2011

Compensating Employees and Employee Owners, and Avoiding Problems with Payroll Tax and Executive Compensation Audits

Mary B. Hevener

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Compensating Employees and Employee-Owners, and Avoiding Problems with Payroll Tax and Executive Compensation Audits

by:

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William & Mary
57th Annual Tax Conference
Tax Education Day

November 10, 2011
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A. Tax and Penalty Exposure.


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<td>A. Employer liability for underwithheld income taxes (Code §3402).1</td>
<td>Currently 25% and 35% for supplemental wages over $1M after 2006, but has ranged from 20% to 28.6%2</td>
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<td>B. Employer liability for underwithheld employee FICA taxes (Code §§3101 and 3102(b)).3</td>
<td>7.65% of unreported income (5.65% in 2011, maybe lower still in 2012), up to OASDI base $94,200 in 2006, $97,500 in 2007,</td>
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1 This is called a “secondary liability” tax, because these income taxes are primarily the employee’s liability, but if they are not paid over to the Treasury, the employer is liable for what was not paid (and cannot collect any tax payment it makes from the employee). Accordingly, the employer’s tax payment is also not treated as “income” to the affected employees. Importantly, the employer’s liability is typically calculated at the applicable “supplemental withholding” rate. However, the employer’s maximum exposure to underwithheld federal income taxes can be reduced, if it can be proven that the employee was in a lower rate bracket, either based on the employee’s total income, or based on the Forms W-4 on file. See Internal Revenue Manual (“IRM”) 423.8.8, “Computing Income Tax Withholding.” The only other way that this “secondary liability” tax can be abated is for the employer to prove that the employee actually paid income taxes on the income reported on Form W-2. Code §3402(d). According to IRM 423.8.4.1, this proof of “tax payment by employees” must be based on the filing with the IRS by the employer of Form 4670, “Request for Relief From Payment of Income Tax Withholding,” with attached Forms 4669, “Statement of Payments Received,” in which the employee attests, under penalties of perjury, that he or she reported the income on Form 1040, and paid the taxes in full. A Form 4669 must be signed by and filed for each employee involved in the abatement request. The abatement provisions of Code §3402(d) do not affect any applicable penalties.

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

3 This is also a “secondary liability” tax, because the taxes are primarily the employer’s liability. If the employer is held liable within the employee’s statute of limitations period for the employee’s share of the FICA tax, which it never withheld from the employee’s wages, the employer’s obligation to the employer for the underpayment is a “matter for settlement” between the employer and the employee. Reg. §31.6205-1(d)(1) (or, prior to 2009, Reg. §31.6205-1(b)(3)). See F.S.A. 200022004, Issue (12) (explaining the employer’s ability to recoup from employees any FICA taxes paid during the limitations period when the employee was still liable for the employee share of FICA taxes). If the employer reported the income on Form 1099 and the worker paid SECA taxes on the income, the worker can get a refund of those SECA taxes (if corrected Forms W-2 and 1099 are issued). If the statute of limitations has closed for the employee, the employer’s liability for underwithheld employee FICA can be offset by the worker’s SECA tax overpayment. Code §6521.
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<td>D. Employer liability for FUTA taxes (Code §§3301 and 3306(a)).</td>
<td>7.65% of unreported income (maybe lower in 2012), up to OASDI base ($94,200 in 2006, $97,500 in 2007, $102,000 in 2008 and $106,800 in 2009-2011) and 1.45% on excess.</td>
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<td>E. Penalty for failure to timely deposit withholding and payroll taxes (Code §6656 and Rev. Rul. 75-191). This failure to deposit penalty does not apply where taxes were not withheld (e.g., either in a case where income is not reported, or where no withholding was collected).</td>
<td>6.2% of unreported income up to $7,000 of total income (state SUTI offsets apply).</td>
</tr>
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<td>F. Penalty for failure to pay employment taxes required to be shown on payroll tax return within 10 days of notice and demand (Code §6651(a)(3)).4</td>
<td>10% of underreported employer FICA taxes discussed in C. and D., plus 10% of all income tax withholding and employee FICA taxes that were withheld but not deposited.</td>
</tr>
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<td>G. Penalty for negligence, disregard of rules or regulations, and substantial understatement of tax (Code §6662).5</td>
<td>25% of total taxes under A., B., C. and D. above (penalty is ½% per month of underreporting, up to 25%); penalty can be avoided by simply paying within 10 days of notice and demand.</td>
</tr>
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<td>H. Penalties for incorrect or untimely Form W-2.6</td>
<td>20% of underpayment of employment taxes. Code §6664(c)(1) provides that the penalty may not be imposed with respect to the portion of an underpayment if the taxpayer acted in good faith and there was reasonable cause for the underpayment.</td>
</tr>
<tr>
<td>(1) Incorrect Form W-2 to IRS (Code §6721).7</td>
<td>$100 per W-2, up to maximum of $1,500,000 for all such failures in the aggregate for the year ($30 per W-2, with $250,000 annual cap if corrected within 30 days of January 31, or $60 per W-2 with $500,000 annual cap if corrected on or before Aug. 1) or, in case of intentional disregard, greater of 10% of underreported amount or $250 per W-2 (with no annual cap). (Lower annual caps apply to</td>
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4 If no return is filed at all, penalties apply under Code §§6651(a)(1) and (a)(2) for failure to file a return and failure to report taxes on such return, that (if both penalties apply to the maximum extent) can total as much as 45% of the taxes not reported.


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

7 These penalties were substantially increased, effective for returns filed after 2010 (i.e., starting with returns for 2010 payments), by P.L. 111-240, enacted in October 2010. Prior to the change, for all taxpayers, regardless of size, the penalties under 6721 were $50 per W-2, up to maximum of $250,000 for all such failures in the aggregate for the year ($15 per W-2, with $75,000 annual cap if corrected within 30 days of January 31, or $30 per W-2 with $150,000 annual cap if corrected on or before Aug. 1) or, in case of intentional disregard, greater of 10% of underreported amount or $100 per W-2 (with no annual cap).
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| (2) Incorrect Form W-2 to employee (Code §6722). | small employers with gross receipts under $5M.)
| | $100 per W-2, up to maximum of $1,500,000 for all such failures in the aggregate for the year ($30 per W-2, with $250,000 annual cap if corrected within 30 days of January 31, or $60 per W-2 with $500,000 annual cap if corrected on or before Aug. 1) or, in case of intentional disregard, greater of 10% of underreported amount or $250 per W-2 (with no annual cap). | (Lower annual caps apply to small employers with gross receipts under $5M.) |
| I. Penalty for willful failure to furnish Form W-2 or willful furnishing of false or fraudulent W-2 (Code §6674). | $50 per W-2. |
| II. Interest | 8% since the first two quarters of 2007 (or 10% in the case of large corporate underpayments), and varies by quarter based on 3 percentage points (or 5 percentage points for large corporate underpayments) over the federal short-term interest rate. Lower rates apply after 2007. |

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

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

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

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<td>A. Loss of corporate deduction for Code §274 items (travel, meals, entertainment and “listed property” such as cars, planes and car phones) not reported as wage income on Form W-2 and as a “compensation” deduction on the originally filed Form 1120.</td>
<td>35% (or corporate tax rate).</td>
</tr>
<tr>
<td>B. There appears to be no longer any need (at least since 2004) to be concerned about potential loss of corporate deduction for Code §83 income (such as stock options, restricted stock) not reported on Form W-2 or 1099 (unless the income was included by the worker on his Form 1040) (Reg. §1.83-6.) See Robinson v. U.S., 335 Fed. Cir. 1365 (2003), cert. den. (2004) (invalidating this regulation).</td>
<td>Zero cost, under Robinson, but 35% (if Robinson is reversed by as-yet-unproposed legislation, or if the IRS continues to insist, as it has in some audits, that Robinson was overridden by Mayo Foundation v. U.S., ___ U.S. ___ (2011).</td>
</tr>
<tr>
<td>C. If the employee was among the top five employees named in the proxy, and is still an officer as of year-end, possible loss of corporate deduction under Code §162(m) for cost of payment, if the value of the payment in combination with the employee’s other compensation exceed $1 million.</td>
<td>35% (or corporate tax rate).</td>
</tr>
<tr>
<td>D. If the payment was part of a “golden parachute” payment, possible loss of corporate deduction under §280G.</td>
<td>35% (or corporate tax rate).</td>
</tr>
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<td>E. Possible IRS allegation of deduction loss for “secondary liability” payments, unless the amounts are reported as income on Form W-2.</td>
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<td><strong>IV. Valuation Issues</strong></td>
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<td>Potential Increase in Amount of Reported Benefit. Employers are allowed to use the “special valuation rules” for cars and planes only if these rules are used for income, employment tax and information reporting purposes. Reg. §1.61-21(c)(3)(i). Corrections referencing these special valuation rules are also possible for prior years for any “control employees” if the original reporting error was made in good faith.</td>
<td>Indeterminate amount of increase in value of reportable benefit. See, the disputes over car valuation in BMW of North America v. United States, 83 A.F.T.R.2d ¶ 99-413 (D.C.N.J. 1998).(unpublished opinion).</td>
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12 See Code §274(e)(2)(A) and Reg. §1.274-2(f)(2)(iii); see also Notice 87-23, 1987-1 C.B. 467. If the employer voluntarily corrects the Form W-2 before being required to do so by an IRS agent, the IRS typically waives this penalty, even though the amount was not reported on Forms 1120 and W-2 as originally filed. Note: Code §§274(e)(2) and (e)(9) were amended by AJCA §907(a) (as corrected by the Gulf Opportunity Zone Act of 2005, §403(mm)-(3), Pub. L. No. 109-135) to limit deductions for entertainment expenses incurred for or on behalf of “specified individuals” to the amount treated as compensation and as wages in the case of an employee. A “specified individual” is defined by reference to §16(a) of the Securities Exchange Act of 1934. See Notice 2005-45, 2005-24 I.R.B. 1228 and Prop. Reg. §1.274-9 and -10.

