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EMPLOYEE BENEFITS: UPDATES TO LAWS, REGULATIONS, AND IRS OPERATIONS IN THE NEW ADMINISTRATION

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When this panel was initially designed (and intended to cover a dozen wide-ranging "hot topics" in payroll taxes, fringe benefits and other employee benefits, nobody anticipated a 40% layoff in IRS staffing, and the resulting dramatic decrease in IRS payroll tax audits (and correlative substantial increase in state-level payroll and worker classification audits). However to comply with our promise to cover IRS audits, we discuss below the proposals announced near the conclusion of the Biden Administration to audit company aircraft and to limit the relief available under the "Section 530" Federal Moratorium on IRS worker classification audits (in place since 1978). We also cover a list of issues recently (and commonly) raised in Federal payroll tax audits (ranging from company cafeterias, skybox tickets, company cars and planes, security studies, withholding on settlement payments; FICA taxation of RSUs held by employees of Controlled Foreign Corporations, and payroll tax deposit penalties), and in state payroll tax audits (typically focused on worker classification issue and underwithholding of state taxes). We also discuss the frustrating delays in IRS return processing, penalty abatements, and release of levies, and assistance that can be provided through "Taxpayer Advocate" filings. Finally we cover a number of legislative changes affecting both employee compensation deductions and payroll taxes (not limited to changes made by the "One Big Beautiful Bill" Act ("OBBBA")), including (a) the selection of the additional 5 highly paid employees who, starting in 2027, must be added to the deduction-disallowance list under Code section 162(m), (b) meal and cafeteria deductions after 2025; and (c) overtime deductions allowed by the OBBBA from 2025-2028, and resulting myriad complications for employers.

I. IRS "Campaign" to Audit Company Aircraft

A. IRS Announcement of Planned Audits

On February 21, 2024, the IRS announced (in IR-2024-46) that its Large Business and International Division intended to open in the spring of 2024 approximately four dozen audits relating to the use of personal jets that are owned or leased by multinational and domestic corporations and "complex partnerships" operating in several industries.[1] These audits may in part have been prompted by the

* The authors would like to thank their partner Rosina Barker for her invaluable assistance with this paper's analysis of the proposed regulations under Code section 162(m), and also their partners, Steve Johnson and Russell Bruch, for their detailed analysis of the complications created for employers by the allowance of tax deductions for certain overtime pay.

[1] Two prior warnings about these audits had been published by the Biden Administration. In his State of the Union address in January, 2024, President Biden had warned that the IRS intended to target tax breaks for corporations and wealthy individuals who use private jets as part of the Administration's broader goal to make big corporations and the wealthy pay "their fair share." Next, following that address to Congress, the White House indicated that the IRS was planning an audit initiative "crack down on high-end tax evasion like deducting personal use of corporate jets as a business expense."

significant increase in private air travel during the COVID-19 pandemic. According to the IRS, the entities selected for audits (starting for the years 2020-2022) were to be identified through "advanced analytics" applied to a database of corporate jet activity that the IRS is developing. It is possible that these audits may in turn lead to audits of high-income taxpayers using these jets. However, nearly two years after this audit initiative was developed, it still remains to be seen whether many audits have been commenced, or what issues the IRS intends to examine.

IRS Commissioner Werfel explained during a press call about these imminent audits that the IRS is concerned that deductions were overstated, and that passengers' personal travel has not been correctly reported as taxable income. (Such reporting would require wage withholding, in the case of any employees' travel, which we assume will also be a focus of these IRS aircraft use audits.) Commissioner Werfel also stated that "Personal use of corporate jets and other aircraft by executives and others have personal and business tax implications and it's a complex area where IRS work had been stretched thin. … These aircraft audits will help ensure high-income groups aren't flying under the radar with their tax responsibilities." He further commented that "On a given taxpayer's tax return, the amount of the deduction for aircraft travel can be in the tens of millions of dollars. That's why it's so important that we get this right, because the amount of the deduction given the value of the asset is so material."[2]

This area is undoubtedly complex, but any confusion about the rules is certainly due to the fact that 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). This lack of guidance is not surprising, given that the IRS also has never issued any update to its pre-1979 regulation generally defining an airplane as a "transportation facility" (not an "entertainment facility").[3]

B. Background of Aircraft Deduction Disallowance Rules (and Exemptions for Many Flights)

1. Exemptions from Disallowance Under Code Section 274(e)(2)

Importantly, long prior to the initiation of this new audit "campaign," the IRS has created many important exceptions to the deduction disallowance rules applicable to corporate aircraft. First, 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.[4]

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[2] Some IRS representatives have estimated that there are 10,000 private jets in the United States. This estimate is also wrong, per recent statistics indicating that there are approximately 15,000 business jets in the United States. *See* Justin Surette, "Here's How Many Private Jets There Are in the USA," Simple Flying (Aug. 24, 2023).

[3] *See* Treas. Reg. § 1.274-2(e)(4)(ii)*(b).*

[4] 255 F.3d 495 (8th Cir. 2001), aff'g 114 T.C. 297 (2000). Notably, the *Sutherland Lumber* case arose after a similar round of IRS audit challenges to airplane tax deductions that started in the mid-1990s. The IRS explained its position in Technical Advice Memorandum ("T.A.M.") 9715001 (4/11/97), concluding that airplane expenses for any personal trips were disallowed to the extent that they exceeded the SIFL rate imputed for personal flights. That guidance was not supported by the statute, legislative history, or any prior IRS guidance (including the IRS's prior 1972 guidance under Code section 274, indicating that expenses incurred by a corporation in providing executives with free air transportation for vacations are deductible even where the corporation did not treat such expenses as compensation paid to the executives on its tax return or as wages subject to withholding. *See* GCM 35050 (9/25/72)). Admittedly, there have been changes to section 274 after 1972, including Congress's 2004 enactment of limitations on aircraft

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 their guest flies for personal entertainment, the aircraft deductions attributable to that flight are limited to the amount of income imputed for the flight. However, the regulations explaining these rules 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.[5])

- 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.[6]

- 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% owners of the entity providing the aircraft who are either "subject to section 16(a) of the Securities Act of 1934 in relation to the taxpayer, or any individual[s] who would be subject to section 16(a) if the taxpayer were an issuer of equity securities referred to in that section)."[7]

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. Even after the 2017 changes to Code section 274(a) enacted by the TCJA, the incremental costs (if any) of passengers' flights to business entertainment events may be disallowed as "entertainment

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deductions in reaction to *Sutherland Lumber*, but those changes had no effect on aircraft deductions for many types of personal trips, as was confirmed by the decisions of the Tax Court and the Eighth Circuit in *Sutherland Lumber*. However, as is discussed below, the 2017 statutory changes to deductibility of "entertainment expenses" might impact some aircraft deductions, although the IRS's guidance implementing those 2017 changes leaves many questions unresolved.

[5] *See* Treas. Reg. § 1.274-10(b)(3). It was not clear that this exclusion would remain available to taxpayers after the changes to entertainment expense deductions made in 2017 by the Tax Cuts & Jobs Act ("TCJA"). However, this regulation was not updated when the IRS issued regulations in 2020 implementing the TCJA changes. For example, Treas. Reg. § 1.274-11 denies a deduction for "any expenditure with respect to an activity that is of a type generally considered to be entertainment, or with respect to a facility used in connection with an entertainment activity" (unless the expense is covered by one of the statutory exceptions in 274(e)). However, IRS guidance under the TCJA changes to Code section 274(a) did not amend Treas. Reg. § 1.274-9 (entertainment provided to specified individuals), or Treas. Reg. § 1.274-10(b)(3) concerning "business entertainment air travel," and the term "entertainment facility" remains undefined for purposes of the disallowance. No IRS announcement suggests that the post-Dec. 31, 2017, deduction disallowance in Treas. Reg. § 1.274-11 (or in Treas. Reg. § 1.274-12 concerning food and beverages) applies to aircraft (other than possibly to the incremental operating costs of certain "business entertainment flights"). Moreover, the IRS has never addressed how the disallowance applies to other types of "listed property" used for entertainment.

[6] *See* Treas. Reg. § 1.274-10(b)(1) (excluding commuting flights) and the Preamble of the final regulations at 115 Fed. Reg. 33169, 33172 (June 15, 2007) (excluding flights for "medical purposes or attending funerals"). The TCJA provided a separate deduction disallowance for "commuting flights" under Code section 274(l), effective in 2018, but (as is dis cussed below) this deduction disallowance does not apply where the commutes are provided for ensuring the "safety of the employee," or to overnight business trips away from a "tax home." It also does not apply the harsh expense-proration rules applicable to entertainment flights, which allocate all the aircraft costs across all passenger miles (or passenger flight hours).

[7] *See* Treas. Reg. § 1.274-9(b).

expenses," but the IRS has never amended these above-outlined rules to mandate disallowance of even the "variable costs" of airplane operation as a result of any entertainment flights, or to specify how to calculate any disallowance where passengers may have various different reasons for taking a flight, as between business, business entertainment, personal (but not entertainment), or business entertainment.

Further, it is even unclear whether transportation to an entertainment event is necessarily part of the "entertainment" itself. Notably, in enacting the 50% (initially 20%) disallowance rule under Code section 274(n) applicable to both entertainment and food and beverage expenses from 2007 through 2017 (which, like section 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.[8]

Similarly, even when issuing its regulations implementing the "Sutherland Lumber override," the IRS never specified that airplanes were classified as "entertainment facilities." Instead, Treas. 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."

2. Limitation to Incremental Expenses of Spousal Travel and Gift Deduction Disallowances

Moreover, although there are other deduction disallowance rules applicable to "spousal travel" (even when it is for business purposes),[9] and to "gifts" (which can be made to directors and other

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[8] *See* S. Rept. 99-313 at 71 (1986) (exempting "cabs to restaurants" from disallowance under Code section 274(n). This exemption was not referenced in, or amended by Notice 86-23, 1987-1 C.B. 467, the IRS's only guidance implementing this disallowance rule.

