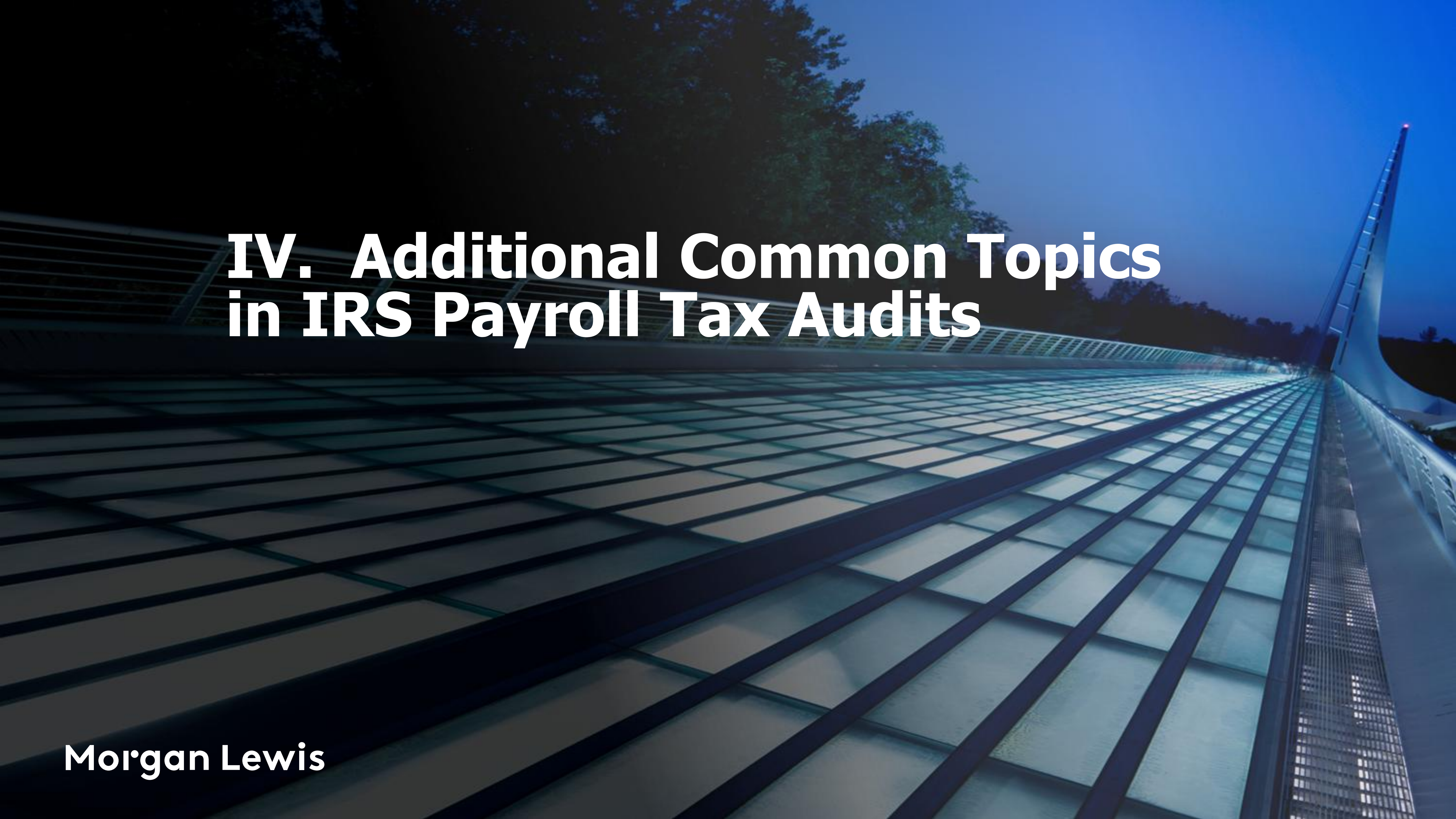
Rev. Proc. 2025-10

- In additional new guidance (obsoleting Rev. Proc. 85-18). Rev. Proc. 2025-10 advances new factors that the IRS will consider in applying the test under Section 530 which requires a determination of whether a service recipient has "treated" workers as employees or independent contractors. Namely, indications that a service recipient "treated" workers as "employees" include:
  1. the withholding of income tax or FICA taxes from any payments made to a worker, whether or not the tax is paid to the IRS;
  2. the filing of an original or amended employment tax return (e.g., Form 941, 940, Schedule H (1040)) with respect to a worker, whether or not tax was withheld;
  3. the filing of a Form W-2 "Wage and Tax Statement" with respect to a worker, whether or not tax was withheld; and
  4. contracting with a third party to perform acts required of employers (an otherwise undefined standard).
- However, the filing of a delinquent or amended employment tax return for a particular tax period with respect to a worker as a result of IRS collection or examination activities or other compliance procedures, does not indicate "treatment" of the worker as an employee for that period.
- IRS correspondence that merely advises the taxpayer that no return has been filed and requests information from the taxpayer is not a compliance procedure.

Rev. Proc. 2025-10

- Rev. Proc. 2025-10 also instructs that other facts may demonstrate whether a service recipient “considered the [worker] as an employee” for other purposes, including whether the service recipient:

1. claimed income tax deductions, or treated payments to the worker as excludable from income, under Code provisions that are applicable only to employees, including under IRC 62(a)(2)(A) (accountable plan business expense reimbursements) **WRONG**, IRC 105 (accident and health insurance benefits), IRC 106 (contributions to accident and health insurance coverage), IRC 117(d) (qualified scholarships), IRC 119 (in-kind meals and lodging, IRC 127 (educational assistance) **WRONG**, IRC 129 (dependent care) **WRONG**, IRC 132 (noncash fringe benefits) **WRONG for nearly all noncash benefits** , or IRC 137 (adoption assistance);
2. claimed employer credits (e.g., paid sick and family leave, employee retention) or other credits based on employee wages;
3. complied with federal or state labor law including minimum wage and overtime rules that are applicable to employees;
4. treated workers as employees for purposes of state or non-tax federal laws (a new factor that contradicts years of IRS guidance, such as P.L.R. 9338039 (6/19/1993) that concluded that state and non-tax treatment of workers was not relevant to Section 530);
5. treated the worker as an employee for purposes of collectively bargained agreements;
6. permitted participation of the worker in any qualified pension, profit-sharing, or stock bonus plan;
7. permitted participation of the worker in nonqualified deferred compensation plan if such participation is limited to employees; and
8. provided state unemployment insurance or worker's compensation insurance coverage for a worker if state unemployment or worker's compensation insurance is limited to workers performing services as common law employees.