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

14 The airplane valuation rules are especially useful because they provide values equal to slightly more than first class. The charter rates (which must be used where the special valuation rules do not apply) provide values of 20 to 30 times first class. See Reg. §§1.61-21(b)(6)(ii) and (iii). However, per the changes to §274 referenced in Note 12 above, the benefit of these valuation rules is largely lost due to the corporate deduction disallowance.
2. **Backup Withholding and Form 1099 Penalties.**

   The IRS regularly reviews the billion-plus Forms 1099 sent every year, and processes them under two different review and penalty systems.

   a. **B-Notices.**

      First a “B-Notice” is sent to payors, to notify them of a name-TIN mismatch, or some other problem with the Form 1099, that will trigger backup withholding (under Code §3406) if a B-Notice is received twice in three years. If a payor fail to apply backup withholding where it is required, the payor is subject to the “backup withholding” secondary liability tax (of 28% of the amount reported on the erroneous Form 1099). Backup withholding also applies if the payor should have withheld, but does not, and then subsequently fails to send any Form 1099. These cases are harder for the IRS to find (since it never receives a “wrong 1099”). But, if these cases are detected on audit, the IRS is much tougher about imposing, and not abating, penalties.

      **Note:** Withholding Potentially Far In Excess of Income or Profits: Backup withholding is particularly onerous where the Form 1099 is required to report “gross proceeds” to the payee (e.g., Code §6045 (attorney fee/settlement reporting), §6050W (payments on credit cards or by third party settlement entities, for which withholding is required, starting in 2012, if the payor has not collected a TINs or ascertained the payee’s exemption from US tax), or where the amount reported is not even a cash payment (e.g., Code §6050P, debt forgiveness income).

   b. **Information Reporting Penalties.**

      The second Form 1099 processing program sends penalty notices to payors, for some (up to all) of the same Form 1099’s that attracted the B-Notices. These penalty notices, under Code §6721 and 6722, are sent at a different time than the B-Notices (usually 6 months after). Payors, in response, must explain what they have done in responding to B-Notices, and in operating their Form 1099 system.

   c. **Limited Application of 28 Percent Tax to Underreported Benefits.**

      Some IRS agents try to apply the 28% backup withholding tax under Code §3406 in cases where a company has failed to report income to an independent contractor. This penalty can be abated, if the company had obtained the worker’s taxpayer identification number (i.e., the Social Security Number or the EIN of the worker’s personal service corporation) before the cash or benefit was paid, because, technically, Code §3406 applies only where the worker “failed to furnish a TIN,” or the IRS notifies the company that the TIN furnished was wrong.
B. Overview of Special Procedural Rules and Tax Doctrines Governing Fringe Benefit and Other Payroll Tax Audits and Reporting Penalties.

1. The “Confusion Doctrine.”
   a. Overview.

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


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

   b. Objective vs. Subjective Confusion.

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

c. Possible Limitation to "Secondary Liability" Cases.

As applied in most circuits to date, the confusion doctrine has resulted in the waiver of the employer's liability not only for "secondary taxes" (i.e., FITW and employee FICA) but also liability for the employer's share of FICA. Some circuits do not extend the doctrine to the employer share of FICA taxes, however. See North Dakota State University v. U.S., 84 F. Supp. 2d 1043 (D.N.D. 1999), aff'd 255 F.3d 599 (8th Cir. 2001); HB&R v. U.S., 229 F.3d 688, 2000-2 U.S.T.C. ¶50,795 (8th Cir. 2000); and IBM v. U.S., 87 AFTR 2d ¶2001-389 (Fed. Ct. Cl. 2001). (The issue was also raised during oral arguments on February 3, 1999 of the appeal of American Airlines v. U.S., but it was never briefed; a full refund of the per diem employment taxes in dispute was ultimately paid in an out-of-court settlement. This refusal by some courts to allow any refund of employer FICA is troubling, and appears unsound from a policy standpoint, because employer FICA is merely the "matching half" of employee FICA. However, the Supreme Court, in Fior D'Italia v. U.S., 536 U.S. 238 (2002), was not persuaded by the argument that employee FICA taxes on tips must be "matched" by employer FICA taxes on the same tips, and by a wage history. Accordingly it is possible that if the split among the circuits on this issue is ever litigated, it is possible that the "confusion doctrine" will be limited to FITW and employee FICA taxes, thus requiring employers to pay the employer share of FICA, and FUTA taxes, despite its proof that the law is "confusing."

d. Limited Application to Refund Cases.

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

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

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

2. Interest-Free Correction Procedures.

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

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

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

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

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

Note: If an employer concedes an error in any audit cycle, it should immediately correct the same error that may have been continued in later audit cycles, because this "interest abatement" argument will not apply in the later cycles.
3. **“Reasonable Cause” for Abating Proposed Penalties for Failure to Deposit under §§6656 and 6651(a)(1) and Penalties for Incorrect Forms W-2 and 1099 (under §§6721 and 6722).**

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

The general reasonable cause guidelines on which taxpayers can rely are contained in IRM 20.1.4 (which updates the long-standing Policy Statements P-2-7 and P-1-18), and in section 6656 of the Code and the underlying regulations. According to P-1-18, "[p]enalties support the Service's mission only if penalties enhance voluntary compliance." IRM 20.1.5.1 (7/1/2008) reconfirms that penalties are designed to "encourage voluntary compliance." In other words, penalties are not intended to raise revenue or to punish for punishment's sake. Instead they are intended to promote voluntary compliance. Accordingly, any employer with both a record of deposit compliance and prompt corrective actions to correct deposit errors should not be subjected to deposit penalties, especially in any case where the error was made following a careful, comprehensive review of the applicable IRS guidance controlling the employment tax deposit requirements.

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

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

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

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

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

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

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

An important case is pending before the Tax Court, John J. McLaine v. Commissioner, Docket No. 15932-07L, which is expected to address the issues of (a) whether an employer’s payment of income tax withholdings might be creditable to employees; (b) whether the IRS as a matter of policy or practice does “collect taxes twice,” and (c) whether, if an employer’s tax payment actually or effectively were to stop an audit of the employee for the same taxes, the employer’s payment of taxes should be treated as “effective income” to the employees (thus triggering a gross-up, as happens for example, when an employer pays §409A taxes on its employees’ behalf, pursuant to Announcement 2007-18). (Years ago, the IRS has concluded that an employer’s tax payment was income to employees, in G.C.M. 39577 (Dec. 1, 1986) and PLR 8635004 (3/17/1986), each of which had concluded that where an employer “as a matter of practice, paid the additional income and employment tax liability of [its] employees, so as to maintain goodwill.” However, the IRS changed this position in FSA 20022004 concluded instead that where an employer has no right to collect the taxes from the
employees, and no historic practice of paying employees’ taxes, that its payment under Code section 3403 is not “income” to the employees.)

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

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

C. **Hot Audit Topics.**

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

   a. **Background.**

   Reviving audit tactics from the “Taxpayer Compliance Measurement Program” (“TCMP”) audits from the 1970s, the IRS announced in late 2009 that it plans to examine 6,000 taxpayers across the next three years. It appears, however, that the IRS will meet under half its original goal, and also that only @100 large companies will be audited. The major focus is on small companies, governmental entities, and exempt organizations. IRS spokespersons have acknowledged that the audits will be “invasive,” but so far it appears that the primary focus of this program is on smaller employers, and tax-exempt entities.