[9] Code section 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. *See* Treas. Reg. §§ 1.132-5(t)(1), 1.274-2(g), and 1.274-2(f)(2)(iii). Importantly, too, although there have been many cases concluding that a spouse's travel triggers imputed income, there have been instances in which courts have concluded that spousal travel was for business purposes. In *Warwick v. United States*, 236 F. Supp. 761 (E.D. VA. 1964), the court addressed whether travel expenses by an employee's wife were deductible business expenses. The employee was a senior executive at a major tobacco wholesale company with operations worldwide. The duties of the company officers included becoming well-acquainted with the business of the big tobacco companies in Europe. They were encouraged to have very close and friendly relationships with the European customers. They were expected to entertain those customers when they came to the U.S. The court noted that the wife's duties on these trips were to "assist her husband establish the close friendly intimate relationship with the customers that [the employer] required of her husband." *Id.* at 765. In finding that the wife's travel expenses were deductible business expenses, the court noted that the trips "were not pleasure trips and were not vacation trips." *Id.* at 766;*see also U.S. v. Disney*, 413 F.2d 783 (9th Cir. 1969), and *Wilkins v. U.S.*, 348 F. Supp. 1282 (D Neb. 1972) (each also allowing deductions for spousal travel expenses). Further, in *Bank of Stockton v. Commissioner*, T.C.M. 1977-24, the Tax Court analyzed whether a bank was entitled to a business expense deduction for reimbursements made to certain shareholder-employees for expenses incurred by them in taking their wives to banking conventions. The Tax Court determined that the expenses were ordinary and necessary, rather than nondeductible dividends. In reaching its conclusion, the court noted that,

independent contractors),[10] 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.

3. Limitations on Applicability of Code Section 162(m)

In the case of publicly held corporations and publicly traded partnerships whose top executives' compensation in excess of $1 million per year is subject to the deduction disallowance rules under Code section 162(m), there are two applicable exemptions from these disallowance rules. First, the rules do not apply to any passenger's travel for bona fide business reasons.[11] Second, and even more importantly, even in the case of personal travel by an executive and/or the executive's guests, these section 162(m) disallowance rules apply only to compensation deductions.[12]

Importantly, Treas. 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."[13] Very clearly the employer is not claiming these depreciation expenses as "compensation."[14] Therefore, although this regulation disallows a "compensation" deduction for any

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"bankers without their spouses [at the convention] are few and out of place." The IRS should not be able to substitute its own business judgment for the Company's in deciding whether or not the travel by executives' spouses was for a bona fide business purpose. *See Peoples Life Ins. Co. v. U.S.*, 373 F.2d 924 (Ct. Cl. 1967) (where, in concluding that the payment of spousal travel expenses was not remuneration for services, the court noted that the employer's "good faith judgment, based on its own expertise developed from years of experience, must necessarily be afforded at least some respect").

[10] Since 1987, Code section 102(c) has prohibited the exclusion of any "gift" made to an "employee," but this term has never been defined to include any individuals other than common law employees, and thus presumably exclude any directors or other independent contractors. *See* Prop. Treas. Reg. § 1.102-1(f)(2), and note that these proposed regulations, issued in 1989, are not scheduled ever to be finalized. *See* Notice 92-12, 1992-1 C.B. 500, Section I.

[11] Code section 162(m)(4)(C)(ii) and Treas. Reg. § 1.162-33(c)(3)(iii)(B) provide that these rules do not apply 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."

[12] Code section 162(m); Treas. Reg. § 1.162-33(c)(3).

[13] Note that the regulation was not affected by Code section 7805(e)(2), which renders inapplicable any temporary regulation issued after November 20, 1988, because the 1992 amendments to this regulation finalized part of this regulation, and the amendments left in place the portions that had been published before 1988. In making these changes, the IRS explained at length, in T.D. 8451, that the portions of this regulation that were grandfathered from application of Code section 7805(e)(2) are left in place.

[14] Notably, Treas. Reg. § 1.162-25T (published in 1988) as well as the SIFL rules (published in 1985 and finalized in 1989) were completely ignored by the IRS when, in 1996, the IRS issued final regulations governing deduction limitations applicable to spousal travel under Code section 274(m)(3). More specifically, Treas. Reg. § 1.132-5(t) provides that "If an employer treats as compensation under section 274(e)(2) the amount paid or incurred for the travel expenses of a spouse, dependent, or other individual accompanying an employee, then the expense is deductible by the employer as compensation and no amount may be excluded from the employee's gross income as a working condition fringe benefit." This regulation posits that the amount that is deductible is limited to what is imputed- a concept that was overturned a few years later by *Sutherland Lumber*. But this regulation also never made much sense, as applied to company planes, because the employer does not treat the "travel expenses" as compensation for either business flights or personal flights on a company plane. Instead, for personal flights, and also for any business flights that the employer might *elect* to treat as taxable income (in order to avoid any deduction disallowance under Code

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 Treas. Reg. § 1.274-9 and -10, there should be no additional deduction disallowance applied under Code section 162(m).

Notably, the original proposed regulations under Code section 274(e)(2), as well as the predecessor guidance, in Notice 2005-45, 2005-1 C.B. 1228, had warned that even if the amount imputed as income to "specified individuals" was exempted from the deduction disallowance provisions of Code section 274(e)(2), it was possible that Code section 162(m) would apply to the amount imputed as SIFL income. More specifically, the Preamble of the proposed regulations cited Notice 2005-45, noting that "commentators disagreed with this conclusion," on grounds that (a) the aircraft expenses were not "compensation" expenses, and (b) that under Treas. Reg. § 1.162-25T, any amounts of SIFL imputations cannot be deducted as compensation; instead, the costs of operating the aircraft are deductible (but, again, not as compensation). The IRS clearly disagreed with these comments, but its response, as stated in the Preamble of the proposed regulations, was very confusing, stating as follows:

"However, the IRS and Treasury Department believe that the deduction limitation of section 162(m) applies to amounts treated as compensation for purposes of section 274(e)(2). The legislative history of section 162(m) provides that the deduction limitation of section 162(m) applies to all remuneration for services, including cash and the cash value of all remuneration (including benefits) paid in a medium other than cash regardless of whether the remuneration is deducted as compensation. H.R. Conf. Rep. No. 103–213 (1993) at 585 (993–3 CB 463). Any amount included in an employee's income for entertainment flights is remuneration for services and therefore is subject to section 162(m)."[15]

No illustrative example was provided to illustrate this statement, which made little sense, in application. Assume, for example, that an executive's personal flight on an aircraft had a SIFL value of $1,000, and "operating costs" of $5,000, and total "fixed and operating costs" of $10,000. The SIFL costs could not have been deducted, per Treas. Reg. § 1.162-25T(a). Further, the regulations under Code section 274(e)(2) would limit the deduction of the fixed plus operating expenses allocable to the flight to only $9,000 (i.e., $10,000 less the $1,000 of value imputed). The $1,000 that was not disallowed is still not classified as a "compensation expense," so it was never clear whether, in fact, the IRS expected that $1,000 that was not disallowed under section 274(e)(2) to be disallowed instead under section 162(m), if the executive's other compensation exceeded $1 million.

After taxpayers objected (again) to any such disallowance rule, or to any treatment of airplane expenses as "compensation" expenses, the IRS did not repeat this warning in its final regulations under either section 274(e)(2) or in the revised regulations under section 162(m). Thus, based on Treas. Reg. § 1.274-5T, we have not seen any companies adding into the section 162(m) deduction disallowance computations either imputations of SIFL income, or any other airplane expenses attributable to personal flights. But it remains to be seen if the IRS will try again, in these airplane audits, to raise this dead horse, in order to beat it again.

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section 274(m)(3)), it is only the SIFL value that is reflected as compensation on Form W-2. Further, the employer is specifically prohibited from deducting that SIFL value as compensation.

[15] 72 Fed. Reg. 33173 (June 15, 2007).

C. Unlikely Violations of Section 280F by Most Plane Owners/Operators

1. Overview of Section 280F

One important initial focus of this new round of IRS aircraft audits will also be on potential violations of Code section 280F, the provision limiting claims for accelerated depreciation under Code section 168 for airplanes (as well as other specified "listed property") when there is excessive personal use of the aircraft by business owners and their employees.[16] The IRS's focus on bonus depreciation is apparent from the initial round of IRS training materials developed for the IRS examining agents assigned to this new audit campaign (which materials were obtained through a Freedom of Information Act request).[17] These materials, as released, 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. But, importantly, the IRS's own "training materials" misapply the statute and regulations, as discussed below.

Under Code section 280F(b)(1), if any listed property is not at least 50% used in a "qualified business use" for any tax year, the depreciation deduction allowed for that property is limited to straight-line depreciation. Code section 280F(d)(6)(B) defines "qualified business use" as any use in the trade or business of the taxpayer except for the uses listed in section 280F(d)(6)(C), which were designed to prevent taxpayers from disguising the excessive personal use of business owners by structuring the use as either a compensation arrangement or a lease. Section 280F(d)(6)(C)(i) provides that qualified business use does not include:

> (I) leasing property to any 5% owner or related person,
>
> (II) providing use of the property as compensation for the performance of services by a 5% owner or related person (irrespective of whether that personal use is taxed), or
>
> (III) use of property provided as compensation for the performance of services by any person who is not a 5% owner or related person, *unless the value of such use is treated as taxable income and, where required, subjected to federal income tax withholding*.

That italicized language is critical, because if any employer has provided an airplane for personal use of its employees (and guests) who are *not* either 5% owners (or related persons), and has valued that personal use under the SIFL regulations, and taxed the employee on that use, then that personal use, per the statute itself, is deemed to be "qualified business use".

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[16] In the many years between issuance of airplane deduction limits under Code sections 280F, 274(m)(3), 274((e)(2) and the IRS' recent announcement of this new audit campaign, there have been very few litigated cases involving plane travel valuation and deduction. In one, *E. Bruce DiDonato v .Comm'r,* T.C. Memo. 2013-11, the taxpayer had inconsistencies in its flight manifests, very limited substantiation of business travel, and apparently no imputation of income for the values of flights by family members. Most taxpayer with corporate aircraft keep much better records, impute income for personal flights, and carefully monitor compliance with their accelerated depreciation claims.

[17] *See* Tax Notes Doc. 2024-31360 (10/31/2024), and E. Schilling, "Corporate Jet Tax Breaks at Risk in IRS Probes of Personal Use," Bloomberg News The latter article explains that the IRS fully redacted about 80 percent of the records sought, saying FOIA allows agencies to exempt agency memos that "wouldn't be available by law to parties other than those in litigation with the agency." The IRS's refusal to release unexpurgated training materials is a bit odd, since the IRS has previously released (and posted on its web site) many unredacted "Audit Techniques Guides" applicable to a wide range of issues that the IRS has announced it plans to raise in payroll tax audits, including nonqualified deferred compensation, equity compensation, golden parachutes, and split dollar life insurance. *See* https://www.irs.gov/businesses/small-businesses-self-employed/audit-techniques-guides-atgs.