IV. Additional Common Topics in IRS Payroll Tax Audits

IV., Part A. Overview of “Alphabetical List” Approach to IRS Payroll Audits

Summary Of Focus of IRS Payroll tax audits

- The IRS payroll tax audit staff has decreased by well over 50% during the past year,
- The few payroll tax audits conducted recently by IRS auditors have focused on the same issues raised in audits over the past two decades, i.e.,:
  - Company cafeterias
  - Cars provided in kind and by reimbursements
  - Airplane use
  - Entertainment events
  - Spousal travel
  - De minimis fringes.
  - Litigation settlements
  - Timing of deposit of payroll tax withholdings on equity compensation

Areas with Very Few Audits

- Despite the length of the IRS payroll agents initial Information Document Requests, there have been surprisingly few audits of any of the following issues:
  - Nonqualified deferred compensation (including either FICA taxes under section 3121(v)(2), or the section 409A rules governing plan design and operation, and ultimate compensation distributions.
  - Golden parachutes (either on the payroll tax side, or the deduction side).
  - Withholding and deduction of compensation to the highest-paid company executive (including any review of FITW rates, or any examination for compliance with Code section 162(m))..

IV., Part B. - FICA Taxes Imposed ON RSUs Held by CFC Employees Who Worked in the U.S. During RSU Vesting Period – C.C.A. 202327014 (released 7/7/2023)

Divergent Outside Counsel Advice, and Many Payroll Audits

- For over a decade, the IRS has contended, in audits of companies with expatriate employees, that the equity compensation attributable to work in the US should be FICA-taxable in the US (even though the employees were working overseas at the time of vesting).
- Several large accounting firms have been advising their that no FICA taxes were imposable, even though companies have been losing audits for ten year on this issue.
- The IRS had assessed taxes in many audits, but did drop some, on grounds that (a) only the CFC likely could be held liable; and (b) there was no IRS guidance on point.
- However, on 7/7/2023, the IRS released CCA 202327023- concluding both that FITW applies to ALL the equity compensation held by US citizens and green card holders, and much more troublingly, that FICA taxes apply to all of the US-allocated wages.

Immediate (and Premature) Use of the CCA in a $30M Audit

- One large international company had been undergoing a protracted audit on this issue of "FICA on RSUs held by CFC employees," and its NOPA was issued on May 15, 2023.
- The NOPA copies CCA 202327014, word-for-word, for its FICA tax conclusions, and assesses a $30M FICA tax liability on US-allocated income of RSUs that vested while the NRA worked for the CFC.
- This premature release of CCA 202327014 (prior to "no sooner than 75 days after Notice of Disclosure is sent to the taxpayer") violates Code §6110(f)- raising interesting procedural problems.
- There were enormous errors in the IRS computations, which have taken over two years (and two Protests) to resolve.

Arguments Supporting Elimination of FICA Tax Liability

- The RSUs are “nonqualified deferred compensation” under the special FICA tax timing rules of Code §3121(v)(2), and thus are subject to FICA taxes at the point of vesting – i.e., before any stock is paid out.
- At the point of vesting for the RSUs exempted from FICA, the CFC employees were all working for a “non-American Employer” (as defined in Code §3121(h)), and thus were exempt from FICA taxes, per Code §3102(b).
- However, the employer, in a “mirror image” of its position on FICA taxation of CFC-vested RSUs, had imposed FICA taxes on 100% of the RSU payouts for RSUs vesting in the U.S. (with no limitation of that income only to the US-allocable income). Thus, if the IRS were to insist on imposing FICA taxes on RSUs based on U.S.-allocated income (per Reg. §1.861-4(b)(2)), the company would be entitled to a FICA tax refund, larger as the proposed assessment (after it was corrected).

Arguments Supporting Elimination of FICA Tax Liability, cont.

- The IRS has no grounds for extending the income-allocation rules of Treas. Reg. §1.861-4(b)(2) to determined the FICA taxes here, because these regulations by their terms, apply only to income tax withholding.
- It seems likely that the IRS had decided to limit these 1995 regulations only to FITW, because the IRS knew that Congress, in 1983, had enacted a so-called "decoupling amendment" (in Code § 3121(a)) , which specifically blocks the IRS from extending FITW exemptions to FICA taxes, unless the FICA statute support such an extension.
- Specifically, this 1983 amendment says: Nothing in the regulations prescribed for purposes of chapter 24 (relating to income tax withholding) which provides an exclusion from "wages" as used in such chapter shall be construed to require a similar exclusion from "wages" in the regulations prescribed for purposes of this chapter [22 relating to FICA]…,.
- Given both this decoupling rule, and the fact that the Reg. §1.861-4(b)(2) does not even mention FICA taxes, the IRS examining agents (and National Office employees issuing the C.C.A.) should be blocked from extending FITW sourcing rules to FICA taxes, because the FICA statute supports a much broader exclusion, providing a complete FICA tax exemption where an RSU vests while the employee is working for a CFC.

Arguments Supporting Elimination of FICA Tax Liability, cont.

- The IRS has wrongly assessed not the CFCs, but instead the U.S. parent company, for failure to collect & pay FICA taxes, insisting that the U.S. company is the "statutory employer" under Code §3401(d)(1) (as extended to FICA taxes by SCOTUS in *Otte v. U.S.,* 419 U.S. 43 (1974)*).* This IRS reliance on §3401(d)(1) is wrong for many reasons:
  1. The CFCs paid for the RSUs, per re-charge agreements, so the definition of "statutory employer" as interpreted by the IRS does not apply to these facts.
  2. The RSUs, at vesting are a "noncash fringe" (as that term is defined in Ann. 85-113, and confirmed by the regulations under Code §3121(v)(2)).
  3. The statutory employer rules of Code §3401(d)(1) are inapplicable to any "noncash fringes" (as the IRS has confirmed in CCA 200329029), because the noncash fringe rules are issued under Code §3501(b) – which is in a different chapter from Code §3401(d)(1), and thus no FICA liability can be imposed on the U.S. company.

Arguments Supporting Elimination of FICA Tax Liability, cont.

- Even C.C.A. 202327014 concedes that it "might" be possible for an employer to abate some of its liability for non-withheld FICA taxes by proving that the CFC employer paid foreign social insurance taxes on that RSU income- which should be abated under applicable tax treaties between the U.S. and many CFC's countries.
- One blocker to claiming such a treaty exemption is the decision released June 22, 2023 by the Court of Federal Claims in *Thomas J. Bond v. U.S.*, concluding that collection of a "certificate of coverage" ("COC") is a procedural prerequisite to claiming any FICA tax exemption under any totalization agreement, even if it has been proven (and stipulated) that "double taxes" had been collected.
- The IRS did not raise this problem about COC collections in C.C.A. 202327014 (nor did Exam raise the issue in the NOPA that copies it), but the Examining Agent has told the taxpayer that if COCs are not collected, FICA taxes will not be abated.

Arguments Supporting Elimination of FICA Tax Liability, cont.