   **Note:** The IRS had hoped to use these results to prepare an extrapolated report on “business tax compliance” with all the issues under audit. However, in a Study dated May 17, 2011, the Treasury Inspector General for Tax Administration determined that the sample results (and, in particular the audit sample of large taxpayers) was “too small of a sample to provide meaningful compliance estimates.”

   **Note:** **Possible State Referrals.** Given increased coordination between the IRS and state tax agencies, it is possible that audit results will be coordinated with state tax authorities.
b. **Five areas identified for attention during original round of executive compensation examinations.**

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

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

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

(4) Payroll tax compliance overview. These questions will focus on W-4/W-9 collections, information return compliance and timing of payroll tax deposits).

(5) Worker classification/independent contractors. The focus of these audits will be, ultimately, to collect solid revenue estimates for an expected Administration proposal to repeal §530 of the 1978 Revenue Act.

Note: Many of the listed issues related to areas where the published guidance has been issued in final form and only relatively recently (e.g., golden parachute, split dollar life insurance, nonqualified deferred compensation, ISOs, ESPPs, and certain fringe benefits). Some taxpayers have simply not been paying attention to the new rules.

2. **Discounted and Backdated Stock Options.**

a. **Background.**

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

b. **409A Audits.**

Audits under §409A do not involve “withheld” taxes (unless the employer has failed to tax the compensation completely, which did not happen in the case of most
nonqualified stock options audits. However, the IRS attempted, through a 2006 settlement program, to require employers to pay taxes on employee’s behalf (on a gross-up basis).

c. **ISO Audits.**

Several audits are still continuing of ISO plans that were allegedly “backdated.” As a technical matter, these audits can actually *generate refunds* for the employer companies, since if the company failed to claim deductions with respect to options that were believed to be ISOs, the IRS’s challenge can yield corporate deductions with respect to exercises of the “disqualified” ISOs.

3. **Gift Cards and De Minimis Fringes.**
   
a. **IRS’s Challenge of “Gift Cards” as “Cash Equivalents.”**

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

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

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

Arguably, limited use gift cards do not constitute cash equivalents. See e.g. Prop. Reg. §1.274-8(c)(2) (and its pre-1987 predecessor regulation, Reg. §1.274-3(b)(2)(iv)), for purposes of the employee length of service/safety awards, this regulation provides that a “gift certificate” will be treated as an effective substitute for the employee award that could be purchased with the certificate (instead of as a substitute for cash), provided that the gift certificates are non-negotiable, not transferable, and not able to be used to receive cash or a reduction of a balance due on the employee’s account with the issuer of the gift certificate.

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

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

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

(3) prior to 1993, monthly transit passes provided at a discount not exceeding $21; $21 per month worth of tokens or fare cards; or, by technical correction, $21 per month in cash reimbursements to cover commuting. 1986 Act, S. Rept. No. 99-313 at 1026 and H. Rept. No. 99-841 at 11852; Reg. §1.132-6(d)(1). (Prior to July 1, 1991, the limit was $15.) The Energy Policy Act of 1992, Pub. L. No. 102-486, and several subsequent inflation-indexing statutes have created a statutory exclusion for “qualified transportation fringe” benefits (Code §§132(a)(5) and (f)), including, inter alia, monthly transit passes, in amounts that have been increased gradually from $60 per month, through $100 per month, (indexed for inflation), to (in 2009-2011) $230 per month.

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

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

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

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

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

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

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

(6) traditional birthday or holiday gifts of property with a low fair market value. (See Rev. Rul. 59 58, 1959 1 C.B. 17, covering Christmas hams and turkeys; but see Leschke v. Commissioner, T.C. Memo. 2001-18 ($61 gift nut baskets given to employees held to be taxable to the employees, and therefore deductible by the employer; although a potential exclusion under Code §132(e) was not addressed, presumably because the employer's counsel believed the case was easier to win if it were conceded that the nut baskets were “income” to the employees));

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

(8) coffee, doughnuts, and soft drinks;

(9) “group meals” (an undefined, but potentially very useful term);

(10) local telephone calls;

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

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

Note: None of these listed benefits is subject to any dollar limit (as even the IRS has admitted, in Information Letter 2008-0023). However, some agents, on audit, have adopted creative new readings of the list above, indicating that it applies only to “occasional tickets to Little League games and second-run movies, and to flowers from Wal-Mart, single pieces of fruit, and paperback books.” Obviously none of the italicized words are in the regulations, but this agent’s position shows the IRS’s narrow view of excludable fringes.

Note: In enacting Code §102(c)(to repeal any exclusion for “gifts” to an employee) and §74(j) (providing an exclusion for certain length-of-service and safety achievement awards), the 1986 Act “clarified” that the de minimis exclusion can apply to “employee awards of low value” not excludable under Code §74(c), or to “traditional awards (such as a gold watch) upon retirement for an employer.” 1986 Act Blue Book at 33 and
37 38; Prop. Reg. §1.274-8(d)(2). (Unfortunately, this proposed regulation is not scheduled to be finalized. See Notice 92-12, 1992-1 C.B. 500.)


a. Background.

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

b. 2011 Legislation Provides only Partial Relief.

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

(1) **Release of Guidance.**

On September 14, 2011, the IRS released Notice 2011-72 and related guidance to IRS examining agents (Control No. SBSE-04-0911-083), providing welcome relief that eliminates all recordkeeping requirements in connection with employer-provided cell phones and “other similar telecommunications equipment” that are provided to employees primarily for business purposes. Unfortunately (and probably intentionally), the Notice does not address cash reimbursements for cell phone use – that guidance was provided in a “Field Exam Memo” which instructs agents to GENERALLY apply similar relief to cash reimbursements. However, nothing was done to change, pursuant to “substantial authority,” the rule in Reg. §1.132-6(c) prohibiting cash (and cash reimbursements) from ever being a “de minimis fringe” – except in limited situations that do not involve cell phones. (Notice 2011-72 cites Reg. §1.132-6(c), warning again that cash fringes are not de minimis fringes, although the Field Exam Memo states that “agents should not necessarily assert that the employer’s reimbursement [for cell phone use after 2009] results in additional income on wages to the employee” [Emphasis supplied].)

(2) **General Relief.**

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

(a) Deductible expense, that is also

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

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

As for reimbursements for cell phones, employers should avoid:

(i) reducing salaries and substituting phone reimbursements;

(ii) paying for coverage not needed by the employee (e.g., international coverage for employees with only U.S. clients); and
(iii) "significant" increases in the reimbursed amounts.

(See the MLB Lawflash – attached and also available at:

(3) Guidance on Refunds for 2010 Not Provided.

For any employers who taxed employees on some portion of their cell phone use in 2010, arguably Forms W-2c could be issued, allowing employees to claim income tax refunds, and allowing employers to claim FICA refunds for themselves and their employees. Some employers and employees may not want the hassle of amending returns, however. Also, it is unlikely that the IRS would allow refunds where the employers had taxed any cash reimbursements for cell phones.

(4) Likely Reasons for Relief.

Both before and after the legislation was enacted, the IRS and Treasury Department were considering possible regulatory changes to the existing rules that would provide a more streamlined substantiation process for cell phones. See IRS Information Letter 2008-0012 (April 24, 2008) and Notice 2009-46 (soliciting public comments). See also, the MLB Lawflash http://www.morganlewis.com/pubs/EB_BusinessCellPhones+PDAs_LF_17jun09.pdf

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

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

5. **Tax Return Preparation for Expatriates and Company Executives.**

   a. **Background.**

   The “working condition fringe” exclusion applicable under Code §132(d) to benefits provided to employees that would be deductible by the employees, if paid for directly, does **not** apply to itemizable deductions, such as financial counseling, that are deductible under Code §212. *See* Treas. Reg. §1.132-5(a)(iii); Code §212; Rev. Rul. 73-13, 1973 1 C.B. 42; PLR 8547003 (7/31/85) and FSA 200137039 (6/19/01) (tax return preparation paid by employer).

   b. **Potential Ground for Exclusion.**

   Despite the IRS National Office’s generally adverse position about tax return preparation, the working condition exclusion should apply if and to the extent the financial counseling is deductible under Code §162 (e.g., advising the workers generally about the company’s benefit plans). A PLR request was submitted on this issue in 1988, requesting a segregation of the counseling provided into Code §162 and §212 components, but the IRS was unwilling to rule on the factual questions presented. *(See letter from Richard Skillman to IRS in Tax Notes Highlights, February 10, 1988.)* More recently, in at least one audit, an appeals officer agreed that the employer’s additional cost of tax-return preparation for expatriates was excludable from the employee’s incomes, so long as the employer had imputed at least the reasonable “fair market value” of preparation of a domestic tax return.

   c. **Continuing National Office Opposition to Exclusion.**

   In PLR 199929043 (April 22, 1999), the IRS ruled that the fair market value of financial counseling services provided to families of terminally ill employees and survivors of deceased employees are **not** excludable from income under 132(a)(3), but instead must be included in the terminally ill employee’s income or, alternatively, in the survivors’ income.