The IRS's "training materials" unfortunately simply ignore this important exception applicable when flights are provided to non-5% owners, and properly taxed. The examples include a line for in the examples for "Income Non 5% Owner or Related", which is separate from the line for "Business flights." Since the FOIA-released examples all seem to assume that all the passengers on these hypothetical flights are 5% owners, they also assume that there are "zero" flights to record on this line. But, if there are any flights that were both provided and taxed to non-5% owners, they must be deemed to be "qualified business use" – and that critical point is simply omitted from the IRS's examples.

Instead, the FOIA-released training materials examples focus on another exception (discussed immediately below), applicable when it is shown that the "qualified business use" of the aircraft (excepting the three exceptions listed above from Code section 280F(d)(6)(C)(i)) constitute at least 25% of the use of the aircraft. In some of the hypotheticals in these recently released materials, the uses by 5% owners exceeds 75% of the aircraft usage, but, in the real world (outside these "hypotheticals'), such extensive personal use by 5% owners and related person rarely occurs for most (if not all) aircraft owners. Instead, the easy way for airplane providers to avoid loss of bonus depreciation is simply to ensure that at least 25% of the aircraft use is either real business use,[18] or constitutes personal flights provide and taxed to non-5% owners.

2. Exception Where Leases and Personal Use by 5% Owners (Plus Any Untaxed Personal Use by Non-5% Owners) Do Not Exceed 75% of Use

For aircraft, Code section 280F(d)(6)(C)(ii) provides that this 5% owner rule does not apply if at least 25% of the total use of the aircraft during the tax year consists of qualified business use that is not excluded under section 280F(d)(6)(C)(i).[19] However, in TAM 200945037 (7/29/2009), the IRS concluded (without statutory support) that even *business flights* provided to a 5% owner or related person on board are excluded from qualified business use, and further concluded that the taxpayers addressed in the TAM were not regularly engaged in the business of leasing aircraft and thus were subject to the 50% qualified business use test.[20]

Thus, under this controversial TAM, even if the owner's use is for business purposes of the owner, any such use still counts as owner use (which, if it exceeds 75%, results in denial of accelerated depreciation). For this reason, companies with 5% owners are usually very careful to ensure that at least 25% of the aircraft's use during each year is business use, excluding all use by the 5% owner (and that owner's invitees). However, the IRS will no doubt be looking for instances where this 25% test is not met.

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[18] As is discussed below, the IRS has contended in a Technical Advice Memorandum ("TAM") released in 2009 that "qualified business use" does not include even bona fide business use by a 5% owner or related person, but that position is not supported by the statute or legislative history. Due to the extensive expurgations in the FOIA-released materials, it is not clear whether the recently released "training materials" for these audits adopt the same limited definition of "qualified business use."

[19] A separate exemption from depreciation limitations of section 280F applies where aircraft (or any other listed property) is leased or held for leasing by any person regularly engaged in the business of leasing such property. *See* Code section 280F(c)(1).

[20] If there were passengers on such a business flight (who are not the 5% owner's personal guests or individuals who are flying for personal/entertainment reasons), the IRS will permit the use of the plane to be allocated between the 5% owner's use and the other passengers' business use based on the "occupied seat hours" or "occupied seat miles" methods outlined in Notice 2005-45 and Treas. Reg. § 1.274-10. (Any maintenance flights must be allocated similarly, between any 5 percent owner's flights and flights by "one or more other persons.") Notably, however, per the next-to-last paragraph of this T.A.M., it appears that the IRS *might* say that any flight provided to a passenger that is "essentially a favor done at the behest of [a 5% owner]" is not counted as a "qualified business use" flight. The National Business Aircraft Association filed many comments with the IRS opposing this T.A.M., with little effect.

(That scrutiny is likely to be heightened by the fact that the OBBA restored the ability to claim accelerated depreciation for 100% of aircraft costs in the first year of operation.)

D. Generous Valuation Rules for Personal Plane Travel for Employees and Contractors

1. SIFL Rate Valuations

The safe harbor valuation rules applicable to personal flights on "employer-provided aircraft,"[21] 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.[22]

These SIFL valuations have declined over the years, and the highest valuation currently approximates first class commercial fares.[23] Thus, IRS agents, as part of these projected audits, will likely be checking these valuations, for purposes of both payroll tax and deduction audits. Certainly the IRS is allowed to check all the computations (including the identification of the "control employees" on a flight, the characterization of the flight as "business" or "personal," the measurement of the flight distance (under the special rules in the SIFL regulations for measuring from embarkation to departure of each passenger, measured in terms of "statutory miles" instead of "nautical miles," and the weight of the plane), but the IRS

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[21] Although these valuation rules are by their terms applicable only to benefits provided "employers" for the personal use of "employees," the regulations generally define that term to include "any person performing services in connection with which a fringe benefit is furnished." (Treas. Reg. § 1.61-21(a)(4)(ii)). Thus, whether benefits are provided to common law employees, partners, directors, or independent contractors (or to the spouses, family members, or guests of any such individuals), these valuation rules apply to determine the amount of income properly taxable to the service-provider, with respect to all personal flights taken by the service-provider, or by a spouse, family members, or any personal guests.

[22] The SIFL rates were based on a proposal on flight valuation published in Tax Notes entitled "Fringe Benefits: Valuation of Personal Use of Corporate Aircraft: Comparison of SIFL rates to Actual Coach and First-Class Rates," by Mary B. Hevener. *See* 26 Tax Notes 11 (Jan. 7, 1985). The IRS promised to use these SIFL rates, per a letter agreement of May 13, 1985 entitled "New Valuations for Personal Use of Corporate Planes," published at 131 Cong Rec. S6369-6374 (May 16, 1985), and also discussed in Senate floor debates at 131 Cong. Rec. 12356-12360 (May 16, 1985) This agreement was also referenced in the Preamble to the final fringe benefits regulations, which confirmed that the SIFL valuation rules were an attempt to approximate commercial airfare rates. *See* T.D. 8256, 54 Fed. Reg. 28579 (July 6, 1989).

[23] Treas. Reg. §§ 1.61-21(g)(5) and (6). These "SIFL rate" values vary with the identity of the employee, the weight of the aircraft, and the length of the flight, and they are subject to inflation-indexing changes which are published twice a year. There were three different sets of SIFL rates published DOT in 2020-2022, because the DOT's normal SIFL measurement (which equals airline industry expenses, divided by seat miles) had been substantially increased as a result of the dramatic decline during the COVID-19 Pandemic in numbers of airline passengers (and, accordingly, in "seat miles"). Accordingly, the DOT provided two alternatives, taking into account the massive Pandemic-triggered federal grants to domestic airlines, and allowed employers to choose among SIFL alternatives. Most companies used the lowest of the three alternatives, which produced values as low as any SIFL rates since the first half of 1994. In the second half of 2022, when the DOT again adjusted the value of the alternative SIFL rates, most companies switched back to the primary rate (which effectively restored SIFL values to their pre-2021 level). The SIFL rates applicable in the first half of 2024 were published in Rev. Rul. 2024-8, 2024-16 I.R.B. 877, and those applicable in the second half of 2024 were published in Rev. Rul. 2024-20, 2024-40 I.R.B. 646.

cannot allege that "these values are just too small," if all the computations were accurate, because, as explained above, these values were based on an agreement between Congress and the IRS.[24]

In application, these SIFL regulations value each seat on any particular "flight" (as defined in the regulations) 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 top executives (called "control employees") and their guests, [25] as opposed to flights by any "noncontrol" employees, as shown below:

SIFL Cents-Per-Mile Aircraft Multiples

Maximum Certified Takeoff Weight of Plane or Helicopter	Aircraft Multiple for Control Employee	Aircraft Multiple for Non-Control Employee
Over 25,000 lbs.	400.0%	31.3%
10,001-25,000 lbs.	300.0%	31.3%
6,001-10,000 lbs.	125.0%	23.4%
6,000 lbs. and less	62.5%	15.6%

In using the SIFL formulas, the value of each flight is determined on a passenger-by-passenger basis; deadhead flights are not counted; and round trips are counted as at least two flights (or more than two if there are deplaning stopovers requested by employees).[26] Refueling, servicing, weather conditions or emergency stops are not counted. Intermediate stops also are not counted if they are for business reasons of the employer unrelated to the particular flight of the employee.[27] Flights by passengers under two years old are also not counted. Complex valuation and potential deduction disallowance rules also apply to foreign travel.[28] Finally, if the personal travel by the executive is covered by the "security exclusion" (as a

[24] There has been some Congressional criticism over the years about the SIFL rate values. For example, in March 2024, six Senators (Warren, Markey, Sanders, Wyden, Lighthouse, and Van Hollen) sent a letter to the IRS and Treasury, applauding the announcement of airplane audits, and also encouraging the closure of the "outlandish accounting" applicable to flight valuation, stating that this SIFL "loophole" "allows ultra-wealthy taxpayers to avoid tax on personal trips." *See* Tax Notes Doc 2024-7874. A subsequent letter to Tax Notes from a retired IRS agent/appeals officer agreed that the valuation rates were too low, but wrongly observed that the flight value stated in the Congressional letter was substantially overstated. The letter's author had wrongly used the valuation rate for a "noncontrol" employee. *See* Letter of J G. Cohen, 184 Tax Notes 89 (July 1, 2024).

[25] Treas. Reg. §§ 1.61-21(g)(8) and (9) define the term "control employee" to include: (a) the 10 most highly compensated elected officers from each corporation within the employer's controlled group; (b) the 50 (or, if less, top 1%) most highly paid common law employees across the control group; (c) any 5% or more owners; (d) a director from any company in the controlled group; and (e) any guests or family members of such individuals. Minimum compensation limits apply to persons in groups (a) and (b), and retirees who were control employees after reaching age 55 or within three years before their retirement stay control employees forever.

[26] Treas. Reg. § 1.61-21(g)(1).

[27] Treas. Reg. § 1.61-21(g)(3).