- Three additional arguments for abatement are raised in the NOPA response (covered in the discussion below of a different payroll tax audit question – relating to CFC employees who travelled to the US for training purposes):
  - The IRS has no jurisdiction over the CFCs, so cannot collect payroll taxes from them.
  - There would be a substantial net loss to the U.S. Fisc if NRAs were subjected to small amounts of FICA taxes for 10 years (thus qualifying for Social Security benefits throughout their retirement).
  - The IRS has never issued any formal guidance supporting its position, so taxes should be waved under the "Confusion Doctrine" of *Central Illinois RR v. U.S.*

IV., Part C - Company Cafeteria Litigation

Morgan Lewis

Persistent IRS Refusal to Agree that Section 119 Exclusions Should be Liberally Applied.

- Employer-operated cafeterias have been audited by the IRS for over 20 years, and the IRS has persistently refused to follows its relatively liberal regulations, or to update its regulations for any of the several taxpayer-favorable statutory changes enacted by Congress.
- See, e.g., T.A.M. 201903017 (9/18/2018) and Generic Legal Advice Memorandum 2018-004. *See also* T.A.M.s 96502001 (3/29/1996) and 9143003 (7/11/1991).
- Basically, IRS agents respect the section 119 exclusion only for “prisons, hospitals, ships, Greenland, Iceland, and some casinos.,” in striking contrast to the pro-taxpayer positions taken by the IRS in the 1940s, when the IRS was willing to issue favorable rulings, following cases like *Benaglia v. Commissioner*, 36 B.T.A. 838 (1937), acq., 1940-1 C.B. 1, even before Section 119 has been added to the Code (in 1954).
- However, many employers have negotiated relatively favorable payroll tax settlements, and thus have not been willing to expend the time and funds that would be required to litigate a case.

Litigation Filed At Last in the Midwest.

- In September, 2025, a company in the Midwest has filed a refund claim for the payroll taxes assessed by the IRS with respect to its company cafeteria, which has offered a free lunch program 1915, and had actually received a favorable private letter ruling from the IRS in 1948 (before Code section 119 had even been enacted).
- These lunches have been offered by the company for 110 years to approximately 4,000 employees.
- The employer had both written policies and collective bargaining agreements restricting non-management employees to a 30 minute lunch period (plus 5 minutes of travel time), during which period it would have been impossible for the employees to obtain a meal, since there were completely inadequate nearby public eating facilities.
- Despite these incredibly favorable facts, the IRS had revoked its prior ruling in 1991, claiming that the company had not proved that “substantially all” of its employee met the criteria for a section 119 exclusion (ignoring both the lack of any definition of this term, and also ignoring Congress’s later change to Code section 119(b)(4), allowing the exclusion to apply if merely half of the employees met the section 119 criteria.
-

Litigation filed at last in the Midwest, Cont.

- The company is suing for a refund.
- Its petition points out:
  - its mandatory short meal period, and the scarcity of local restaurants,
  - the substantial additional business benefits to the employer of offering these on-premises lunches, including employee collaboration over business development ideas, improvements to health and reduction of health insurance costs, increasing employees' efficiency and effectiveness, and protections against inadvertent disclosures of client and stakeholder information.
- It remains to be seen whether the Department of Justice will decide to concede the case even before a court hearing (as happened with BOC Group's litigation in 2000).

V. Recent Surge in State Unemployment Tax & Worker Classification Audits

Recent Surge in State Unemployment Insurance Audits & Worker Classification Audits

- State Audits: There's been a large recent uptick in state unemployment audits (often brought triggered by states desperate to repay their loans covering Pandemic unemployment benefits, which if not repaid automatically increase the FUTA taxes owed by employers in that state by 0.3% points per year).

- DOL Audits: The DOL has audited before and after issuing New DOL worker classification final regulations (resulting in (1) multi-million dollar penalties for unpaid overtime wages; (2) employer-share FICA and FUTA taxes on the "wage" portions of the settlements; and (3) likely referrals to the IRS for a payroll tax audit.

- IRS Audits: Despite the 45-year-old Federal Moratorium ("Section 530" of the 1978 Revenue Act), the IRS still audits companies' Forms 1099, trying to deny "Section 530 Relief," and to block Tax Court jurisdiction. These challenges to 530 Relief are based upon (1) workers treated as "employees" by states or the DOL in many recent cases; (2) state laws mandating employee status; (3) court-ordered expense reimbursements (potentially affecting "contractor" status); (4) employees switching to director status; and (5) acquisitions of businesses with classification problems.

- State follow-on Audits. The IRS (and the DOL) often notify the states that an employer has been audited, which in turn triggers state-level audits (for allegedly unpaid both unemployment and payroll taxes).

State Income Tax Withholding (and Information Reporting) for Traveling Employees

- Companies with peripatetic workforces – i.e., 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.
- Work-from-Home Programs have also triggered major issues with state-level withholding.
- Some states provide thresholds before withholding is triggered, based on days worked, dollars earned, or some combination of the two. The precise amount of withholding required is typically (but not always) determined by comparing the **total number of working days in a particular state to the total number of overall working days**. Notably, for lower-paid workers, minimal allocated income may be less than the standard deduction and a personal exemption, but for higher-earners, state tax (and withholding) liabilities can be triggered by only a few weeks (or even days) of work).
- During the Pandemic, special exemptions were offered by many states- but most of the lenient rules have expired.
- The Federal Form W-2 includes spaces in Boxes 15-20 at the bottom of the Form for reporting income to *two different states* (separated by a broken line),and the accompanying IRS instructions to Form W-2 say, "If you need to report information for more than two states or localities, prepare a second Form W-2." However, payroll systems may not accommodate (or capture) multiple work locations, and employees almost invariably complain if employers report wages in more than one state.
- Employee complaints about excessive withholding increased after the TJCA's elimination of most state tax deductions, and some employees are asking for reimbursements, with gross-ups (like the benefits provided to international travelers).

State Income Tax Withholding (and Information Reporting) for Traveling Employees, cont.

- 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, particularly if the trigger for withholding is only one day. Most employers apply a 30-day rule before they start to track (except in NY, which relentlessly enforces a 14+ day withholding trigger)
- Federal legislation has been pending for nearly 20 years to implement a withholding (and taxation) exemption for less than 30 days of travel, but it is strongly opposed by Senator Schumer, and likely will not be reintroduced while he is the Senate Minority Leader.

State Income Tax Withholding (and Information Reporting) for Traveling Employees who leave one State for Another

- Many states apply so-called "look-back sourcing rules," or "trailing liability rules," specifically designed to ensure the taxation of various types of compensation earned by and paid to person who worked in the state during some period of time before leaving the state.
- New Jersey, for example (N.J. Rev. Stat. § 54A:5-8(a)(2)) states that NJ income taxes appl to "Income from sources within this State for a nonresident individual… means the same as compensation, net profits, gains, dividends, interest or enumerated… to the extent that it is *earned, received or acquired* from sources within this State in connection with a trade, profession, occupation carried on in this State or for the rendition of personal services performed in this State."
- New York (§631(b)(1)(F)), similarly applies look-back sourcing rules to "income [including equity, bonuses and severance] received by nonresidents related to a business, trade, profession or occupation previously carried on in this state, whether or not as an employee, including but not limited to, covenants not to compete and termination agreements. Income received by nonresidents related to a business, trade, profession or occupation previously carried on partly within and partly without the state shall be allocated in accordance with the provisions of subsection (c) of this section [which authorizes the issuance of regulations to determine apportionment of income to New York State]."