6. **Company Cafeterias and Other “Eating Facilities.”**

   Dozens of employers nationwide are currently facing audits (or court cases) involving their company cafeterias. The issues being raised include:
a. whether the eating facility’s revenues at least equaled the facility’s “operating costs,” in compliance with Code §132(e);

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

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

(1) the meals are excludable under §132 and are in fact provided in an “eating facility.” (The IRS has refused to agree that “non-traditional” eating facilities satisfy the regulatory definition);

(2) the meals qualify as “de minimis,” apart from the operating cost/operating revenue test of §132.

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

7. FICA Taxes on Tipped Employees’ Wages.

Until 2008, the IRS had conducted surprisingly few audits of employers with tipped employees, even after winning the Supreme Court case addressing the IRS’s ability to impose only the employer half of FICA taxes on estimated underpayments of tips by tipped restaurant employees. (See Fior D’Italia v. U.S., 122 U.S. 2117 (2002)). The scarcity of audit was in large part due to the many “TRAC” and “TDRA” agreements
between the IRS and employers in the restaurant, casino and cosmetology industries. However, since 2008, the IRS has been conducting many more of these audits, and expanding them to impose penalties on employees, after the "tip rate" has (allegedly) been determined by the agent.

8. Coordination with Corporate Audits on Timing and Amount of Compensation Deductions.

a. Overview.

Many payroll tax examinations also raise issues that carry over to the amount and timing of the corporation's tax deduction, relative to the year in which the income was recognized by the individual. Examining agents have discovered instances where the companies have been claiming deductions in years before the compensation was paid (e.g., without regard to the bonus accrual rules, or deduction timing rules applicable to deferred compensation) or are claiming deductions that could be denied under Code §§280G or 162(m). It has also discovered executives who have underreported income or never filed tax returns.

b. Bonus Accrual Challenges.

In several recent audits, examining agents have questioned the employer's entitlement to accrue a deduction for annual performance bonuses (paid within 2-1/2 months of the year-end), on grounds that the "all-events test" is not satisfied, since the final awards to cash of the bonus pool participants had not been determined as of the end of the accrual year, and further because the employer technically could have reduced the awards (e.g., because every employee had to work until the payment date) or cancelled the plan before payment. (See, e.g., Bennett Paper Corp. v. Commissioner, 78 T.C. 458 (1982).) The "identity of the bonus recipient" issue should not affect the bonus accrual, under Washington Post Company v. U.S. 405 F.2d 1279 (Ct. Cl. 1969) and U.S. v. Hughes Properties, 476 U.S. 593 (1986) (cf. Rev. Rul. 76-345, 1976-2 C.B. 134). However, the IRS concluded in CCA 200949040 (followed by the issuance of an "automatic change in accounting" procedure made by modifying Section 19.01(2)(a)(i)(B) of the Appendix to Rev. Proc. 2008-52, by Section 2.20 of Rev. Proc 2009-39, and by Section 19.01(2) of Rev. Proc. 2011-14) that if the employer imposed a "work to the payment date" requirement, the bonus would not be accruable (although this position remains questionable, pursuant to cases like Burnham v. U.S., 878 F.2d 86 (2d Cir. 1989)). Certainly, though, an employer's contractual and practical ability to reduce the bonus pool or cancel the plan may be affected by historic company practices, accrual-year board resolutions locking in the "bonus pool," and state contract law. In short, an employer's ability to avoid an audit adjustment on this issue will likely turn on its own facts, and the state law.

Note: The employer's continuing discretion to reduce (or cancel) bonuses prior to payment has also provided the IRS with grounds to prevent employers from applying FICA taxes in the year before the bonuses was
paid. Many employers filed refund claims for employees who terminated service in the bonus payment year before reaching the OASDI wage base. By relating the bonus back to the prior year (under Code §3121(v)), the employers hoped to exempt the bonus from FICA. The IRS rejected one such claim in FSA 199952005 (Aug. 11, 1999), on grounds that the bonuses were not vested until paid, and that the employer’s refund claim was filed in bad faith.

9. Other Deduction Disallowance Issues: “Schedule M Audits”.

IRS examining agents (including payroll tax examiners, but more frequently the corporate tax auditors), routinely question a host of different fringe benefit deduction items, which may (or may not) have been accurately reflected by the company onto Schedule M. These audits are not discussed in detail in this outline, but typical targets are:


b. $1 Million Cap (§162(m))

c. 50% Disallowance for Meals & Entertainment Expenses (§274(m))

d. Special Examination of Trucker Per Diems (and assignment of deduction disallowance to charities)

e. Spousal Travel

f. Entertainment Facility (Boats and Planes)

g. “Lavish” Expenditures and other 100% Disallowance Items

h. Pre-1996 COLI “Janitor Insurance” Policies. After winning a number of cases in the late 1990s involving COLI plans that lacked economic substance and business purpose (e.g., Winn-Dixie Stores v. Com’r., 113 T.C. No. 21 (1999), the IRS stopped raising these issues because most companies abandoned their plans. However, in 2010, at least one company was audited with respect to its pre-1984 COLI policy, on grounds that it did not satisfy the: “four out of seven” rule.
10. Valuation and Deduction of Meals, Airplanes, Travel Costs, etc.


These audits focus on:

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

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

b. Per Diem Plans.

At first, audits of per diem plans were industry-specific (only for airlines and truck companies), but now cover many industries. They typically focus on the amounts of the per diems; the documentation of whether employees were in fact "away from home;" the "recharacterization" of wages as per diems; and, the application of the 50% disallowance to per diems.

c. Moving Expenses.

Audits of moving expense plans typically focus on: the amounts of reimbursements; reporting and withholding issues on amounts over deduction limits and on mortgage interest reimbursements; and, the deductibility of home sale losses. The number of moving expense audits might have increased if there had ever been a decision in Gallo Winery v. U.S., but that case was settled without a decision. The taxpayer won its home sale loss deduction case in Amdahl Corporation v. Commissioner, 108 T.C. No. 29 (1997), on the grounds that the employer never took title to the house. When the same defense was raised in Gallo Winery, the government counterclaimed for payroll taxes on the loss (and home sale expenses) reimbursed to the employee.

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

These audits all focus on the operation of the de minimis exclusion, and on the proper valuation of these commuting trips.

e. Employee Awards.

(1) Dollar limits on awards for length of service and safety achievement;
f. Withholding and Reporting for Settlements Damages.

As an indication of the recent IRS activity in reviewing litigation settlements, the IRS issued (in 2008) detailed guidelines for its field agents to use in reviewing settlement, to determine whether damages (including both damages paid to plaintiffs, and amounts paid to attorneys) were correctly reported, and subjected to withholding taxes. See Program Manager Technical Assistance 2009-035.

D. Possible Active Future Audits.


   a. Background.

   Perhaps because of reviews of plans for potential §409A and §162(m) issues, many employers have realized that vesting-at-termination guarantees that apply to RSUs or restricted stock may trigger FICA taxes on the RSU in the year of vesting, or early taxation of the restricted stock. With FICA taxes and RSUs in particular, this failure to tax is surprisingly widespread. As a general matter, this failure to impose FICA taxes on vested RSUs has not bothered IRS agents, since the IRS reserves the right to FICA-tax at the point of distribution any compensation that had not been appropriately FICA-taxed at the point of “vesting.” Thus, in a rising market, and further taking into account the interest-free adjustment available (under Rev. Rul. 75-464), if a payroll tax underpayment error is corrected within the statute of limitations, the IRS on audit has very little incentive to require a company to go back to correct a FICA underpayment on RSUs - particularly since it has a continuing ability, even beyond the time that the statute of limitations has run on the vesting year, to collect FICA from the ultimate payment. However, in a falling market, the IRS DOES have a potential ability to collect more FICA taxes, by mandating that the employer go back to correct a FICA underpayment at the point of “vesting.” In addition, under Rev. Rul. 75-464, it must be shown that the employer made some reasonable “mistake” - instead of simply blatantly avoiding the law - in order to qualify for interest-free adjustment. The IRS may not be equally generous with restricted stock, however, because the income tax rules do not provide the IRS with optional dates on imposing taxes, so, even in a rising market, technically the IRS would be required to tax the restricted stock at the date the early-retirement conditions were met. Also, the IRS may raise significant taxes, if the restricted stock tax-timing is accelerated, if the officers holding the restricted stock had
other compensation over $1M, and if the restricted stock was not eligible for any performance exemption from 162(m).

b. **GCM 38739.**

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

c. **Code §3121(v) Issues.**

In any case where RSUs are subject to the special FICA/FUTA tax timing rules applicable under Code §3121(v) (as for any other NQDC), it is possible to delay the imposition of tax until the end of the year (the "rule of convenience" or until quarter one of the next year ("lag method")). These exceptions may help avoid any FICA penalty on RSUs.