[28] Even though Code section 274(c) and the underlying regulations might appear to apply merely to limit deductions by the employer, Treas. Reg. § 1.61-21(g)(4) provides that additional income must be imputed to employees if any portion of a trip outside the U.S. both lasts more than 7 days and is comprised 25% or more of personal days, thus triggering application of the foreign travel deduction disallowance rules. Thus, unless more than 75% of the days of

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.[29]

2. The Half-Capacity Rule

Another special aircraft travel valuation rule applies if at least half the "regular seating capacity" of the aircraft is filled with business travelers at the time the individual whose flight is being valued both boards and deplanes the aircraft. For this purpose, the "regular seating capacity" means the maximum number of seats that have at any time been on the aircraft while owned or leased by the employer, excluding seats which are occupied by bona fide flight crew, and excluding seats that cannot at any time be legally used during takeoff (unless such seats, in contravention of the law, have in fact been so used).[30]

"Business travelers" for this purpose means only persons performing services for the company who are traveling primarily on company business (excluding bona fide flight crew members), and who therefore may exclude their flights as a working condition fringe.

If this "half-capacity" rule test is met, current and retired employees, partners of the employer, and their spouses and dependent children may fly in the remaining seats for free.[31] Guests of employees as well as independent contractors and directors of the employer may fly in the remaining seats at the non-control employee rate (explained above).[32]

3. Reversion to Charter Rates Applies Only Where Valuation Rules Are Disregarded

If any company has misapplied or disregarded the SIFL rules explained above, such as by misidentifying "control employees," or using an incorrect aircraft weight classification, or erroneously claiming that a flight is a "business flight," then the SIFL values might still be applied on an "amended return." However, if the IRS corrects the valuation in an audit after the statute of limitations has expired

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the trip are spent "primarily on business" (including application of special regulatory rules for weekends, holidays, and the days of travel by a "reasonably direct route" to and from the foreign location), then the SIFL valuation rule must also be applied to the portion of any flight that is not deductible by reason of section 274(c) – *i.e.*, to the fraction of the flight distance equal to the number of non-business days divided by the number of travel days. *See* Treas. Reg. § 1.274-4(c).

[29] If the spouse or dependent children fly or ride separately, separate studies (plus proof of need for security) would be needed for each of them, in the absence of which the higher SIFL rates would apply. Treas. Reg. § 1.132-5(m)(3).

[30] The IRS went to bizarre lengths to provide guidance relating to these jump seats, in Treas. Reg. § 1.61-21(g)(12)(v), providing special rules applicable if jump seats are used by flight crew member, where the flight crew member may not (or may not) have been flying for business, but not in fact serving on the flight crew. Basically, if any jump seats ever has been used during takeoff by a non-crew member, then is counted as an available seat. But if a jump seat has only been occupied during takeoff by flight crew, then that seat is *not* counted, and the person sitting in the seat is not counted either. However, if the jump seat happens to be occupied by an "extra" flight crew member who's flying, but is not primarily there to be on the flight crew, then the first rule applies – in which case the jump seat is counted, and the passenger is treated as a "business" passenger, depending on that passenger's primary purpose in flying. This abstruse regulation is rarely at issue, though, because in most cases, the jump seats are occupied by flight crew members who are flying because they are member of the flight crew, and thus that seat and the passenger are simply disregarded.

[31] *See* Treas. Reg. § 1.61-21(g)(12) and 131 Cong. Rec. S6367-6374 (daily ed. May 16, 1985).

[32] Treas. Reg. § 1.61-21(g)(12)(B)(iii).

on correcting information returns, the IRS can apply "charter values" to value flights by passengers (by allocating the charter value among all the passengers), and then propose to collect payroll tax withholding from this substantially increased value.[33]

Despite this warning about reverting to "charter rates" as a penalty for incorrect valuations, to the best of this author's knowledge, this regulation has been applied only once in an IRS audit, because, , nearly all companies are careful to apply correctly the complicated SIFL rules described above. Further, in the event that "charter values" were used by the company or by the IRS on audit to value any flight, then the deduction applied by the entity to any "entertainment flight" might also be increased.[34]

4. Confusion in IRS Rules for Identifying Flights by "Control Employees"

The identification of "control employees" on any particular flight has been complicated for any company with multiple entities within its controlled group by the addition of a special rule to the 1989 final regulations (in Treas. Reg. § 1.61-21(g)(8)) expanding upon the pre-1989 rule that had provided that "the officer definition and the limitations and the director definition are applied to each such separate employer rather than to the aggregated employer."[35] That rule was simple to apply, since it simply required the counting of the top-ten highest paid officers in each company.

However, the IRS regulation-drafters were concerned that a potential for abuse existed, if a company could simply appoint its top ten officers to service as officers of every other company in the group. To stop such a hypothetical abuse, final regulations provide that "An employee who is an officer or director of one employer (the "first employer") shall not be *counted* as an officer or a director of any other employer aggregated with the first employer under the rules of section 414(b), (c), or (m)." Confusion arises, though, as a result of the use of the italicized word "Counted" instead of "treated.

In contrast to the airplane valuation rules, the IRS has adopted a very different definition of the term "control employee" for purposes of travel in chauffeured cars (where that definition is intended to prevent the very low "$1.50 each way" rule in Treas. Reg. § 1.61-21(f)(5) being applied to commutes by "control employees." Under that definition of "control employee" for car travel, there is no "10-officer" limit like that applicable to plane travel; instead, an "officer" of any entity is a "control employee" if the individual earns more than $50,000 (inflation-indexed). But, in designing that separate rule, the IRS had been concerned that persons might be "officers" of an entity, but get the car from *another e*ntity in the group, and thus say "I'm not an officer of the entity providing the car." To prevent such an abuse, the IRS wrote this chauffeured car regulation to warn that: "An employee who is an officer or a director of an entity

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[33] *See* Treas. Reg. § 1.61-21(g)(13).

[34] In its Preamble to its final regulations under Treas. Reg. §§ 1.274-11 and -12, limiting meal and entertainment deductions, the IRS recognized that adjustments were needed in the regulations that historically provided an exemption from deduction-disallowance for compensation expenses only where the expense had been treated as "compensation on the taxpayers' income tax return as originally filed" and as "wages to the employee for purpose of withholding under Chapter 24." These final regulations deleted the reference to the treatment on the taxpayer's original income tax return (which did not make sense anyway, given the above-described prohibition in Treas. Reg. § 1.162-25T on claiming compensation expenses for airplane deductions), and allow a deduction for the amount subjected to Federal income tax withholding, and thereby apparently allow a deduction increase for wages subjected to FITW in an audit. *See* 85 Fed. Reg. 64031-32 (Oct. 9, 2020).

[35] The pre-1989 rule is admittedly difficult to locate, because former President Trump mandated the repeal of nearly all temporary regulations (exception those that had not been replaced by final regulations). Such prior temporary regulations simplify analysis of final regulations, because their mere existence expedites review and comparison of changes.

(the "first entity") shall be *treated* as an officer or a director of all entities aggregated with the first entity under the rules of section 414(b), (c), (m), or (o)." (Emphasis supplied.)

But, importantly, the IRS certainly knew that it did not include the quoted sentence above in its airplane regulations, because, in the Preamble of the 1989 final regulation, the IRS specifically acknowledged the difference between these two different valuation rules, by stating that it had not used the directive "shall be treated as an officer" in the airplane rules, stating as follows:

> CONTROL EMPLOYEE DEFINITION. Under the proposed regulations, the safe harbor value of a flight on an employer-provided aircraft depends on whether the employee is a control employee. Those regulations define a control employee as any officer of the employer, limited to the lesser of one percent of all employees of the employer, or ten employees. If an employer is part of a controlled group of corporations or is otherwise required to be aggregated with other employers under certain aggregation rules, the proposed regulations provide that the officer test must be applied with respect to each separate employer, rather than with respect to the employer group. Commentators objected stating that the officer test should be applied with respect to the employer group, rather than to each separate employer, Under this approach, an employee would be a control employee only if the employee were an officer of the controlled group of entities. Because employees are generally officers of separate entities of a controlled group of corporations, rather than officers of the group, the final regulations retain the rule of the proposed regulations. *However, an officer of one entity of a controlled group of entities shall not be treated as an officer of any of the other entities of the controlled group.* [36]

In short, while admittedly it is clear under the airplane rules' definition of "control employee" that ten "new" officers must be "counted" at each company, and thus, for example, it is not possible to "push out" persons from being "control employees" of a subsidiary company by appointing 10 people from the parent to be "officers of all entities". However, it's also very possible (indeed, common), that a person who is an "officer" of a subsidiary actually *received* the flight because he or she is an employee of another entity in the group, and the flight-recipient was *not a "control employee" of the entity providing the flight.* Under such facts, then the passenger should be entitled to have such a flight valued at the "noncontrol employee" rate.

E. Lack of Recent Audits Despite Agent Training for the "Aircraft audit Campaign"

Certainly, the above-described deduction disallowance rules and valuation (and withholding) rules applicable to travel on company aircraft are extremely complicated. Yet, as the popularity of corporate aircraft travel has increased, most companies have worked hard for years to apply correctly both the valuation rules and the tax deduction disallowance provisions. Accordingly, even if the few remaining IRS auditing agents were to start using their "training" to start these audits, such audits should not present major tax problems for the thousands of owners or lessees of aircraft that have been extremely careful to identify any personal trips that are taxable to company employees and contractors, to value those trips correctly, and, finally, to apply the complicated deduction disallowance rules whenever applicable. However, in preparation for any potential IRS audit now or in the future, companies certainly should be sure to retain their flight logs (including for foreign travel), passenger manifests, notes on any business reasons for the

[36] *See* 54 Fed. Reg. 28579 (July 20, 1989). Emphasis supplied. In the view of one of the IRS authors of these final regulations, the SIFL regulations did not adopt any significant expansion of the definition of "control employee" in order to avoid any violation of the 1985 agreement between Treasury and Senator Dole (referenced in note 16 above). *See* M. B. Hevener and A. J. Guarisco, "Fringe Benefit Regulations: New Details on Benefit Exclusions and Valuation Rules," 45 Tax Notes 743, 753-754 (Nov. 6, 1989).

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. Increasing Popularity of "Security Studies" for Top Executives

Many companies are reevaluating their corporate security practices and considering enhancements to the security protections that they provide to their executives and other senior leaders. Companies exploring such security practices should keep in mind that executive security protections trigger special income tax consequences for purposes of both income imputation and employer tax deductions (and also may be considered disclosable compensation under Securities and Exchange Commission disclosure rules, which are beyond the scope of this paper[37]).

More specifically, under current U.S. Department of the Treasury regulations relating to taxation of fringe benefits, if a private sector employer establishes an "overall security program" and can show that there is a bona fide business-oriented security concern with respect to the employee, then a significant portion of the value of certain personal security benefits may be excluded from the employee's income. Such a security concern exists only if the facts and circumstances establish a specific basis for concern regarding the safety of the employee existing at the time the security protection is provided. The basis for this concern must be specific to the particular employee, and a generalized concern for the employee's safety is insufficient to establish a bona fide concern. Once such a security concern is determined to exist, the employer must periodically evaluate the situation for purposes of determining whether the concern persists with respect to the employee.