State Income Tax Withholding (and Information Reporting) for Traveling Employees who leave one State for Another, cont.

- The problem for employers is that the state sourcing rules governing the taxation of equity compensation and the income allocation withholding rules for equity compensation received by nonresidents vary greatly depending on the state. This makes it difficult for employers to determine the appropriate way to handle equity compensation sourcing, and also creates an administrative burden for employees, who may be taxed in more than one state on their equity compensation (and/or severance and bonuses))
- Just with respect to equity compensation, some states apply a "grant-to-vest" sourcing method, while others apply "grant-to-exercise," and the state of residence at the point of realization of the equity compensation likely would tax all of the equity compensation, sometimes without giving full credit to the state income taxes paid in other states.
- It is already extremely burdensome for employers to track even the withholding on current wages for traveling employees, but tracking and taxing compensation attributable to prior years' work in various states is overwhelmingly complicated.
- Very few (if any) employers apply these look-back sourcing rules when employees merely travel to states on a temporary basis. It is hard enough applying these rules when employees relocate their offices from one state to another.

VI. Planning for 5 New Executives in the §162(m) Group – Starting in 2027

Morgan Lewis

Expansion of “Covered Employee” group in 2027

- The TCJA revamped IRC §162(m) effective in 2018 by removing the performance-based compensation exception and expanding the scope of covered employees.
- The American Rescue Plan Act (ARPA) further expanded the list of covered employees to include five more of the highest-paid employees for ***tax years beginning after December 31, 2026***. Once this provision is effective, covered executives would include:
  - (1) the CEO;
  - (2) the CFO,
  - (3) the three additional highest-paid executive officers (determined under the SEC’s definition of “compensation”) who are captured under the existing rule,
  - (4) all officers who are included under the “once-covered-always-covered” rule adopted under the TCJA; and
  - (5) five additional “employees” (the “ARPA-5”) (who might overlap with the persons covered in (4), if they were officers after 2016 in any year prior to the current year). (Thus, if after termination of service a former executive were to receive a large amount of post-termination compensation, that person would be treated as part of the “ARPA-5”- and thus effectively could knock another person out of the group.)
- The ARPA-5 employees could include persons with no policymaking roles at the company, who are simply highly paid in a single year, whether at hire, CIC, termination, or due to large equity compensation awards.
- But- these “ARPA-5” employees are not subject to the “tattoo” rule (i.e., “once-covered-always-covered”) (unless thay are subject to that rule because they were included under (4) above).

Proposed Regulations Issued in January 2025

These new rules have created many questions, many covered in detailed comments submitted by the AICPA on August 29, 2022 (asking that FINAL regulations be issued by January 2025). Treasury/IRS finally issued proposed regulations on 1/14/2025.

There are a number of surprising rules in the proposed regulations (discussed below), several of which have no support in the statute or legislative history, which apparently were adopted to "prevent abuse." Outlined in the 5 next slides are the most significant changes:

- Definition of employee to include non-employee service providers
- Definition of "compensation"
- Allocation among affiliated group members
- Treatment of Foreign affiliates

Interestingly, there were very few comments filed on the proposed regulations. MLB filed a detailed comment, asking for a hearing, and instead has been offered an "in-person meeting" with IRS & Treasury drafters.

Proposed Definition of "Employee" to Include Non-employee Service Providers

- The Proposed Regulations define an "employee" as any employee of the publicly held corporation, or any of its affiliates, regardless of whether the individual performs services for the publicly held corporation. (This is consistent with the longstanding final regulations.)
- However, the Proposed Regulations, very surprisingly, also define an "employee" for this purpose to include an employee of a completely unaffiliated entity (i.e., outside the controlled group) who is not an employee or an officer of the publicly held corporation but who performs "substantially all" of the individual's services "during the relevant taxable year" for the publicly held corporation.
- This rule is troubling, because it requires public companies to identify ARPA-5 employees not just from "employees" of the public company (and its controlled group) but also from individuals who have never been employed by the public company or any affiliated corporation, who are not currently employees of the public company, and whose compensation is not "arranged to be paid by" the public company or any affiliates in the public company's group.
- This concept of focusing on finding an "employment relationship" when compensation is "arranged to be paid" by another entity seems to be based in the IRS's guidance under Section 530 (discussed above), but should not be relevant for purposes of Section 162(m).

Problems Created by this Sweeping Definition of “Employee”

1. This rule lacks statutory authority, since IRC 162(m) caps the deduction for compensation paid by a public company to its employees. The employees of a corporation include its common law employees, and by statute for certain purposes may include its officers who are not its common law employees. But the Proposed Regulations cover services performed on behalf of the publicly held corporation by employees of an unrelated company, even if those individuals are neither employees nor officers of the public corporation. There is no apparent statutory authority for this expansion of the term “employee.”

2. Even the description is muddled. although the individual performing the work is the common law employee of the service-provider entity (and not an employee of the publicly held corporation), the Proposed Regulations describe the arrangement as one in which the individual provides services “to” the client publicly held corporation. Under the Proposed Regulations’ assumptions (i.e., the individual is the employee of the entity and not an employee or even an officer of the publicly held corporation), in many situations the individual provides services “to” the service-provider entity that in turn renders services to the publicly held corporation. For example, assume that a large accounting or law firm is paid $40M by a public company for a huge project, and one of its employees works full time on the project. Technically, $39M that $40M would not be deductible, if $40M put the employee in the “ARPA-5”.

3. Under the Proposed Regulations, the payments made by the publicly held corporation are not in any way limited to the compensation actually paid to the individual for the individual’s services.

4. Also, there is no definition of “substantially all” services, nor is it clear how the publicly held corporation is to determine whether an unrelated company’s employee devoted “substantially all” of such employee’s time to services performed on behalf of corporation.

5. There is also a mismatch in the timing rules. The limitation applies with respect to an individual who performs “substantially all” of the individual’s services during the “relevant taxable year” on behalf of the publicly held corporation, but the deduction cap applies “whether or not” the related services “were performed during the taxable year.” This raises questions as to how to apply these rules when services are performed in one year, but compensation is paid and deducted in a different year.

Proposed Definition of "Compensation" – Counting Payments from Unrelated Entities

- the proposed regulations count as "compensation" not just the compensation paid to the identified ARPA-% individuals during the year, but also "the aggregate amount allowed as a deduction" to the public company that is paid to any entity (including entities outside the public company's controlled group) that employs even a single individual whose services are "substantially all" performed for the public company "during the relevant taxable year."
- Thus, as proposed, the "compensation" used in identifying the ARPA-5 (and disallowed, to the extent it exceeds $1M) could include 100% of the payments made by the public company to the employer of this individual, completely without regard to the compensation actually paid to that individual, and, indeed, completely without regard to compensation at all (since the payment could include reimbursements for business expenses, or even purchases of capital assets).
- The proposed regulations also do not even reference Code section 162(m)(4)(C)(ii), which excludes from deduction disallowance "any benefit provided to or on behalf of an employee if at the time such benefit is provided it is reasonable to believe that the employee will be able to exclude such benefit from gross income under this chapter."