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

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

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

In 1993-94, the IRS prepared a booklet (and videotape) for employment tax examiners, to alert them to “The Basics” of payroll tax audits. These materials included instructions on the fundamental principles of payroll tax examinations, as well as an *alphabetical* list of potential items that could be addressed in any payroll tax audit.
That list (only part of which are so far being covered routinely, in large corporate audits) appear below:

- automobile allowances
- awards or prizes
- back pay awards
- bonuses (cash or noncash)
- cafeteria plans
- chauffeur service
- communications equipment (such as car phones)
- company owned or leased aircraft
- company owned or leased vehicles
- company WATS line (personal use)
- country club memberships
- dependent care assistance programs
- disability payments
- discounts on property or service
- discounted airline passes
- educational reimbursements
- executive dining rooms
- estate planning
- financial counseling
- financial seminars
- free or subsidized lodging
- frequent flyer tickets used for personal purposes
- golden parachute payments
- group-term life insurance over $50,000
- holiday gifts
- home security systems
- income tax preparation
- legal counseling
- loans (low-interest or interest-free)
- local transportation for commuting
- luncheon-club memberships
- meal money because of overtime
- meal allowances/reimbursements (not away overnight)
- memberships in athletic facilities
- moving expense reimbursements
- nonqualified stock bonus plans
- nonqualified stock option plans
- outplacement services
- parking
- personal computers allowed to be taken home
• personal liability insurance
• physical examinations and/or use of health/medical facilities
• qualified stock options
• reimbursements of expenses on sale of personal residence
• retirement gifts
• safety or length of service awards
• severance pay
• scholarships or fellowships
• sick pay
• spousal travel
• uniform allowances
• use of recreation vehicles or boats
• use of vacation homes
• vacations (all expense paid or discounted)
• whole-life insurance

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

3. Whistleblower Audits.

a. Background.

A surprising number of recent audits of workforce-wide never-taxed benefits have arisen due to "whistleblower" complaints - which may be driven by disgruntled employees, former contractors, or business competitors – many of whom are attracted to file these reports out of a hope to benefit from the increased rewards payable to whistleblowers. These increased rewards were part of a little-noticed provision in a December 2006 tax bill, which increased the awards to informants who report perceived "tax abuses" by other taxpayers from the prior law reward levels of 10% to 15% (capped at $10M) to 15% to 30% of what the IRS collects. The new provision (in Code §7623(b)) applies increased benefits to any returns of individuals with gross income over $200,000, if the additions to tax, plus taxes, penalties, interest and other amounts in dispute exceed $2M. The increased reward applies if the tip leads to collection of taxes, penalties and interest of over $2M. (See W.S.J., "Legislation Raises the Rewards for Tips Uncovering Big Fraud," Dec. 20, 2006 at D-2.) There are tax law firms (e.g., the Ferraro Law Firm in D.C.) whose practice centers around assisting whistleblowers file these complaints.
b. Recent Increased Collections.

Historically, the IRS has paid only approximately 8% of the informants who came forward with specific information about tax evaders. Between the late 1960s and the 2006 statutory increase in the award levels, the IRS had received 258,000 reward claims (of which 20,000 claimants received rewards totaling $89M). The new legislation was intended to increase the incentives for people to become informants, and it appears that it has done exactly that. In its annual report for fiscal 2009 submitted to Congress and posted to the IRS website December 13, 2010, the IRS Whistleblower Office reported that “Many of the individuals submitting this information claim to have inside knowledge of the transactions they are reporting, and often provide extensive documentation to support their claims.” The FY 2009 report contained the following information on claims:

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cases Received</td>
<td>2,751</td>
<td>3,704</td>
<td>5,678</td>
</tr>
<tr>
<td>Number of awards Paid</td>
<td>227</td>
<td>198</td>
<td>110</td>
</tr>
<tr>
<td>Number of Awards over $2M</td>
<td>12</td>
<td>8</td>
<td>5</td>
</tr>
<tr>
<td>Amount of Awards Paid</td>
<td>$13.6M</td>
<td>$22.4M</td>
<td>$5.68M&lt;</td>
</tr>
<tr>
<td>Amounts Collected per Audits</td>
<td>$182M</td>
<td>$156M</td>
<td>$206M</td>
</tr>
<tr>
<td># of Affected Taxpayers</td>
<td>?</td>
<td>?</td>
<td>1,941</td>
</tr>
<tr>
<td># Filed (All Unpaid) Claims</td>
<td>?</td>
<td>476</td>
<td>460</td>
</tr>
<tr>
<td>Meeting §7623(b)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The pending claims are for enormously larger amounts than those shown above. According to a recent GAO report of April 2011, the IRS had received claims for over 1,400 whistleblowers including more than 9,500 taxpayers. The IRS reportedly has rejected approximately 1,300 claims, while 245 are near completion. Some claims have been paid, including one for $4.5 million. The many still pending claims cover unpaid taxes of over $100 billion; one single claim is for over $10 billion in taxes. (See W. S. Journal 9/10/2011 “IRS Whistleblower Program Faulted.”) Commentators on this most recent report have explained that they “believe that the IRS is on the verge of making payments under the new program, and when they do, informants will rush into the marketplace.” (2011 Tax Notes Today 240-4.)

One reason that awards under the 2006 statute have been delayed is that the IRS has been waiting not only until the whistleblower audits were concluded, but also until the two-year statute has expired on any refunds, before making payments. Another contentious issue between the IRS and practitioners and lawmakers has been the definition of “collected proceeds” used in determining the award. The IRS’s Internal Revenue Manual provisions covering section 7623, indicates that “collected proceeds” do not include offsets, application of net operating losses, refunds, or other amounts that might reduce a tax liability. Another controversial issue is that the IRS actually applied backup withholding to the award it has distributed (even though such withholding is not required, or even permitted, when the payor has the payee’s T.I.N.). Finally, some
whistleblowers have been concerned about maintaining their confidentiality, logically if they were required to sue for collection of their perceived proper reward.

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

Note: U.S. Tax Court held in 2010 that it had jurisdiction to review the IRS Whistleblower Office's decision to deny an award. (See William Prentice Cooper III v. Commissioner, 135 T.C. No. 4 (July 8, 2010).) This case, too, may have a significant effect on the numbers of filed reports.

Note: Another case is pending in Tax Court over a whistleblower's ability to suppress his identity by expurgating all identifying information from the pleadings and the ultimate decision.

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


Meals in kind furnished (with or without a charge) on the employer’s business premises and “for the employer’s convenience” are excludable from income under Code §119. No discrimination rules apply to this exclusion. Unfortunately for taxpayers, the IRS reads this exclusion very narrowly, to apply only where there are virtually no other eating establishments in the vicinity, so that it would take employees well over an hour to obtain a meal commercially. Several cases are pending in district courts on this issue. See also Boyd Gaming v. Commissioner, T.C. Memo 1999-45 (as partially overridden by IRC §119(b)(4), enacted with retroactive effect in 1998). Under the revised statute, if over 50% of the meals at a cafeteria satisfy §119, all the meals will satisfy §119. However, except in the casino, entertainment and hotel industries (which are eligible for an amazing industry-specific amnesty offer, provided by Ann. 98-78), the IRS is continuing to audit taxpayers, and routinely denies the existence of any Code §119 exclusion. (See, e.g., T.A.M.s 9502001 and 9143003.)

2. Per Diem Taxation Cases.

The tax treatment of per diems is still an issue that the IRS challenges in audits of truckers, nurses, and airline employees.

Note: A court challenge is pending with respect to the taxation of per diems of non-resident alien flight attendants.

3. Corporate Aircraft.

Numerous cases have been released in 2010 and 2011 dealing with small business owners who used their aircraft largely for personal reasons. (See, e.g., Peter
While most of the initial cases have involved taxpayers with insignificant business use, the Peter Morton case and other pending cases involve taxpayers that did in fact have significant business use, but the IRS is essentially challenging the plane deductions generally, on grounds that (a) the records were insufficient, (b) “charter rates” should have been imputed, and/or (c) any planes owned in LLCs by individuals cannot be deducted (or at a minimum are not eligible for accelerated depreciation – See TAM 200945037).