The regulations provide examples of factors indicating a specific basis for concern regarding the safety of a particular employee, including threats of death, kidnapping, or serious bodily harm with respect to the employee or a similarly situated employee because of either employee's status as an employee of the employer or a recent history of violent terrorist activity (such as bombings) that may affect the employee or a similarly situated employee. For these purposes, a "similarly situated employee" may be an employee of the same employer or, presumably, of an unrelated employer.

The most common way to establish an overall security program that supports the exclusion from federal income taxation of excludable security benefits is by hiring an outside security consultant to conduct an independent security study. Under the applicable Treasury regulations, an independent security study with respect to a private sector employer exists if:

- a security study is performed with respect to the employer and the employee or a similarly situated employee, by an independent security consultant—to be considered independent, the security consultant must be an outside firm or person, as opposed to another employee of the same employer;

- the security study is based on an objective assessment of all facts and circumstances;

- the recommendation of the security study is that a 24-hour overall security program (as described below) is not necessary and such recommendation is reasonable under the circumstances; and

[37] See, however, the numerous law flashes and blogs posted on Morgan Lewis's website reporting on SEC disclosure requirements applicable to executive perquisites.

- the employer applies the specific security recommendations contained in the security study to the employee on a consistent basis.

The regulations do not specifically require that a security study be obtained either before security is provided (although in most cases the security study is obtained in the year that the security protection is first provided to the employee) or each time a new security threat arises. Most independent security studies summarize the nature of the threat to the particular employee, in partial support of the study's recommendation against 24-hour protection, and nearly all of the studies explain in detail the appropriate security protection that should be provided in response to the threat. Finally, it is advisable for any independent security study to include the locations and the typical period of time during which security protections will be necessary. Many companies periodically request updates to their security studies, especially when the covered employees change their work locations and/or residences.

Once a security study is obtained, the study can be used subsequently by the employer to justify the security protection extended either to the employee (or employees) cited in the study or to any similarly situated employee for whom the bona fide security concern exists.

If the employer satisfies the security study requirements with respect to employees, then a significant portion of the value of security protections can generally be excluded from the employees' federal taxable income as "working condition fringes." This exclusion is available for either in-kind security protections or cash reimbursements (although reimbursement arrangements are rarely established and are not recommended for items such as charter air service purchased directly by an executive due to Federal Aviation Administration limitations on such reimbursements, outside the context of time-share leases), provided that the employer must verify that the payment is actually used to purchase the security protections. An additional exclusion for cybersecurity and identity theft protections (which are often also added as part of home office security protections) applies under a long-standing Internal Revenue Service (IRS) moratorium on audits of these particular protections.

Alternatively, an overall security program can be established without the use of an independent security consultant if the employer can show that a bona fide business-oriented security concern exists with respect to the employee and security protections are provided to the employee on a 24-hour basis, whether the employee is at work, at home, or conducting business or personal travel. Employers rarely use this 24-hour security method to establish an overall security program due to the high cost and invasive nature of the security involved.

Importantly, even when a security study is in place (or where 24/7 security protection is provided), the value of some benefits still must be imputed as income to the protected executive. There are several special rules for imputing income, as, for example:

- The value imputed as income for a personal trip by the protected executive (or for a personal trip by a spouse or dependent child accompanying the executive) on an airplane owned or leased by the company is taxable, although the taxable amount is reduced by nearly half as compared to the amount that would be imputed absent the overall security program (and the amount allowed as a deduction to the company for personal flights by top executives would be correlatively reduced since the company's deduction is limited to the amount imputed).

- The value imputed as income for any ride in a chauffeured car can be calculated based on the IRS's vehicle-valuation rules, referencing only the value of the car without the cost of additional security protections, and the entire value of the chauffeur's services may be excluded, provided that the chauffeur is trained in defensive driving.

The final, and substantial, benefit for the employer is that the deduction disallowance under Code section 274(l) (enacted in 2017) that applies to "commuting expenses" – even if the expenses are treated as taxable income to the employees- does *not* apply where the commuting benefit is provided for the safety of the employee. 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." The original proposed regulations implementing this rule had provided that proof that the commute was provided to secure the employee's safety was deemed to exist whenever employers had obtained outside security studies. By contrast, Final Treas. Reg. § 1.274-14(b) provides specifically that "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."

Notably, however, the Preamble of these final regulations indicates that the reference to Treas. Reg. § 1.61-21(k)(5) (as opposed to the reference to security studies in Treas. Reg. § 1.132-5(m)) 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." Indeed, it is possible that since the commuting disallowance regulations no longer specifically cross-reference Treas. 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. Limitations on the Section 530 Moratorium Protections

A. Overview

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. Where the protections apply, they both reduce the employer's federal employment tax exposure to zero for both past and future years, and also offer employer-only relief from employment tax exposure, plus the ability to continue treatment of the workers as independent contractors for payroll tax and information reporting purposes.

B. The Section 530 Tests

A "shorthand" summary of the various components of Section 530 Relief is provided below.

- 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 it followed the practices of a significant segment of the service recipient's industry in treating 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.

In addition to the guarantee of protections under the three-part test above, Section 530(b) of the 1978 Revenue Act 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."[38]

C. Tax Court Jurisdiction and Section 3509 Relief

At the same time that it provided protections from IRS challenges to employer's classifications of worker as "independent contractors," Congress also provided both an ability to challenge IRS audit determinations in court, and special tax calculation relief.

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

- an examination in connection with the audit of any person;

- a determination either that one or more individuals performing services for such person are employees of such person for purposes of subtitle C, or that such person is not entitled to relief under Section 530(a) with respect to such an individual;

[38] Note, too that Section 530(d) of the 1978 Revenue Act (as amended in 1986) provided 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." However, this enormously controversial 1986 Act change attracted thousands of taxpayer comments, and in response to this taxpayer opposition, 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). Thus, the blocker from Section 530 protections applies only to "technical service specialists" who work either for their own companies or for leasing companies. Unfortunately, the 2025 IRS guidance appears to undermine the protections provided by Notice 87-19.

- an "actual controversy" involving the determination as part of an examination; and

- the filing of an appropriate pleading in the Tax Court.

Notably, the IRS for many years contended that until and unless it has issued a special "Notice of Determination of Worker Classification," (also referred to as am "NDWC" or a "ticket to Tax Court"), no taxpayer was entitled to file a petition in Tax Court. The Tax Court disagreed with the IRS's position, in three separate cases, each concluding that the Tax Court has the right to determine whether a taxpayer can file a worker classification case in Tax Court, irrespective of whether the IRS had issued (or refused to issue) any NDWC.[39] In Rev. Rul. 2025-3, the IRS seems to be reasserting its right to control whether a petition can be filed in Tax Court, by issuing more liberal rules governing whether any NDWC will be issued. However, as a matter of law, all these new scenarios listed in Rev. Rul. 2025-3 that illustrate when the IRS will and will not issue an NDWC should have little bearing on whether the Tax Court will assert its jurisprudence under IRC 7436, because the Tax Court has already concluded that it has an independent ability to determine when cases can be filed, and whether Section 530 relief will be applicable.

Importantly, even if an employer ultimately does not "win" full protection from IRS challenges to worker classification, Congress in 1978 also established a system, under Code section 3509, for reducing employment tax assessments, provided that if service recipient had issued Forms 1099, by substantially limiting assessments for both any Federal income tax withholding ("FITW), and the employee share of FICA taxes. (Section 3509 does not provide any relief regarding the employer's portion of FICA taxes nor FUTA tax, but the relief from FITW and employee-share FICA is substantial. More specifically, the effective Code section 3509(a) maximum assessment 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 (pursuant to Code section 3509(c)) only if any failure is attributable to "intentional disregard." (FUTA taxes are also owed.)

D. Changes to Section 530 Protections in January 2025

In January 2025, in the final weeks of the Biden Administration, the IRS updated 40-year-old guidance governing Section 530 relief. Rev. Rul. 2025-3, 2025-4 I.R.B. 443 provides five new fact scenarios that illustrate whether Section 530 relief is available (under the IRS's interpretation of the statute); and when the IRS should issue a "Notice of Determination of Worker Classification" (entitling the taxpayer to file a case in Tax Court under Code section 7436). Specifically in this ruling, the IRS warns that if the employer has classified workers as contractors for ALL PURPOSES, then a determination would be made as to whether Section 530 applies, and whether a Tax Court case could be filed. But if the company has simply failed to withhold on part of the compensation of workers otherwise treated as employees, Section 530 relief does not apply, and no petition can be filed in Tax Court. Importantly, too, in any case where an entity has employed workers through a third party that reports weekly pay on W-2; but directly pays year-end bonuses out of its own bank account (which are not reported on Form W-2), Rev. Rul. 2025-3 warns

[39] *See SECC v. Comm'r*, 142 T.C. 225 (2014) (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) (Tax Court upheld Code section 7436 jurisdiction in the absence of any NDWC. *See also Reflection Resources v. Comm'r*, T.C. Memo. 2020-114, in which the Tax Court determined section 7436 jurisdiction did not exist over certain tax periods despite the IRS having issued a NDWC for the dismissed tax periods).

that it will *not* agree that either Section 530 or Code section 3509 reduced rates are applicable (although it will allow the taxpayer to file a petition in Tax Court if no agreement is reached during the audit).

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. More specifically, 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." However, 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."

In additional new guidance (obsoleting guidance issued forty years earlier, in Rev. Proc. 85-18). Rev. Proc. 2025-10, 2025-4 I.R.B. 492, 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.

More specifically, according to this Revenue Procedure (issued completely without following any notice and comment procedure), the indications that a service recipient "treated" workers as "employees" include:

- 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;

- 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;

- the filing of a Form W-2 "Wage and Tax Statement" with respect to a worker, whether or not tax was withheld; and

- 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 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:

- claimed income tax deductions, or treated payments to the worker as excludable from income, under Code provisions that (according to the Revenue procedure) are applicable only to employees, including under IRC 62(a)(2)(A) (accountable plan business expense reimbursements), 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), IRC 129 (dependent care), IRC 132 (noncash fringe benefits), or IRC 137 (adoption assistance);

- claimed employer credits (e.g., paid sick and family leave, employee retention) or other credits based on employee wages;

- complied with federal or state labor law including minimum wage and overtime rules that are applicable to employees;

- 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);

- treated the worker as an employee for purposes of collectively bargained agreements;

- permitted participation of the worker in any qualified pension, profit-sharing, or stock bonus plan;

- permitted participation of the worker in nonqualified deferred compensation plan if such participation is limited to employees; and/or

- 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.