Proposed Definition of "Compensation" to Identify the ARPA-5 Based on Compensation Deductions, not Form W-2

- The Proposed Regulations define "compensation" for the ARPA five group as the aggregate amount of compensation paid to an employee by all members of the affiliated group that is allowed as a tax deduction for remuneration for services under chapter 1 of the Internal Revenue Code (determined without the deduction cap of Code Section 162(m)(1)), without regard to the whether the services are performed during such taxable year.

- This definition departs from the definition of "compensation" used or purposes of identifying the corporation's three highest paid executive officers (group (2) referenced above). For this purpose, Code Section 162(m)(3) defines compensation on the basis of total compensation required to be disclosed in the proxy or Form 10-K under the Exchange Act for named executive officers.

- This tax deduction-based definition of compensation may produce a mismatch between the year in which services are performed and the year in which the deduction is denied. For example, an employee with significant deferred compensation paid as a lump sum may be among the ARPA five highest compensated employees in the year in which the deferred compensation is paid, based on the amount of compensation that is otherwise deductible in that year. This could happen for a retiring employee with a significant lump sum SERP payment, or an employee who in a single year exercises stock options earned over many years.

- In addition, and even more confusingly, this overbroad definition might be read to cover even capital losses with respect to an asset that might have been purchased "to obtain the services of an individual" (e.g., a house, or a car) which was required to be purchased under an employment contract, but sold many years after the individual terminated services. – or even qualified retirement plan contributions. (We doubt that this result was intended by the drafters.)

- The tax deduction-based definition of compensation may pose significant implementation issues, since tax deductions are typically not recorded for all payors in an affiliated group, on the basis of service providers.

- In short, this definition makes it virtually impossible for a company to predictably identify the ARPA-5 "compensation" that should be taken into account in ranking individuals. It is also extremely very hard to apply, because compensation deductions are not often not divided among employees – e.g., - how can airplane deductions be allocated among employees with personal use of the planes?

Allocation Among Affiliated Group Members

- As explained above, in determining the ARPA five group, the publicly held corporation must identify the highest paid employees within its affiliated group, without regard to whether the individual is an employee of, or performs services for, the publicly held corporation.

- Thus, if an employee receives compensation from more than one member of the affiliated group, the Proposed Regulations provide rules for allocating the cap among the amounts paid by each member.

- If an affiliated group includes more than one publicly held corporation, the Proposed Regulations provide that the ARPA five group will be identified separately for each such corporation and its affiliates and provide rules for identifying the respective affiliates for each such publicly held corporation.

- An affiliated group containing more than one publicly held corporation will accordingly be divided into separate subgroups, each with its own group of five highest paid employees.

Foreign Affiliates

- The Proposed Regulations provide that an employee's compensation includes compensation received from any controlled foreign corporation that is a member of the affiliated group.
- The preamble to the Proposed Regulations takes the position that this provision merely clarifies a provision that existed as far back as the 1995 regulations.
- Although Kurt Lawson, from Treasury's Employee Benefits Counsel, had indicated that the Treasury intended to issue detailed guidance, instead of doing that, public comments are specifically requested on how these rules should apply to controlled foreign corporations.
- No comments were submitted.

Planning to Avoid Unnecessary Deduction Disallowance

- In summary, identifying the likely top 5 is very difficult, when future compensation (and even the on of "compensation" is not known, and the proposed IRS guidance is controversial and confusing.

- But, once the "2027 ARPA-5" are known, it would be advisable to have them defer (or accelerate) as much compensation as possible, in order that deductions might be claimed for years before or after the individuals are in the ARPA-5.

- Yet, such deferrals or accelerations could affect whether the individual in fact would be includable in the "top additional 5."

- Also, deferral elections much comply with IRC § 409A- which means they would have to be made in the year before any services were performed – so elections for compensation payable in 2027 – but earned in 2026, would have to be made in 2025.

- Very few opportunities exist to avoid deduction – disallowance, otherwise – except for grandfather rules, and (possibly) divorce.

VII. Planning for Increased Deduction Disallowance in 2026 for Company Cafeterias - MAYBE

Morgan Lewis

TCJA Statutory Change to Code section 274(o), Effective in 2026

- The disallowance provision in Code §274(o), effective for years starting after 2025, applies a 100% disallowance (increased from the 50% disallowance under Code §274(n), to:
- "Meals provided at convenience of employer. Except in the case of an expense described in subsection (e)(8) or (n)(2)(C), no deduction shall be allowed under this chapter for --
- (1) any expense for the operation of a facility described in section 132(e)(2), and any expense for food or beverages, including under section 132(e)(1), associated with such facility, or
- (2) any expense for meals described in section 119(a)."

Analysis of the Statute: Exemption for Certain Boats and Oil Rigs

The statute quoted above opens by acknowledging exemptions under 274(e)(8) (as added by the OBBBA) and 274(n)(2)(C).

- The first exemption covers any entities that charge "FMV" of food in a bona fide transaction – i.e., all restaurants, and also any employer-operated cafeteria that charges 150% of the Direct Operating Costs (which is the amount deemed by regulations to be the FMV of the cafeteria food).
- The second exemption covers certain commercial vessels, fishing vessels, and oil rigs.
- **There is NO exemption for cafeterias where there's been "imputation" to employees for the FMV of food.**
- Some taxpayers hoped the OBBBA would add that exemption – but, as discussed below, it appears that the 100% disallowance may not apply anyway to free or deeply discounted cafereria food.

Analysis of the Statute, Cont.: Application to "Facilities described in §132(e)(2)"

- But, while it helped that the OBBBA created an exemption from the 100% disallowance by referencing Code §274(e)(8), the disallowance still applies only to any "facility described in section 132(e)(2)".
- But that statutory reference applies ONLY to a facility that charges enough for meals to cover 100% of the "direct operating costs" of the food!
- Many companies provide far deeper discounts (typically taking the position that most cafeteria meals are excludable under Code §119), thereby hoping to meet §132(e)(2), since that provision's last sentence states that any employees eating Code §119 meals are DEEMED to have paid the DOC of such a meal, and also Code §119(b)(4) provides that if "more than half" the employees on an employer's business premises are eating 119 meals, then all are DEEEMED to be eating 119 meals.
- However, in literally hundreds of audits, the IRS takes the position that virtually no meals are excludable under Code section 119!
- Thus, cafeterias with providing free or deeply discounted meals would *not* be subject to this onerous disallowance, while companies that charge between 100% and 149.9% of the direct operating costs would be subject to a disallowance potentially covering all of the fixed and operating cost of the entire cafeteria!