Note: Briefs will likely be filed in 2011 in a case challenging the deduction of a corporate aircraft held by a Subchapter S corporation.

4. Limited Tax Court Jurisdiction over Payroll Taxes.

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

a. The Tax Court will consider only cases that are certified by the IRS as ones involving worker classification; (See Notice 2002-5, modifying and superseding Notice 98-43);

b. Even in these certified cases, the Tax Court initially concluded that it had no jurisdiction to resolve the amount of taxes in dispute, or the related penalties (See Henry Randolph Consulting v. Commissioner, 112 T.C. 1 (1999) and 113 T. C. 250 (1999)), although its jurisdiction was expanded by the CRTRA, to include resolution at least of the taxes and penalties in dispute, in Evans Publg. Inc. v. Commissioner, 119 T.C. 242, 244 (2002) and Charlotte’s Office Boutique, 121 T.C. 89 (2003); and
c. Code §7436 is so confusingly drafted, it is not clear whether the remaining issues in a tax cases (not directly involving the classification issue) would be procedurally blocked from litigation in another court, after the Tax Court resolves the classification issue.

For these reasons, it is expected that most payroll tax cases will continue to be filed only in District Courts and in the Court of Federal Claims.

F. Payroll Tax Refund Claims.

1. Background of CSX/Quality Stores: Refund Claims for FICA Taxes on Involuntary Severance pay; and IRS Recent Actions in Denying Long-Pending Claims.


   In 1969, Congress designed special income tax withholding rules for certain involuntary severance benefits, after first recognizing that these payments are not “wages” for services, but instead are essentially payments for not performing services. However, to be sure that the terminated employees would have enough withheld taxes to pay their income tax bills on April 15 of the year after the severance, Congress designed special rules that “treated” these payments as wages subject to withholding, if the payments met the following conditions:

   • The amount must be paid under a plan to which the employer is a party;
   • The amount must be paid as a result of a reduction in force, discontinuance of a plant or operation, or other similar conditions; and
   • The employee must, in fact become separated from employment, either permanently or temporarily.


   b. IRS’s Narrow Exemption from FICA Taxes for “SUB Pay Plans.”

   Both before and after the enactment of Code §3402(o), the IRS has issued a series of revenue rulings, reflecting many different requirements and changes in position, outlining the conditions under which the IRS was willing to exempt certain
limited types of “supplemental unemployment benefits” from FICA taxes. (See Rev. Rul. 56-249, 1956-1 C.B. 488, Rev. Rul. 58-128, 1958-1 C.B. 89, Rev. Rul. 60-330, 1960-2 C.B. 46; Rev. Rul. 77-347, 1977-2 C.B. 362; Rev. Rul. 80-124, 1980-1 C.B. 212; and Rev. Rul. 90-72, 1990-2 C.B. 211.) The IRS never issued any FICA tax regulations outlining this exemption, nor did it ever concede in any of these conflicting rulings that the FICA exemption was as broad as the exemption from “wages” that Congress had recognized in adopting Code §3402(o).

c. **Supreme Court’s Decision in Rowan v. U.S.**

In 1981, the Supreme Court held, in *Rowan Companies v. United States*, 453 U.S. 247, 254 (1981), that certain longstanding IRS regulations under the federal income tax withholding provisions (“FITW”) (contained in Treas. Reg. Section 31.3401(a)-1(b)(9)), which created an exemption from FITW for certain meal and lodging expenses, were implicitly applicable for FICA purposes as well, even though no correlative exemption from FICA had ever been added to the FICA tax regulations, simply because both the FICA and FITW statutes were applicable only to “wages,” so if a particular benefit was exempted from “wages” for FITW purposes, it must similarly be exempted from “wages” for FICA purposes.

d. **“Decoupling Amendment” and Other Changes to FICA Rules in 1983.**

In 1983, as part of a series of changes (and revenue raisers) affecting the FICA tax provisions, Congress reacted to *Rowan* in several ways. First, it added a new FICA tax exemption for “meals and lodging” (in Code §3121(a)(19)) that is even broader than the regulatory exemption from FITW, since the FICA exemption applies not only to all meals and lodging that are excludable from income pursuant to Code Section 119, but also to any meals and lodging that “is reasonable to believe” are excludable under Code Section 119. Second, Congress added a new next-to-last sentence to Code §3121(a) to allow for regulatory distinctions between the exclusion from “wages” for income tax withholding and for other payroll tax purposes. That provision (called now the “decoupling amendment”) states specifically:

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 [the FICA tax] chapter.

The same legislation that made these changes also repealed several statutory exemptions from FICA taxes that applied to “retirement benefits” and to “stand-by pay.” However, this 1983 legislation did not address or discuss any FICA tax exemption for “involuntary severance pay.”
e. **CSX #1 and CSX #2.**

In 2002, in *CSX Corporation v United States*, 52 Fed. Cl. 208 (April 1, 2002) ("CSX #1") the Court of Federal Claims concluded that involuntary layoff payments are exempt from FICA taxes, provided only that these payments qualify as "supplemental unemployment compensation benefits" pursuant to Code §3402(o)(2), recognizing (as discussed above) that a statutory exemption from "wages" for FITW purposes must implicitly also apply to FICA taxes (unless the IRS had issued regulations saying otherwise). After a protracted appeal, this taxpayer-favorable decision was reversed in 2008 by the Federal Circuit Court of Appeals, in a decision which by its terms acknowledged "that this issue of statutory construction is complex and that the correct resolution of the issue is far from obvious." (*CSX Corporation v United States*, 518 F.3d 1328 (2008) "CSX #2").

f. **CSX #1 Refund Claims.**

Immediately after the release of *CSX #1*, and continuing until 2008, companies across the U.S. began filing claims for refund of the FICA taxes that had been collected from involuntary severance benefits. A few of these claims were actually paid by the IRS; and many others were "bundled" into a group of claims (that had been "purchased" by a company that has assumed the case would be affirmed on appeal), which in turn were filed as formal claims for refund filed in the Court of Federal Claims; ultimately these claims were all denied, after the decision in *CSX #2*. However, many other claims have simply been held in abeyance, pending ultimate resolution of the case in court.

Note: **Recent IRS Denial of Many of these Longstanding CSX #1 Refund Claims.** In February of 2010, the IRS began denying many of these longstanding claims (apparently believing that it would win the decision in *Quality Stores v. U.S.* – discussed below). Any employers who have received such claim denials should file an appeal of the denial (acting within 30 days of receiving the denial letter, if possible). It is assumed that these claims, plus all other refund claims, will continue to be "held in abeyance" until the IRS issues settlement guidelines to resolve this FICA tax dispute.

Note: However, employers must monitor these suspended claims, to be sure to obtain timely Forms 907 extending the deadline to file court cases claiming the refund (which, unless extended, is two years from the date of claim denial).

g. **Quality Stores v. U.S.: Decision, and Pending Appeal.**

On February 23, 2010, the Federal District Court in the Western District of Michigan, in *United States v. Quality Stores, Inc.* rejected the rationale of the Federal Circuit Court of Appeals in *CSX #2*, and instead adopted the reasoning and conclusion of
the Federal Court of Claims in CSX #1, holding that severance payments paid in connection with a reduction in force or other downsizing event are not "wages" subject to FICA taxes, because they fall within the exclusion allowed for supplemental unemployment benefits under Code §3402(o) and its legislative history, and further because these types of layoff benefit were simply intended to serve as "support for workers in lieu of a lost ability to earn wages," and thus "the collection of social benefit taxes on the wage-replacement benefits makes little sense." (Slip opinion at 12.)

Even though there is only $1,000,125 of FICA taxes at issue in the Quality Stores case itself, there are $2 to $4 BILLION in refund claims still pending (filed after CSX #1), and there likely will be hundreds of millions of dollars of additional claims filed after Quality Stores. Not surprisingly, on April 23, the government filed a Notice of its intent to appeal the decision to the Sixth Circuit. Briefs have been filed by the company and the government, and amicus briefs were filed by the American Payroll Association and ERIC.