Again, many of these new "tests" are simply not indications of whether or not a worker is an employee! For example, expense reimbursements and educational assistance, per longstanding IRS regulations, can be provided tax free to both employees and independent contractors.

IV. Additional Common Topics in IRS Payroll Tax Audits

A. Overview of Time-Honored Audit Issues

The few remaining IRS payroll tax auditors continue to audit the same topics that have been covered in detail in our numerous prior submissions to SFTI annual conferences, including not only company planes, but also on-premises cafeterias, company provided cars (and reimbursements for employee cars, entertainment events (including skyboxes), spousal travel, de minimis fringes, and litigation settlements. Finally, every audit of any public company (with traded stock) involves an examination of the timing of the company's deposit of payroll taxes, often with substantial penalties being proposed for lateness of even a day. There have been surprisingly few audits of nonqualified deferred compensation (including either section 3121(v)(2) FICA taxation, or the section 409A rules governing the design and operation of deferred compensation plans), or of golden parachute payments, or of withholding and deduction of compensation to the highest-paid executives.

The two recent developments of interest not discussed in prior SFTI annual conferences are, first, auditors' proposals to apply FICA taxes to "restricted stock Unit" ("RSU") payouts to employees working overseas for companies with international operations (even though the companies are directly employed by "controlled foreign corporations," over which the IRS generally has no taxing jurisdiction), and, second, a pending case involving a company cafeteria that has been providing free lunches to employees since 1915. Each development is discussed below.

B. FICA Taxation of RSU Payouts to CFC Employees

1. Background

For over a decade, in its audits of companies with expatriate employees, the IRS has contended that the equity compensation attributable to work in the United States should be FICA-taxable in the U.S. (even though the employees were working overseas at the time of vesting), and even though compensation earned by employees while working for non-American companies outside the U.S. is exempt from FICA taxes by statute.

Several accounting firms have been advising their clients that no FICA taxes were imposable, even though their clients have been losing audits for over a decade on this issue. However, the IRS did drop some audits, on the stated grounds that (a) only the Controlled Foreign Corporation ("CFC") likely could be held liable; and (b) there was no IRS guidance on point.

2. Release of Chief Counsel Advisory Opinion 202327023, Preceded by a NOPA

Presumably in an effort to resolve at least the "lack of guidance" problem, on July 7, 2023, the IRS released C.C.A. 202327023, concluding both that FITW applies to ALL the equity compensation held by US citizens and green card holders, but, more troublingly, that FICA taxes apply to all of the US-allocated wages.

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. This NOPA copied C.C.A. 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 C.C.A. 202327014 (prior to "no sooner than 75 days after Notice of Disclosure is sent to the taxpayer") violates Code section 6110(f)- raising interesting procedural problems. But, in addition, there were enormous errors in the IRS computations, which have taken over two years (and two Protests) to resolve.

3. Arguments Rebutting the Positions in CCA 202327014

The company who had received the NOPA (which preceded issuance of the CCA to an unknown different entity) has raised numerous procedural arguments in its Protest, including:

- Its RSUs are "nonqualified deferred compensation" covered by the special FICA tax timing rules of Code section 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 section 3121(h)), and thus were exempt from FICA taxes, per Code section 3102(b).

- However, this company, in a completely reasonable "mirror image" of its position on FICA taxation of CFC-vested RSUs, had imposed FICA taxes on 100% of the RSU payout, for RSUs vesting in the U.S. (with no limitation of that income 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 Treas. Reg. § 1.861-4(b)(2)), the company would be entitled to a FICA tax refund,

which in fact exceeded the proposed assessment (after it had been corrected for the IRS's numerous factual, legal and mathematical errors).

- In any event, the IRS has no grounds for extending the income-allocation rules of Treas. Reg. § 1.861-4(b)(2) to determine the FICA taxes, because these FITW regulations by their terms, apply only to income tax withholding.[40]

- The IRS has wrongly assessed not the CFCs, but instead the U.S. parent company, for failure to collect and pay FICA taxes, insisting that the U.S. company is the "statutory employer" under Code section 3401(d)(1) (as extended to FICA taxes by the Supreme Court in Otte v. U.S., 419 U.S. 43 (1974)). However, the IRS's reliance on section 3401(d)(1) is wrong for many factual and legal reasons.[41]

- Even CCA 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.[42]

- 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).

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[40] 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 section 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 Treas. 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.

[41] First, as a factual matter, 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, since the US company did not "fund" the benefits. Second, the RSUs, at vesting are a "noncash fringe" (as that term is defined in Ann. 85-113, and confirmed by the regulations under Code section 3121(v)(2)). Third, the statutory employer rules of Code section 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 section 3501(b) – which is in a different chapter from Code section 3401(d)(1), and thus no FICA liability can be imposed on the U.S. company.

[42] 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 CCA 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.

- The IRS has never issued any formal guidance supporting its position, so taxes should be waved under the "Confusion Doctrine" developed by the Supreme Court in its decision in *Central Illinois Railroad v. U.S.*

4. Company Cafeteria Litigation

a. Overview

As explained above, employer-provided meals are one of the fringe benefit items that has been under continual examination in IRS payroll tax audits for the past twenty years. Despite the fact that the IRS had developed the original income exclusion for "convenience of employer" meals (in response to taxpayer-favorable court cases), even before the enactment of Code section 119 in 1954, and despite the existence of final regulations intended to recognize an income exclusion, the IRS for over two decades has persistently failed to fairly apply the pertinent Code section 119 legal standards (or to update its regulations to reflect favorable changes to the statute in 1978 that had been specifically intended to override IRS regulations unfavorable to taxpayer). These regulations and IRS's position are explained below. At long last, as of September, 2025, it appears that the IRS's absurdly limited reading of the regulations will soon reviewed by yet another court.

b. IRS Regulations

The critical issues addressed in the regulations under Code section 119 all appear to recognize the existence of a relatively liberal income exclusion, as explained below.

- "There shall be excluded from gross income of an employee the value of any meals or lodging furnished to him, his spouse, or any of his dependents by or on behalf of his employer for the convenience of the employer, but only if … the meals are furnished on the business premises of the employer."[43]

- "In determining whether meals are furnished for the convenience of the employer, the fact that a charge is made for such meals, and the fact that the employee may accept or decline such meals, shall not be taken into account."[44]

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[43] Code section 119(a)(1). The term 'business premises of the employer" generally means the place of employment of the employee." Treas. Reg. § 1.119-1(c)(1).

[44] Code section 119(b)(2). This provision was added in 1978 for the specific purposes of limiting controversial IRS regulations that had been designed to narrow the section 119 exclusion.) See the Congressional Record of June 28, 1978 at 12362-12370, which in large part reflects Congress's debate about the extension of the moratorium on taxing fringe benefits, which was ultimately included in the Revenue Act of 1978 (and lasted through 1984, when Congress replaced the moratorium with detailed statutory guidelines on the taxation of noncash fringe benefits). However, this floor debate also included a specific modification to the language of the general (and temporary) moratorium, to override the IRS's controversial regulations. (See H.R. 10574, introduced by Rep. Cotter of Connecticut and Rep. Burke of Mass, and approved for addition to the fringe benefit by Rep. Barber Conable.) During the Senate Floor debate of this provision, Senator Bob Dole also specifically referenced the concept of "substantial noncompensatory business reason," explaining that he was "… concerned that the IRS has attempted to narrow the meaning of the broad term "convenience of the employer,." and further stating that the "… existing regulations, in essence, provide that meals are regarded as furnished for the convenience of the employer if there is a substantial noncompensatory employer business reason irrespective of the presence of a compensatory reason. That principal remains intact." See 124 Cong. Rec. at 23883-84 (Aug. 2, 1978). Yet the IRS has never retracted these regulations, or issued any other guidance conceding that its regulations were limited by the 1978 change.

- "All meals furnished on the business premises of an employer to such employer's employees shall be treated as furnished for the convenience of the employer if, without regard to this paragraph, more than half of the employees to whom such meals are furnished on such premises are furnished such meals for the convenience of the employer."[45]

- "Meals furnished by an employer without charge to the employee will be regarded as furnished for the convenience of the employer if such meals are furnished for a substantial noncompensatory business reason of the employer."[46]

- "The question of whether meals are furnished for the convenience of the employer is one of fact to be determined by analysis of all the facts and circumstances in each case."[47]

- "[I]f the employer furnishes meals to his employee for a substantial noncompensatory business reason, the meals so furnished will be regarded as furnished for the convenience of the employer, even though such meals are also furnished for a compensatory reason."

- "In determining the reason of an employer for furnishing meals, the mere declaration that meals are furnished for a noncompensatory business reason is not sufficient to prove that meals are furnished for the convenience of the employer, but such determination will be based upon an examination of all the surrounding facts and circumstances."

- "Meals will be regarded as furnished for a substantial noncompensatory business reason of the employer when the meals are furnished to the employee during his working hours to have the employee available for emergency call during his meal period."

- Meals will be regarded as furnished for a substantial noncompensatory business reason of the employer when the meals are furnished to the employee during his working hours because the employer's business is such that the employee must be restricted to a short meal period, such as 30 or 45 minutes, and because the employee could not be expected to eat elsewhere in such a short meal period."

- "Meals will be regarded as furnished for a substantial noncompensatory business reason of the employer when the meals are furnished to the employee during his working hours because the employee could not otherwise secure proper meals within a reasonable meal period. For example, meals may qualify … when there are insufficient eating facilities in the vicinity of the employer's premises."

- "A meal furnished to a restaurant employee or other food service employee for each meal period in which the employee works will be regarded as furnished for a substantial noncompensatory business reason of the employer, irrespective of whether the meal is

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[45] Code section 119(b)(4). This provision was adopted to override a Tax Court case, which had applied a deduction-disallowance to Section 119 meals, because it was not proved that "substantially all" the meals were provided for the employer's convenience. Per the legislative change, the "substantially all" test was replaced with a "more than half" test. Here again the IRS has never amended its regulations to reflect the statutory change to Code section 119(b)(4).

[46] Treas. Reg. § 1.119-1(a)(2)(i).

[47] Treas. Reg. § 1.119-1(a)(1) (which also contains the remainder of the taxpayer-favorable instructions quoted in the text above).

furnished during, immediately before, or immediately after the working hours of the employee."