Analysis of the Statute, cont: "Food or Beverages Associated with a Code §132(e)(2) Facility"

- The "food or beverages … associated with such facility" must cover only "food or beverages associated with a facility described in section 132(e)(2),"- as discussed above.
- Thus, again, this 2026 100% disallowance TRIES to apply to food and beverages in on-premises company cafeterias- but, per the terms of the statute, again the disallowance would apply only to the companies that charge between 100% and 149.9% of the direct operating costs!
- Companies that charge LESS than 100% of the DOC are again avaoiding the disallowance, by its terms.
- But there's more!.....

Analysis of the Statute, cont: "Food or Beverages Desribed in Code §132(e)(1)"

- Next, in the case of "food or beverages [described in] section 132(e)(1)" while this reference generally includes all "de minimis food or beverages," such as items served in "snack rooms," the IRS has conceded in TAM 201903017 (9/14/2018) that snack room food is not considered part of the items provided in the "eating facility."
- More specifically, that TAM states as follows:
  - "Because Taxpayer's snack areas are not eating facilities, the value of snacks furnished to employees in these snack areas are not excludable from gross income under section 132(e)(2). Since the snacks in the snack areas are not provided in an employer-operated eating facility, these snacks are not considered meals for which the value may be determined using the 150% multiplier provided in § 1.61-21(j)."
- Thus, the snack room food and beverages expenses would also be exempted from this 100% disallowance under Code §274(o) (but still subject to the 50% deduction disallowance in Code section 274(n)(1)).
- But there's more!!!

Analysis of the Statute, cont.: 100% Disallowance for "Any Expense for Meals Described in Section 119(a)."

- To continue, in the case of expenses for "meals described in section 119(a)," because the IRS has persistently taken the position that hardly any meals are provided "for the convenience of the employer," (excepting cafeteria in prisons, on ships, or in Iceland or Greenland).
- Thus, given the IRS's persistent position in payroll tax audits, it is hard to see how the IRS could deny an exclusion for meals, on grounds that they are not covered by Code section 119, but then deny a deduction, on grounds that these meals are so covered.
- And, last, since this statute keeps referring to "119" meals- which onliy apply to common law emlpoyees, it also seems that Code section 274(o) does not apply to independent contractors' meals.

Regulatory Guidance: Will the IRS wake up?

- The IRS has not yet issued any regulatory guidance under Code section 274(o).
- It was clear that this provision was added because the IRS was frustrated to discover that after companies LOST payroll audits, they applied for a corporate income tax refund – since the 50% disallowance under 274(n) is not applicable if there has been imputation for the employees' meal costs (which happens in a payroll audit).
- But it is also clear that the stastute does not operate as it was intended to operate.
- It is not clear whether the IRS will propose technical corrections to Code §274(o), if it ever realizes that its intended application of a 100% disallowance to all company cafeterias applies ONLY to eating facilities that charge 100% to 149.9% of direct operating costs – which clearly has an entirely perverse operational effect.

VIII. Income Tax Deductions for "Qualified Overtime Pay"- and the Myriad Complications Created for Employers and Employees

Morgan Lewis

What is “qualified overtime compensation” for purposes of the QOC deduction?

The complications created by this new statute are enormous (and explained in detail at on our MLB website, at https://www.morganlewis.com/pubs/2025/08/one-big-beautiful-bill-acts-qualified-overtime-compensation-deduction-faqs-for-employers

For starters, Code §225(c)(1) defines “qualified overtime compensation,” or “QOC,” as “overtime compensation paid to an individual ***required*** under section 7 of the Fair Labor Standards Act of 1938 that is in excess of the regular rate (as used in such section) at which such individual is employed.”

What is *not* "qualified overtime compensation" for purposes of the QOC deduction?

The following pay types do *not* qualify as QOC, in light of the FLSA overtime pay rules:

- The "regular rate" portion of FLSA-mandated overtime pay.
- Overtime pay required solely under state law, such as overtime calculated on the basis of hours worked within a 24-hour period.
- Overtime pay that employees are entitled to receive pursuant to the terms of an employer's policy or a collective bargaining agreement that does not otherwise qualify as <u>required</u> overtime pay under the FLSA.
- Wages paid to "exempt" or "noncovered" employees who are not subject to the FLSA overtime pay rules.
- New Code § 224 allows a deduction for "qualified tips" an employee receives.

Does “qualified overtime compensation” include all pay an employee receives when working more than 40 hours in a workweek?

For sure, QOC does NOT include all overtime pay, even when employee have qualified overtime work. Instead, the deduction relates only to the EXTRA 50% of pay that the FLSA mandates. For example:

> If a nonexempt employee has a base rate of $10 per hour and receives no other compensation, the employee’s “regular rate” of pay is $10 per hour. Under the FLSA, the employer must pay the employee $15 per hour for each overtime hour worked ($10 x 1.5). However, only $5 per hour (i.e., the overtime premium) of the $15 paid qualifies as QOC. The $10 of the $15 that represents the employee’s “regular rate” of pay does not qualify as QOC.

Does state-mandated overtime pay that is not required to be paid under the FLSA qualify as QOC?

Plus, if the FLSA does not MANDATE' the provision of overtime, there's no deduction. Again, for example:

> Assume a nonexempt employee in California works 10 hours in a day and does not perform any other work that week is entitled to be paid two hours of overtime pay pursuant to California's overtime law. The employee, however, is not entitled to any overtime pay under the FLSA because the employee did not work for more than 40 hours during the workweek. Consequently, the employee does not earn any QOC despite receiving state-mandated overtime pay attributable to the 9^{th} and 10^{th} hours the employee worked on a single day.

Does contractually mandated overtime pay that is not required under the FLSA qualify as QOC?

Employers that generously provide MORE than 50% extra for overtime pay are not qualifying their employees for an extra deduction. For example:

> Pursuant to the terms of a collective bargaining agreement, an employee is contractually entitled to receive "double-time" pay (i.e., two times the employee's "regular rate") for all hours the employee works in excess of 40 hours during a workweek. The employee has a $10 "regular rate" of pay per hour and works 44 hours during a workweek. While the employee will receive $80 in pay for the four hours of "overtime" (i.e., $10 X 2 X 4 hours), only $20 qualifies as QOC (i.e., $10 X 0.5 X 4 hours).

Does contractually mandated overtime pay that is not required under the FLSA qualify as QOC?

Another example:

> Pursuant to an employment agreement, an employee is contractually entitled to receive “time-and-a-half” (i.e., 1.5X the employee’s “regular rate”) for all hours the employee works on federal holidays. The employee, who has a $10 “regular rate” of pay per hour, works eight hours on the Fourth of July federal holiday and works no other days during the workweek. Although the employee is contractually entitled to be paid $120 ($10 x 1.5 x 8 hours) for working on the Fourth of July, none of the employee’s pay qualifies for QOC because the employee did not work for more than 40 hours during the workweek.

Does contractually mandated overtime pay that is not required under the FLSA qualify as QOC?