Note: Likelihood of Success on Appeal? It is hard to "handicap" the chances that the taxpayers will prevail on appeal (or whether, if the Sixth Circuit affirms the Michigan District Court's decision, the Supreme Court would grant certiorari). However, it should be noted that in Appoloni v. U.S., 450 F.3d 185 (6th Cir. 2006), the Sixth Circuit affirmed a pro-government FICA tax decision by the Western District of Michigan, and reversed a correlative decision (sub nom Klender v. U.S.) by the Eastern District of Michigan, in paired FICA tax cases filed as class actions by teachers throughout Michigan seeking refunds of the FICA taxes that had been withheld on certain payments made in exchange for the relinquishment of statutorily granted tenure rights. However, in this Quality Stores opinion, the judge (writing for the Western District of Michigan) cites, and purports to follow, the reasoning of Appoloni, so, even though the FICA refund was granted in Quality Stores, and denied in Appoloni, it still seems likely that the Sixth Circuit may once again affirm this new decision by the Western District of Michigan (just as it previously affirmed the Western District of Michigan, in Appoloni).
2. Immediate Renewed Interest in Refund Claims, after *Quality Stores*.

   a. Marketing of “Claim-Filing Services.” Just as happened after *CSX* #1, starting in April 2002, news reports spread quickly about possible FICA-savings opportunities resulting from the *Quality Stores* decision. Some firms have proposed fees that include both fixed fees, plus variable add-ons, depending upon the amount of the potential FICA tax refund. Other firms proposed more reasonable filing fees ($2,000 to $3,000). Many employers (and some individual employees) have opted instead simply to file the claims on their own.

   b. Application for Refund Claims.

      Importantly, even if the employer has filed an extension of the statute of limitations for years before 2006 in connection with ongoing payroll audits, such an extension would not be deemed by the IRS to extend the time within which the employer may file a refund claim with respect to the employee share of FICA taxes. Instead, the IRS takes the position that years before 2006 (or, before 2007, for claims filed between April 15, 2010 and April 15, 2011), were not open for “*Quality Stores*” refund claims, because the employer’s extension of its own statute of limitations does not operate to extend the employee’s statute of limitations. (In general, a claim for credit or refund of employment taxes must be filed within 3 years from the time the return is filed or 2 years from the time the tax was paid, whichever of such periods expires later. (Code §6511(a)). For this purpose, employment taxes that are filed and paid before April 15 of the succeeding calendar year are considered to be filed and paid on April 15 of that calendar year. (Code 6513(c)).

      Note: It is not entirely clear that the IRS’s position on this issue (blocking any claims by employers with open statutes of limitation) would necessarily be sustained by the Courts, as is discussed below. However, the IRS nevertheless does take the position that the statute of limitations for 2006 expired on April 15, 2010, the statute of limitations for 2007 will expired April 15, 2011, and the statute of limitations for 2008 will expired on April 15, 2012, so employers should act quickly to file refund claims, if they have paid FICA taxes on involuntary severance benefits under any RIF or other layoff plan over the past four years.

   c. “Perfecting” the Claim by Contacting Employees.

      As a procedural prerequisite to the employer’s claim, before any employer can be paid its claimed FICA tax refund, the employer is required, by Treas. Reg. §31.6402(a)-2(a)(2)(i), Rev. Rul. 81-310, 1981-2 C.B. 241, Rev. Rul. 2009-39 I.R.B. 951, and *Chicago Milwaukee Corp. v. United States*, 40 F.3d 373 (Fed. Cir. 1994), to obtain (or at least to request) the written consents of the affected employees, before receiving any refund payments. Pursuant to these written consents, (when they are collected) each employee participating in this refund claim will: (a) authorize the Company to apply for the refund of the employee share of FICA taxes; (b) state whether
the employee has previously claimed a refund or credit of any portion of the over collected FICA taxes with respect to the termination benefit payments; and (c) confirm that he or she will not claim any additional refund or credit with respect to the FICA taxes for which the participant has authorized the Company to file a claim for refund. In the cases where the employees are contacted but do not provide the required consents, the Company should retain proof that the employees have been asked to provide consents; and is allowed to request a refund only for the employer half of FICA taxes. See also Macy's New York, Inc. v. United States, 484 Supp. 181 (S.D.N.Y. 1980), citing Entenmanns's Bakery, Inc. v. United States 465 F.Supp. 1118 (E.D.N.Y. 1979) (requiring an employer make some reasonable effort to adjust their overpayments to employees and former employees, including a letter to their last known address, prior to claiming a refund of only the employer half of FICA taxes).

Note: A different result was reached in Atlantic Department Stores, Inc. v. United States, 557 F.2d 957 (2d Cir. 1977), which imposes this requirement of “repayment or notification of employees” as a precondition to the employer-share FICA refund claim only for CURRENT employees. However, where the cost of contacting the employees is small relative to the size of the claim, the IRS’s position is that employers still should include employees in the employer-share refund claim (unless the employer, after making reasonable efforts, has not been able to obtain the employees’ consents).

Note: No Employee Response Ensures Collection of Employer Half of FICA. If the employee is asked to join the claim, but does not consent (or does not even answer), the employer then claims just the employer half of the FICA tax. Notably, some employees may have received OASDI refunds as a result of some other job by claiming a Code §31(b) credit. Unfortunately, such claims MAY block the employee from joining the employer’s claim under the current (but out-of-date) FICA tax refund regulations, even though the employee has never obtained through this credit any refund of Medicare taxes. However, we have drafted consent forms so as to ensure that even if the employee claimed the 31(b) credit, the employee can nevertheless join the employer’s claim with respect to Medicare taxes.

d. No Need to “Perfect” Before Claim is Filed.

Employers are NOT required to “perfect” the claims before filing a refund claim for a prior year. But, if employers are involuntarily terminating employees in 2010, it is advisable to include in the severance package the requisite “consent forms,” so as to eliminate the need to collect the consents in future years.

Note: If these consents are collected from employees as they terminate, then the refund claims in future years could be assembled quickly, without any need to spend time hunting back through old records to discover the
classes of RIF'd employees who would be affected by a claim. (Employers should also make sure the records of RIF'd employees, at least starting in 2010, are organized under some system, so as to simplify any future refund claim filings.)

e. Timing of “Perfecting” the Refund Claim.

The IRS recognizes that claims do not have to be “perfected” before they are filed, but it generally requires employers to “perfect the claims” within a “reasonable period of time” after the claim is filed. See G.C.M. 38786 and I.L.M. 200029030. (On the other hand, most of the claims filed under CSX #1 have still never been “perfected.”) If the IRS were to start to insist that all these outstanding claims must be “perfected,” this means that the employers have to go through the expense and hassle of contacting each of the affected employees, to ask them to join the claim (or not join the claim), and sign (or, possibly, return by e-mail) the paperwork required by the regulations. The employer also has to determine which employee’s claim involves “full FICA” and which involve Medicare taxes only. The initial claim can be filed with only “estimates” of the taxes to be refunded, but the IRS is insistent that the follow-through must occur BEFORE the IRS will consider the substance of the claim. (Most taxpayers of course would prefer to debate the merits of the claim first, then decide whether or not to incur the expenses of contacting employees, calculating the precise amount involved, etc.) Nobody knows how long the IRS will let employers “stall” without collecting this information.

f. Benefits of Filing Claims Joined by Both Employers and Employees.

Apart from the obvious benefit of avoiding an IRS attempt to deny the claim for a procedural failing, there are three additional reasons supporting the filing of claims that include the employee share of FICA taxes. First, should the claim need to be litigated, it is helpful to be able to represent to the court that employees will also benefit from a decision in taxpayer’s favor. Second, if separate or different claims are filed by employees and employers, it becomes more difficult to represent whether both sides in fact believe that the payments in question are not “wages” in the first instance. Third, when an employer is soliciting employee consents, it is possible to explain to employees that the costs of filing the claim will be pro-rated between the employer and employee shares of FICA (or, alternatively, that the employer will retain the interest on the employee share, to help cover expenses).

g. Advice Against Taking “No FICA Tax on Severance” Filing Positions on Original Returns.

Employers should not take positions on original quarterly Forms 941 or on any Forms W-2 (for 2010 or later years) that involuntary severance payments are suddenly completely exempt from FICA taxes, after Quality Stores, without conducting a careful risk assessment. It is also not advisable for an employer to file “claims for credit” of prior years’ FICA taxes, thus obtaining “immediate” refunds, without asking the IRS
to review the claims, because the IRS can charge the employee with a deficiency with respect to BOTH employer and employee FICA taxes, for as long as the employer’s statute of limitations remains open with respect to returns on which such FICA tax exemptions were claimed. Moreover, in the event that Quality Stores is reversed on appeal, the employer would owe interest and penalties for both halves of FICA taxes, if it does not act immediately after the case is reversed to voluntarily pay to the IRS both halves of the FICA taxes that it failed to pay in the prior years.

Note: It is not possible to file a claim for credit of overpaid FICA taxes for 2007 at this point in any event, since pursuant to the “90-day rule” established by Treas. Reg. §31.6413(a)-2(d)(2) (effective in 2009), no overpayment adjustment through such a claim for credit may be made if the overpayment relates to a return period for which the period of limitations under section 6511 will expire within 90 days of filing the adjusted return. (The purpose of the 90-day rule is to give the IRS time to process the request for an overpayment adjustment.) Claims for refund, however, may be filed up until the expiration of the statute of limitations. See also Rev. Rul. 2009-39, 2009-52 I.R.B. 951.