- "Meals will be regarded as furnished for a compensatory business reason of the employer when the meals are furnished to the employee to promote the morale or goodwill of the employee, or to attract prospective employees."

c. Judicial Respect of Employers' Business Reasons for Offering On-Premises Food

The courts (with periodic assistance from Congress in enacting taxpayer-favorable amendments to Code section 119) have continued to respect employers' business reasons for operating on-premises cafeterias. For example, in *Boyd Gaming v. Commissioner*, 177 F.3d 1096 (9th Cir. 1999), the Ninth Circuit refused to "second guess" the business judgment of the taxpayers that reasonably found it convenient to provide on premises meals to employees, noting that it is not appropriate for a court—or the IRS—to substitute its judgment instead. Further, in its acquiescence to the *Boyd Gaming* decision, the Service agreed that it "will not attempt to substitute its judgment for the business decisions of an employer as to what specific business policies and practices are best suited to addressing the employer's business concerns" in applying Code section 119 and Treas. Reg. § 1.119-1.[48] Except for cafeterias in prisons, hospitals, and ships, and cafeterias in the casino, entertainment and hotel industries (which have been eligible for a generous industry-specific amnesty offer, provided by Ann. 98-78), the IRS has continued its audits on this issue, and routinely denies the existence of any Code section 119 exclusion.[49] However, so far most of the audited employers who have been negotiating generally favorable settlements have been unwilling to litigate.[50] That lack of enthusiasm for litigation is changing, however, as is shown below.

d. Pending Litigation 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).[51] These lunches have been offered by the company for 110 years to approximately

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[48] Announcement 99-77, 1999-2 C.B. 243 (July 22, 1999); A.O.D. 1999-010 (Aug. 10, 1999). See also the special IRS amnesty offer, extended by Announcement 98-78, 1998-2 C.B. 245, to employers in the casino, entertainment and hotel industries offering free or discounted cafeteria food.

[49] *See, most recently*, 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."

[50] In 2000, the Department of Justice conceded a case filed in New Jersey (*The BOC Group, Inc. v. United States*, Civil No. 98-3614 (JAG) (D.C. N.J.), involving company cafeterias operated by a taxpayer at its suburban offices campus, even though even though BOC's cafeterias did not fit precisely within any particular one of the regulatory examples of Treas. Reg. § 1.119-1(a)(2). In other words, the DOJ itself concluded that the IRS's application of Code section 119 was too narrow under the facts of BOC's case.

[51] Congress enacted the exclusions for meals and lodging under Code section 119 in 1954, taking the concept and the language directly from cases like *Benaglia v. Commissioner*, 36 B.T.A. 838 (1937), acq., 1940-1 C.B. 1. In *Benaglia*, a hotel manager was permitted to exclude the value of a posh hotel suite and equally extravagant meals on the ground that his presence was necessary to attend to the "numerous, various, and unpredictable" demands of the rich patrons of the hotel, i.e., for the convenience of the employer. 36 B.T.A. at 840. Any benefit to the manager was "merely an incident of the performance of his duty." ld. The IRS decided to follow the case, even though there was no specific statutory support, began issuing private rulings, and ultimately supported the addition of section 119 to the Code , Byrnes & Mcintyre, Famous Events in Tax History, 1 Tax Notes Int'l 260 (1989).

4,000 employees, and the company maintained 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 public eating facilities near one campus location, and no eating facilities within miles of the other campus. However, 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.

The company is suing for a refund, pointing out not only its mandatory short meal period, and the scarcity of local restaurants, but also showing 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. Surge in State Unemployment and Payroll Tax Audits

A. Reasons for Uptick in State Payroll Audits

Counterbalancing the decline in IRS payroll tax audits, there has been a 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).

Some of these audits are started because of IRS or DOL referrals (following payroll or labor (worker classification) audits.

Most state SUTA audits have started based on claims for unemployment benefits filed by workers for whom no SUTA taxes were ever paid (because the workers, per their contracts. Work agreements, and facts of their assignments, had been classified as independent contractors).

B. Audits of Peripatetic Workforces

Many other state payroll tax audits have started because, during and beyond the COVID 19 Pandemic, companies have had increasingly peripatetic workforces, with both employees and contractors working in, and moving among, many different states. All of these moves, either in a single year or over the course of the vesting period for bonuses, stock options, restricted stock, or other equity compensation, and also severance pay, create special problems due to myriad state laws governing the taxation of residents and non-residents. (During the Pandemic, special exemptions were offered by many states- but most of the lenient rules have expired.)

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).

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.[52]

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.

C. Employee Complaints about Overwithholding of State Taxes

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. (Some employees, as part of their complaints about excessive withholding, have even become asking for tax reimbursements, with gross-ups (like the benefits provided to international travelers).

[52] 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]."

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

A. Overview

Code section 162(m) prohibits a publicly held corporation from taking compensation-related tax deductions with respect to the compensation of a "covered employee" to the extent the compensation exceeds $1 million in a tax year. That disallowance has long extended to (1) the CEO and the CFO and (2) the company's three highest paid executive officers for the taxable year (other than the CFO[53] and the CEO). Effective for all years beginning after 2016, under a change enacted under the Tax Cuts & Jobs Act in 2017, this group also include any individual who was a covered employee under either of the two preceding categories in any year after 2016 (known as the "once-covered-always-covered" rule). (Because of the once-covered-always-covered rule, the group of covered employees under this definition will naturally grow over time.)

The definition of "covered employee" under Section 162(m) was expanded further by the American Rescue Plan Act (the "ARPA") in 2021. ARPA extended the list of covered employees to include the company's five most highly compensated employees (including persons who may not be top company officers), effective for tax years beginning after December 31, 2026. The "ARPA five" group must be redetermined every year, and there is not a separate once-covered, always-covered rule applicable to this group. Accordingly the ARPA five group will never include more than five employees in any year, although the group may include individuals who would otherwise be covered employees under the once-covered-always covered rule.

The American Institute of Certified Public Accountants had submitted detailed comments on this statutory provision as early as August 29, 2022, asking that final regulations be issued no later than January, 2025, because, even though the tax deduction is not limited until 2027, all public companies' financial statements must reflect the limitation prior to 2027.[54] On January 14, 2025, in the closing days of the Biden Administration, the IRS released proposed regulations to implement the ARPA amendments to Section 162(m).

B. Controversial Proposed Regulations

Shortly after the issuance of the proposed regulations, taxpayers began complaining that, if finalized, these Proposed Regulations are likely to pose complex and difficult implementation issues for affected companies, for the reasons explained below.

First, 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. To accomplish this result, the proposed regulations apply the definition of "employee" under Code section 3401(c), which includes the corporation's officers (whether or not they are its common law employees). The preamble explains that this definition is used is to prevent "avoidance" of Code section 162(m) either where employees work for corporate affiliates, or where workers who are paid by third party payors. In short, an employee is examined for potential inclusion in the ARPA-five so long as the person performs "substantially all" of the individual's services "during the relevant taxable year" for the publicly held corporation. (No definition is provided of "substantially all," and the proposed regulations

[53] Notably, the CFO was temporarily excluded from this group, under Notice 2007-49, 2007-1 C.B. 1429, in order to conform to amendments to executive compensation disclosure rules published by the SEC in 2006.

[54] Tax Notes Doc. 2022-28359, 2022 Tax Notes Today 16-823.

do not discuss how a public company would gather facts regarding proportions of a workers' services performed for the company.)

Second, 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 controversial proposed definition departs from the definition of "compensation" used or purposes of identifying the corporation's three highest paid executive officers (which 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 has attracted substantial public criticism, because it likely would 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.[55] The tax deduction-based definition of compensation also may pose significant implementation issues, since tax deductions are typically not recorded for all payors in an affiliated group, or on the basis of service-providers who may work for unaffiliated entities. Also, any deduction for bonus accruals, or for depreciable property, or for most non-cash fringe benefits, are claimed on the basis of aggregated groups of employees, or with respect to the cost of entire facilities, or properties, and are simply not subdivided by employee.

The proposed regulations also include rules for allocating deductions among affiliated group members in determining the ARPA five group, since these highly paid employees must be identified across the affiliated group, without regard to whether the individual is an employee of, or performs services for, the publicly held corporation. 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 identify the ARPA five group by looking at all the affiliated group members (and to service-providers to those members, even if they are not employed by the members), 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. (Notably, the regulations will need to be revised with respect to their definition of "affiliated group," because the OBBBA includes a new definition of this term, which references the definition in Code section 414, instead of the definition adopted in the proposed regulations.)

In the case of 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. Public comments were specifically requested on how these rules should apply to controlled foreign corporations (although few comments were received on this issue).

[55] We understand that the IRS is considering resolving this problem simply by excluding former employees from the ARPA-five, subject to a very limited exception applicable where former employees receive bonus payments that were accrued in the year prior to payment.

Finally, and most controversially, there are detailed proposed rules that would cover even non-employee service providers (despite the statutory reference to "highly compensated employees" who are members of the ARPA-five). These rules are implemented though a proposed definition of "employee" for this purpose to include an individual who is the employee or officer of an *unrelated company* and who performs "substantially all of the individual's services during the relevant taxable year for the publicly held corporation." (Again, no definition is provided of "substantially all.) The proposed regulations would define "compensation" used in identifying workers as the aggregate amount allowed as a *tax deduction* to the publicly held corporation (without regard to Code section 162(m)(1)) "to obtain the services performed by such individual, whether or not the particular services that give rise to the deduction were performed during the relevant taxable year."

This rule presents numerous problems. First, it apparently lacks statutory authority, since Code section 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 publicly held corporation. There is no apparent statutory authority for this expansion of the term "employee" of the publicly held corporation.

Second, the proposed regulations describe this rule in a conceptually muddled way. 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. Further, 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. 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 (or how the public company is supposed to gather this information from an unrelated entity). Finally, 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.

C. Public Comments, and Planning for 2027

Public comments have been submitted on all of these issues (by the AICPA, Morgan Lewis & Bockius, and by the Securities Industry and Financial Markets Association ("SIFMA"), but it remains to be seen when, or how, the IRS will respond to these public comments. However, as the 2027 effective date of ARPA's expansion of Section 162(m) approaches, companies must start evaluating their employee tracking and reporting practices and consider whether awards will be (or in some instances have been) granted to individuals who could be covered employees under the new rules. It may be possible to reduce the number of new employees included under the ARPA five group if those individuals are already covered employees under the "once-covered-always-covered" rule. To the extent new individuals must be counted, companies should be mindful of considering the compensation received by any employee within the affiliated group from any member of the affiliated group. Companies should also be mindful of compensation paid to unrelated third parties for services performed by third-party employees who might perform "substantially all" their services to the third-party entity on behalf of the publicly held corporation.