Another example:

An employer elects to count all the paid time off that an employee takes when determining whether to pay out employee overtime. The employee has a $10 “regular rate” of pay per hour. The employee works 10 hours on Monday and works no additional hours that week. The employee takes 32 hours of paid time off on Tuesday through Friday. Although the employer elects to pay the employee $30 ($10 x 1.5 x 2 hours) in “overtime,” none of the employee’s pay qualifies for QOC because the employee did not work for more than 40 hours during the workweek.

In general, which employees are covered by the FLSA?

"Enterprise coverage" under the FLSA applies to employees who work for certain businesses or organizations with at least two employees:

- those that have an annual dollar volume of sales or business done of at least $500,000, and
- hospitals, businesses providing medical or nursing care for residents, schools and preschools, and government agencies.

"Individual coverage" under the FLSA applies to employees if their work regularly involves them in commerce between states (interstate commerce).

Does the overtime pay that employees receive who are exempt from the FLSA's coverage qualify as QOC?

Some industries are also not covered!

- For example, although certain airline and railroad employees may receive overtime pay, these employees may be exempt from the FLSA's overtime requirements because they are subject to the Railway Labor Act (RLA).
- Employees in other industries, such as the agriculture and transportation industries, may also be exempt from the FLSA's overtime requirements.

Does the FLSA apply to employees of non-profit organizations?

Nonprofit employees are potentially eligible. DOL guidance provides:

- Non-profit charitable organizations are not covered enterprises under the FLSA unless they engage in ordinary commercial activities that result in sales made or business done, such as operating a gift shop or providing veterinary services for a fee.
- In determining whether or not a non-profit organization is a covered enterprise, the Wage and Hour Division will consider only activities performed for a business purpose.
- Charitable, religious, educational, or similar activities of organizations operated on a non-profit basis where such activities are not in substantial competition with other businesses do not result in the organizations being considered covered enterprises.

Do tips employees receive from customers qualify as QOC?

No, tips do not qualify.

Although OBBBA provides that "qualified tips" that employees receive may qualify for a tax deduction, under IRC Section 225(c)(2), tips are not subject to the FLSA's tip credit rule and can be excluded from an employee's regular rate of pay.

Deduction Limitation Thresholds and Eligibility Standards

Code §225(a) authorizes a federal income tax deduction for QOC for taxpayers to claim on their Form 1040 individual income tax returns, equal to:

- For single filers:
  - $12,500, reduced by $100 for every $1,000 over the $150,000 modified adjusted gross income (MAGI) phase-out threshold.
  - Single taxpayers with annual MAGI of $275,000 or more will fully phase out and therefore will not be eligible to claim any QOC deduction.
- For married-filing-jointly filers:
  - $25,000 (married-filing-jointly filing status), reduced by $100 for every $1,000 over the $300,000 MAGI phase-out threshold.
  - Married-filing-jointly taxpayers with annual MAGI of $550,000 or more will fully phase out and therefore will not be eligible to claim any QOC deduction.

Additional Eligibility Requirements

In addition to receiving QOC, an individual must also satisfy the following requirements:

- Have a Social Security Number issued by the Social Security Administration before the due date of the individual’s Form 1040 tax return on which a QOC deduction is to be claimed.
- If an individual is married, the individual must file their Form 1040 individual tax return under the “married filing jointly” status.

State Conformity (or Lack of Conformity)

- Rolling conformity states are AK, AL, CO, CT, DC, DE, IA, IL, KS, LA, MA, MD, MI, MO, MT, ND, NE, NM, NY, OK, RI, TN, UT, and VA. These states automatically conform to IRC updates unless they explicitly decouple.
- Static conformity states are AZ, CA, FL, GA, HI, ID, IN, KY, ME, MN, NC, NH, OH, OR, SC, TX, VT, WI, and WV. These states conform to the IRC as of a specific date- but most (including California) do NOT conform as of the date of enactment of the OBBBA, so these changes would not be picked up.
- Selective conformity states are AR, MS, NJ, and PA. These states adopt only certain provisions of the IRC.

Employer Obligations

Employer Obligations and Responsibilities for Determining when/whether Employees Qualify for the QOC Deduction

For 2025, the IRS is NOT requiring any special reporting (despite instructions in the Code that reporting be adopted).

IRC Section 225(a) allows as a deduction "an amount equal to the qualified overtime compensation received during the taxable year and included on statements furnished to the individual pursuant to section 6041(d)(4) or 6051(a)(19)." However, eligibility for the deduction is based not only on receiving QOC, but also on information that an employer likely does not have:

- an employee's tax return filing status
- an employee's annual MAGI, inclusive of all taxable income sources.

Requesting this information from employees would be onerous and raises potential privacy and discrimination concerns.

Note: Per a Tax Notes article published 10/3/2025, the IRS is developing guidance confirming that the payroll industry not to expect penalties for underreporting tips and overtime for tax year 2025, "provided that employers that make a good-faith effort to report and separate qualified tips and overtime pay on employees' Forms W-2 for tax year 2025." It's unclear where the W-2 reporting is placed – Box 14???

Is QOC subject to tax withholding?

Yes. Accordingly, an employer should include QOC on Forms W-2 and tax withholdings attributable to QOC in the following boxes:

- Wages, tips, other compensation (box 1)
- Federal income tax (box 2)
- Social Security wages (box 3)
- Social Security tax (box 4)
- Medicare wages (box 5)
- Medicare tax (box 6)
- State wages, tips, etc. (box 16) (where applicable)
- State income tax (box 17) (if applies)
- Local wages, tips, etc. (box 19)
- Local income tax (box 20)
- Qualified overtime compensation (box TBD, beginning with 2026 reporting)
- Maybe Box 14 (the “Dummy Box”)?

What should an employer do to determine the validity of an updated Form W-4 withholding certificate that an employee submits to receive the financial benefit of any QOC deduction?

- *For tax year 2025*, since updated withholding tables will not be available, the only way that an employee can increase take-home pay during 2025 is to reduce the amount of federal income taxes withheld for the remainder of 2025 by submitting a “new” Form W-4 Withholding Certificatethat includes an additional deduction.
- Employers have limited responsibilities in determining whether an employee’s Form W-4 withholding certificate is valid.
- **Query: Will this new Form W-4 reporting finally start forcing employees off the pre-2018 Forms W-4???**

What should an employer do to determine the validity of an updated Form W-4 withholding certificate that an employee submits to receive the financial benefit of any QOC deduction?

For tax year 2026-2028, employees will likely be able to take expected QOC deductions into account when establishing their Form W-4 federal income withholding level.

TREASURY/IRS AND OMB USE ONLY DRAFT

Form W-4 (2026) Page 4

Step 4(b)—Deductions Worksheet *(Keep for your records.)*

See the Instructions for Schedule 1-A (Form 1040) for more information about whether you qualify for the deductions on lines 1a, 1b, 1c, 3a, and 3b.