Note: This recommendation not to claim automatic FICA tax credits is based upon a concern that even if Quality Stores is affirmed by the Sixth Circuit, the IRS will certainly continue to oppose this position in other circuits (unless and until settlement guidelines, or new regulations are issued). Settlement guidelines are being considered, but it is still not known whether the IRS will attempt simply to reject all the CSX refund claims that have been filed to date, or granted some percentage, depending on the facts. No decisions will be made until after the oral argument on October 6, 2011.


Outlined below is a brief overview of the particulars that an employer (or employee filing individually) would need to assemble in order to file a FICA tax refund claim based on the Quality Stores decision. First, you'll need to collect, for all the years for which refund claims are filed:

- The RIF plan (or at least the SPD explaining the involuntary layoff program);

Note: There is no need to say a lot about these plans, but it is advisable to say enough to be sure that the IRS does not try to knock out the claim later on "variance" grounds.

- Short description of the reasons for the layoffs, and an estimate of the numbers laid off;
• Best estimate of the amounts paid, and the FICA taxes over-collected;

Note: The precise amount claimed need not be stated immediately, but if the claim amount is not known with precision, then after the estimated refund amount, the claim should include the standard "magic language" used when the exact number for the refund claim is unknown, i.e.,: "$XXX, or such greater or lesser amount as shall ultimately be determined, after all supporting documentation and employee consents have been processed." Some companies include this language not only in the description of the claim to be attached to each Form 941-X, but also in a footnote added to the front of the Form using the same words.) In addition, it is generally not advisable to state only "$1.00" for the amount claimed, even though some companies do that, simply because the recent Court of Federal Claims cases on "variance" reject refund claims that are subsequently supplemented after the statute would have expired, by new facts and new legal arguments.

• The Forms 941 (plus any later-filed Forms 941c or Forms 941-X) for the affected quarters in which the amounts were paid;

• Claimant(s)' filing district(s) for the Forms 941.

b. Refund Claim Package.

Using the information outlined above, the taxpayer should complete one Form 941-X for each calendar quarter covered by a refund claim, which reflects the wage and tax adjustments for each such four calendar quarters. As an attachment to all the Forms 941-X, the employer should include a memorandum explaining the claim, and the legal reasons that it should be granted.

Note: Need to Amend Form 941-X to Explain Collection of Employee Consents. Because the employer typically does not have time to collect employee consents before the refund claim is filed, the employer must include in the memorandum supporting the claim (either on Line 21 of Form 941-X or in the memorandum attached to the claim), by stating that the employer is still in the process of collecting those consents.

Note: Entity by Entity Claim. If more than one company in the corporate group filed Forms 941 (and prior Forms 941c), a different set of claims must be filed for each company.

Note: Tie-back of Amounts to Forms 941 (or 941c Already on File). The Forms 941-X should use as the "starting point" the wages and taxes previously reported for each of the quarters by each entity filing a claim. Often the hardest part of the filing is pulling together all those prior
returns. Indeed, in preparing CSX filings for 1998, some companies simply could not locate all their 1998 Forms 941, in which case simply filing a Form 843 with no attachments was the only thing that could be done. Although the validity of these filings may be challenged by the Service, any filing is better than none at all, if there is significant money at issue.

4. **Steps to Follow if the IRS PAYS the Refund.**

If any claims are inadvertently paid, the employer probably should retain the money for two years before paying the employee, because the IRS has two years within which to collect any “erroneous refund,” under Code §6532(b). As noted above, if any company were to take the very aggressive position that RIF payments are exempted from FICA taxes (without taking steps to ensure that its employees would repay to the employer the employee half of FICA taxes that was either not withheld or claimed on refund and repaid), and if the IRS were to audit, and discover this aggressive position, the IRS would unquestionably assert that the employer is liable, not only for its own half of FICA, but also "secondarily liable" for the employee half of FICA taxes (plus interest and penalties).

5. **Possible IRS Reaction to Block or Discourage Refund Claims.**

a. **Require “Perfection.”**

The IRS may try to require “perfection” of the claim to limit the refund.

b. **Deny Claim; Requiring Appeal.**

Alternatively, the IRS may simply “deny” the claim, forcing the taxpayer to appeal, and hoping that taxpayers will forget to request a Form 907 delaying the deadline for appeal.

c. **Legislative or Regulatory Solution.**

It is possible that the IRS may move to issue regulations, or takes some other legislative effort to enact legislation to block future claims. (This tactic of a “statutory block on refunds” has been used before, in the mid-1980's., and the IRS’s issuance of regulations to resolve long-standing FICA disputes was approved by the Supreme Court in *Mayo Foundation for Medical Education and Research v. United States*, Sup. Ct. Dkt. No. 09- --- S. Ct. 2011), although disputes continue (e.g., in *Intermountain Insurance Service v. United States*, No. 10-1204 (scheduled for oral argument April 5 before the DC Circuit), and several other pending cases addressing whether any such clarifying regulations could be retroactive.
d. **Claims of Offset or Counterclaim against the Employer.**

It is conceivable, but less likely that the IRS may try to assert countervailing claims against the employer, to avoid paying a refund. Certainly these claims would likely be unsustainable with respect to employee-share FICA taxes; and possibly also against employer-share FICA taxes.

6. **Possible Issuance of Explanatory Employee Letters, for Employees Wanting a FICA Exemption.**

In this internet era, it is likely that many involuntarily terminated employees will find out about *Quality Stores*, and demand to know why their employer has withheld FICA taxes on their severance pay. It may therefore be advisable for employers to prepare a response letter, explaining that the company will eventually take the proper steps to get a refund, if one is due. Alternatively, if any individual employees want to file for their own refund, they are entitled to do so on their own.

G. **Section 162(m) Audits - New Proposed Regulations on “Per Person Caps.”**

1. **Series of Recent Taxpayer-Adverse Rulings.**

a. **Narrowing and Retroactive Announcements.**

The IRS National Office has been issuing both formal and informal guidance in recent years that significantly (and often without adequate authority) narrow prior announced pro-taxpayer positions under §162(m). These narrowing, and sometimes retroactive announcements started with Notice 2007-49, 2007-25 I.R.B. 1429 (which prohibits plans from permitting termination-based payouts of performance bonuses), and continued through Rev. Rul. 2008-32, 2008-27 I.R.B. 1,(concluding that a person who served as an “interim CEO” could never qualify as an outside director); and include CCAs 200850012 and 200923030 (limiting any exemption from §162(m) for target companies, and reversing prior favorable PLRs).

b. **Unclear Rules on “Covered Employees.”**

In Notice 2007-49, 2007-25 I.R.B. 1429, the IRS narrowed the class of covered employees to four individuals, to parallel changes in the SEC’s proxy reporting rules. The Notice thus counts only one of the two officers identified under the disclosure rules based on position - the “principal executive officer (within the meaning of the amended disclosure rules)” - while exempting the CFO, who is the other officer that the SEC’s amended disclosure rules count based on position. The Notice also counts three officers based on compensation (“if the total compensation of such employee for that taxable year is required to be reported to shareholders under the Exchange Act”). On audit, the IRS has admitted that if any executive listed in the Summary Compensation Table leaves before year-end, that officer’s compensation is exempt from §162(m), and
no other officer fills that spot – but the Notice and other recent private rulings are not entirely clear that this result necessarily applies.

c. Audits of Executive Expenses.

In several recent audits, the IRS has disallowed deductions under §162(m) for planes, cars, expenses, and even legal expenses, despite the fact that these expenses are not treated as “compensation expenses” (under Reg. §1.162-25 and -25T), or are not even “income” (either because of valuation rules, or due to the application of working condition fringe exclusions), and thus should be automatically exempt from 162(m). Worse yet, even though the IRS’s position are not supported by regulations, in two instances, the IRS has increased the proposed tax assessment by civil fraud penalties, under §6663.

2. New Proposed Regulations on “Per Person Caps.”

On June 24, the Internal Revenue Service (IRS) issued proposed regulations clarifying the scope of the performance-based compensation exception to the $1 million deduction limit under Internal Revenue Code (Code) Section 162(m). The proposed clarifications apply retroactively to plan limits for stock option and stock appreciation right (SAR) grants, and prospectively limit existing transition rules that have provided a limited exemption from the §162(m) limits for private companies that become public. (See the MLB Lawflash – attached and also available at: http://www.morganlewis.com/pubs/EB_LF_Performance-BasedEquity%20CompensationException_29june11.pdf)