Finally, the rules affect financial disclosures, since they may potentially affect future tax deductions for equity grants. Awards granted this year may vest after the effective date of the expanded list of "covered employees"—i.e., in 2027 or later, and absent any future changes in law, more equity awards to more service providers may not be deducible at the time of grant. Accordingly, from a financial accounting perspective, companies should implement robust forecasting practices to identify future tax deductions. The expansion of the covered employees list means for many companies that limitations will apply to the tax deductions for their highly-compensated employees (although the difficulties of tracking those employees has not yet been resolved).

VII. Planning for Increased Deduction Disallowances in 2026 for Food, Beverages, and Certain Company Cafeterias

As part of its myriad changes to limit the allowable deductions for a wide variety of employee fringe benefits (including disallowing deduction for moving expenses, qualified transportation expenses, commuting expenses, and many more types of entertainment expenses), the Tax Cuts & Jobs Act of 2017 also dramatically expanded the deduction disallowance applicable to company cafeterias, by enacting Code section 274(o), applicable starting in 2026. The OBBBA amended this provision to add a cross-reference to Code section 274(e)(8), thereby creating an exemption from the disallowance for food and beverages which are sold to "customers" "in a bona fide transaction for an adequate and full consideration in money or money's worth." However, this exemption (which basically applies to restaurant meals) has no application to company cafeterias, where food is sold at discounted prices.

The disallowance under Code section 274(o) that is effective for years starting after 2025 looks disarmingly simple, in denying any deduction 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)."

The problems with this provision are as follows:

- A "facility described in section 132(e)(2)" is one that charges enough for meals to cover 100% of the "direct operating costs" of the food. Yet many companies provide far deeper discounts (typically taking the position that the cafeteria meals are excludable under Code section 119). 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[56] would be subject to a disallowance potentially covering all of the fixed and operating cost of the entire cafeteria!

- The "food or beverages … associated with such facility" presumably covers only "food or beverages associated with a facility described in section 132(e)(2)," and thus, again, this

[56] Any company that charges 150% of the direct operating costs is deemed to be charging "fair market value" for the food, and thus would not be subject to the disallowance, per Code section 274(e)(8).

disallowance would apply only to the companies that charge between 100% and 149.9% of the direct operating costs.

- 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 section 274(o) (but still subject to the 50% deduction disallowance in Code section 274(n)(1)).

- Further, 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," 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.

- Finally, it seems that Code section 274(o) does not apply to independent contractors' meals.

The IRS has not yet issued any regulatory guidance under Code section 274(o), perhaps because it realizes that application of a 100% disallowance ONLY to eating facilities that charge 100% to 149.9% of direct operating costs has an entirely perverse operational effect.

VIII. Income Tax Deductions for "Qualified Overtime Compensation" – and Complications for Employers and Employees

The Qualified Overtime Compensation (QOC) deduction rules—codified in new Internal Revenue Code (IRC) Section 225—provide a potential federal income tax deduction for "qualified overtime compensation," starting in 2025 of $12,500 per year for "single filer" qualifying taxpayers, and $25,000 per year for qualifying taxpayers who file a Form 1040 individual income tax return under the "married-filing-jointly" status. The QOC deduction phases out at above certain income levels,[57] and it is only available on certain overtime pay required under the federal Fair Labor Standards Act (FLSA) that a taxpayer earns between January 1, 2025 and December 31, 2028.

[57] The maximum potential deduction is reduced by $100 for every $1,000 over stated thresholds of "Modified Adjusted Gross Income" ("MAGI"), which vary with the taxpayer's filing status (i.e., $150,000 for single filers and $300,000 for married filers). The deduction is completely phased out for single filers with $175,000 of MAGI, and for married filers with $550,000 of MAGI. (MAGI represents a taxpayer's gross income less all above-the-line deductions (known as "adjusted gross income" or "AGI"), plus income that has been excluded from gross income under IRS Sections 911 (foreign earned income exclusion), 931 (Guam, American Samoa, and Northern Mariana Island earned income exclusion), and 933 (Puerto Rico earned income exclusion).)

Critically, QOC only includes overtime pay that is *mandated* by the FLSA and only the extra "half" premium portion (as in "time-and-a-half") above an employee's "regular rate" of pay.[58] Voluntary payments of overtime exceeding the mandatory extra "half time" do not qualify as QOC. Further, under the FLSA, a nonexempt employee is only required to receive overtime pay after working more than 40 hours within a defined seven-day (168-hour) workweek, so employees in California, or any other states that mandate that overtime be paid for work over a certain number hours in a day (typically, over 8 hours) would not necessarily be receiving pay that qualifies as "QOC." Also, employees in many industries are not covered (such as airlines and railroads), because those employees' compensation is not regulated by the FLSA.

But the massive confusion created by this new tax deduction is not limited only to employees, but extends as well to employers. New Code section 225(c) requires employers to report QOC on Form W-2 wage statements issued to employees and requires service recipients to report QOC on Form 1099-NEC payee statements issued to independent contractors.[59] However, the IRS announced that updated information return templates (*e.g.,* Forms W-2 and 1099) will not be published for tax year 2025, and that employers should "continue using current procedures for reporting and withholding" with respect to QOC paid during 2025.[60] Given the IRS's delay, employers can likewise delay implementing any of the QOC information return reporting requirements until the 2026 tax year. Nevertheless, there are important steps employers should take now, which are summarized below, and discussed in detail in numerous law flashes and webinar materials published by Morgan, Lewis & Bockius.[61] Specifically, we have recommended that employers:

Develop a communications plan to educate employees and manage employees' expectations, explaining that, out of the amounts reported as "overtime" on their pay stubs, the allowable Federal income tax deduction will range from "zero" to "one-third" of that pay stub amount. For example, employees may not appreciate that not all "overtime" is considered QOC. Employees who are exempt from the FLSA's coverage or who receive overtime under non-FLSA rules may not realize that they do not qualify for the deduction. Additionally, employees may not appreciate that the changes only affect federal income tax deductions- i.e., no state income tax deductions in many states,[62] and certainly not FICA taxes. Further,

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[58] *See* IRS Fact Sheet FS-2025-03 (July 14, 2025), which states, "[e]ffective for 2025 through 2028, individuals who receive qualified overtime compensation may deduct the pay that exceeds their regular rate of pay—**such as the "half" portion of "time-and-a-half" compensation**—that is required by the Fair Labor Standards Act (FLSA) and that is reported on a Form W-2, Form 1099, or other specified statement furnished to the individual." (Emphasis added.)

[59] Per the flush language of new Code section 225, the deduction may be available to workers who earn qualifying overtime compensation in their capacity as independent contractors. In general terms, however, the federal FLSA *does not apply to independent contractors*., so it is puzzling that Code section 225 notes that independent contractors might qualify for the deduction. Certainly, though, if an employee earned qualifying overtime pay, but died before it was paid, then the overtime pay would be reported on Form 1099-MISC, in Box 3 –so perhaps Congress was contemplating the payment of overtime compensation to decedents when it drafted this language.

[60] *See* IR-2025-82 (Aug. 7, 2025).

[61] *See, e.g.,* "ONE BIG BEAUTIFUL BILL ACT'S QUALIFIED OVERTIME COMPENSATION DEDUCTION: FAQS FOR EMPLOYERS," available at https://www.morganlewis.com/pubs/2025/08/one-big-beautiful-bill-acts-qualified-overtime-compensation-deduction-faqs-for-employers (published August 12, 2025), and the webinar materials for "Employers' Guide to the OBBA Qualified Overtime Tax Deduction" (published August 30, 2025).

[62] State tax conformity to the QOC rules in IRC section 225 depends on whether a state follows the federal Internal Revenue Code on a static, rolling, or selective basis, but it is possible that some states will simply refuse to follow the Federal deduction rules, even if they otherwise conform to the Federal rules. (For example, Alabama, which had enacted its own overtime tax deduction in 2023 (effective January 1, 2024), repealed the provision after 18 months, because the revenue loss exceeded by 10 times the original estimates (i.e., a loss of nearly $340 million, compared to an estimated revenue loss of only $32 million).

employees may not understand that if they claim overstated deductions, their income tax returns are open for audit for at least three years after they are filed.

Identify employees who qualify for FLSA overtime protections, and those who are exempt.

Monitor regulatory guidance, including future guidance on QOC and reporting from the IRS and from state taxing authorities, and also including IRS guidance on adjustments in income tax withholding that may be elected by employees starting in 2026, to reflect the benefits of the QOC deduction.[63]

Review payroll and reporting systems. Begin working with payroll and legal teams to ensure that payroll systems can (i) identify the "overtime premium" of FLSA-required overtime pay, and (ii) can segregate these premiums for future (i.e., 2026-2028) Form W-2 reporting purposes. (Even more complicated reporting may be applicable in litigation settlements involving overtime pay.) Care must be taken by employers to ensure correct reporting, at least starting in 2026, because otherwise the employer faces potential penalties for incorrect Form W-2 reporting.[64]

IX. OBBBA's Increase in the Form W-2/1099 Information Reporting Thresholds

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. Notably, this increased limit will also apply to the information reporting required under Code section 6045(f) for "gross proceeds" payments to attorneys, which must be 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.

The OBBBA also *retroactively* restored the 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. This limit had been reduced to $600 by ARPA, in 2021, but the IRS had delayed implementation of the reduced limit, and ultimately had required reporting only for gross proceeds payments over $5,000 for the year 2025.

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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[63] Since updated withholding tables to reflect possible QOC deduction will not be available until 2026, 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 Certificate that includes one or more additional allowances.

[64] For the years 2026-2028, an employer's failure to accurately report QOC (if the error exceeded $100) could expose an employer to penalties under Code sections 6721 and/or 6722 (for incorrect Form W-2 information returns sent to the IRS and to the employees, respectively, where the inflation-indexed civil penalties will exceed $350 for each incorrect Form W-2. In addition, employers are potentially exposed to civil damage suits under Code section 7434 for a willfully filed fraudulent information return, equal to the greater of $5,000 or actual damages, plus litigation costs and reasonable attorney fees. Most of the case law under this provision indicates that an erroneous return that is not corrected by the employer is deemed to be potentially subject to this penalty.