1 Deductions for qualified tip income, overtime compensation, and new car loan interest.

a **Tip income.** If your total income is less than $150,000 ($300,000 if married filing jointly), enter an estimate of your qualified tip income (up to $25,000) . . . . **1a** $

b **Overtime compensation.** If your total income is less than $150,000 ($300,000 if married filing jointly), enter an estimate of your qualified overtime compensation (up to $12,500 ($25,000 if married filing jointly) of the "and-a-half" portion of time-and-a-half compensation) . . . . . . **1b** $

In the context of QOC, does an employer have any duty to notify employees about the need to review their Form W-4 that is on file?

No. Generally, a Form W-4 remains valid until an employee provides the employer with a new Form W-4.

IRS regulations provide that, before December 1 of each year, an employer “should” request employees to furnish a new Form W-4 for the next calendar year, in the event of a change of status that could affect an employee’s withholding allowance.

However, millions of employees kept in place their Forms W-4 predating the TCJA (and the regulations providing new forms, to reflect the TCJA changes, did NOT require employees to replace the prior forms, even though they generally exclude too much income from withholding (since they likely were referencing deductions eliminated by the TCJA, for itemized deductions, alimony, state income taxes, etc.)

How will an employer report QOC to employees?

For tax year 2025, employers will not have to report QOC to employees. In IR-2025-82 (Aug. 7, 2025), the IRS announced:

- Form W-2, existing Forms 1099, and Form 941 and other payroll return forms will remain unchanged for TY 2025.
- Federal income tax withholding tables will not be updated for these provisions for TY 2025.
- Employers and payroll providers should continue using current procedures for reporting and withholding.
- These decisions are intended to avoid disruptions during the tax filing season and to give the IRS, business and tax professionals enough time to implement the changes effectively.

How will an employer report QOC to employees?

For tax years 2026-2028, employers are expected to have to report QOC on employee Forms W-2.

Box 12 instructions:

"**TT**—Total amount of qualified overtime compensation. Use this amount in determining the deduction for qualified overtime compensation on Sch. 1-A (Form 1040)."

TREASURY/IRS AND OMB USE ONLY DRAFT

a Employee's social security number

OMB No. 1545-0029

Safe, accurate, FAST! Use IRS e-file

Visit the IRS website at *www.irs.gov/efile*.

b Employer identification number (EIN)

1 Wages, tips, other compensation

2 Federal income tax withheld

c Employer's name, address, and ZIP code

3 Social security wages

4 Social security tax withheld

5 Medicare wages and tips

6 Medicare tax withheld

7 Social security tips

8 Allocated tips

d Control number

9

10 Dependent care benefits

e Employee's first name and initial | Last name | Suff.

11 Nonqualified plans

12a See instructions for box 12 (Code)

13 Statutory employee | Retirement plan | Third-party sick pay

12b (Code)

14a Other

12c (Code)

12d (Code)

14b Treasury tipped occupation code

f Employee's address and ZIP code

15 State	Employer's state ID number	16 State wages, tips, etc.	17 State income tax	18 Local wages, tips, etc.	19 Local income tax	20 Locality name

Form **W-2** **Wage and Tax Statement** 2026

Department of the Treasury—Internal Revenue Service

Copy B—To Be Filed With Employee's FEDERAL Tax Return.
This information is being furnished to the Internal Revenue Service.

What exposure does an employer who fails to comply with Section 225 QOC reporting face?

- However, for 2026–2028, a failure to accurately report QOC could expose an employer to one or more of the following:
  - IRC Section 6721 incorrect Form W-2 information return civil penalties (estimated at $350 per incorrect 2026 information return)
  - IRC Section 6722 incorrect Form W-2 payee statement civil penalties (estimated at $350 per incorrect 2025 payee statement)
  - IRC Section 7434 civil damages for a willfully filed fraudulent information return, equal to the greater of $5,000 or actual damages, plus litigation costs and reasonable attorney fees.

Does the QOC deduction provide any tax or financial benefit to employers?

No. QOC only provides a federal income tax deduction that eligible employees can claim on their Form 1040 individual income tax returns.

What steps should an employer take now?

- How can an employer explain to employees what the QOC deduction entails?
- What is likely to be the main source of employee confusion around the QOC deduction?
- What steps should an employer take to avoid issuing Forms W-2 (when required in future years) with incorrect QOC information reporting?

How can an employer minimize employee claims of erroneous QOC reporting (when required in future years) on the Form W-2?

The QOC deduction rules present many opportunities for employee confusion and potential litigation. To minimize employee claims of employer errors, it is important for an employer to communicate with employees about these rules, in particular:

- What QOC is and how the employer calculated the QOC amount for W-2 reporting purposes.
- The QOC amount reported on an employee’s W-2 does not indicate that an employee is entitled to a QOC deduction. The IRS makes this determination, not the employer.
- The amount of any QOC deduction may be different than the amount an employer reported on the Form W-2 because of other limitations that may apply (e.g., tax return filing status, MAGI).

Key Recommendations

- 1. Develop a communications plan to educate employees and manage employees' expectations – including even for 2025 (when the IRS is not planning to develop any special Form W-2 instructions, despite the fact that the OBBBA required W-2 information reporting.
- 2. Review if employees are properly classified as exempt from FLSA overtime protections and assess overtime protocols and practices.
- 3. Monitor regulatory guidance, including future guidance on QOC and reporting from the IRS and from state taxing authorities.
- 4. Review payroll and reporting systems. Begin working with payroll and legal teams to ensure that payroll systems can (1) identify the "overtime premium" of FLSA-required overtime pay, and (2) can segregate these premiums for future (i.e., 2026-2028) Form W-2 reporting purposes.

Increases by OBBBA in Most 1099 Reporting Thresholds

Morgan Lewis

1099 Reporting Changes- Some Retroactive!

- The OBBBA amended Code sections 6041 and 6041A to increase the information reporting trigger for 1099-NEC and 1099-MISC from $600 to $2,000 (inflation-indexed), effective for payments starting in 2026.
  - Note: This increased limit will also apply to the information reporting required under Code section 6045(f) for "gross proceeds" payments to attorneys, that are reported in Box 10 of Form 1099-MISC. The OBBBA change did not amend section 6045, but there is no stated dollar limit in that Code section. Instead, Treas. Reg. § 1.6045-5(a)(1), governing attorney payments, links to 6041, by providing that "The information return must be filed on the form and in the manner required by the Commissioner. For the time and place for filing the form, see § 1.6041-6." And that referenced section cross-references section 6041.
- But the OBBBA also *retroactively* restore information reporting exemption provided by Code section 6050W for all payments reportable by "third party intermediaries and credit card reporting transactions under Forms 1099-K to $20,000 and 200 transactions.
- It remains to be seen whether this increase in reporting thresholds will also mean that taxpayers will conveniently forget to report on their individual income tax returns amounts that are not reported on any information returns (despite the existence of special schedules attached to Form 1040, requiring the reporting on Form 1040 of otherwise unreported information).

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