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When Excludable Fringe Benefits Aren't Excludable: IRS Audit Defense Planning for Executive Benefits & Other Fringe Benefits

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Agenda

- Fringe Benefits Potentially Affected by OBBBA
- Potential Tax, Penalty & Interest Exposures
- Common Fringe Benefit Audit Issues
  - Business use of personal residences
  - Dependent tuition remission
  - University-provided lodging and meals
  - Air travel (private/charter and spousal)
  - Coach buy-outs
  - Business expense reimbursements
  - Use of gift cards
- Audit Defense Procedural Considerations
  - Valuation concepts
  - Reasonable belief
  - Confusion doctrine

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Fringe Benefits Potentially Affected by OBBBA

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Fringe Benefits Potentially Affected by OBBBA

- UBIT on IRC 132(f) qualified parking and qualified transportation fringes (OBBBA § 112024)
- Permanent elimination of IRC 132(f)(1)(D) qualified bicycle commuting fringe (OBBBA § 110012)
- Enhancement of IRC 127 employer-provided educational assistance fringe (OBBBA § 110113)
- Employee deduction for qualified overtime compensation (OBBBA § 110102)
- Increase 1099 de minimis threshold to $2,000/year (inflation indexed) (OBBBA § 111105)
- Enhancement of IRC 23(a) adoption credit (OBBBA § 110107)

IRC 4960(c)(3)(A) imposes the excess tax-exempt organization executive compensation excise tax on “wages” as defined by IRC 3401(a), so IRS characterization of fringe benefits from nontaxable to taxable could result in substantial payroll tax and penalty adjustments (next section) and IRC 4960 excise taxes.

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Potential Tax, Penalty & Interest Exposures (Why It Matters)

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Potential Tax, Penalty & Interest Exposure

A. Employer liability for under-withheld income taxes (IRC § 3403).	Currently 22% and 37% for supplemental wages over $1M)
B. Employer liability for under-withheld employee FICA taxes (IRC §§ 3101 and 3102(b)).	7.65% of unreported income up to OASDI base ($176,100 in 2025). This is increased by a 1.45% (Medicare tax) on excess (plus 0.9% in Ad Med Tax, for employees with wages over $200,000)
C. Employer liability for employer FICA taxes (IRC § 3111).	7.65% of unreported income up to OASDI base ($176,100 in 2025). This is increased by a 1.45% (Medicare tax) on excess (plus 0.9% in Ad Med Tax, for employees with wages over $200,000)
D. Employer liability for FUTA taxes (IRC §§ 3301 and 3306(a)).	6% of unreported income up to $7,000 of total income (state SUI offsets may apply).
E. Penalty for failure to timely deposit withholding and payroll taxes (IRC § 6656 and Rev. Rul. 75-191). This failure to deposit penalty does not apply where taxes were not withheld (*e.g.*, either in a case where income is not reported, or where no withholding was collected).	10% of underreported employer FICA/FUTA taxes discussed in C. and D., plus 10% of all income tax withholding and employee FICA taxes that were withheld but not deposited.
F. Penalty for failure to pay employment taxes required to be shown on payroll tax return within 10 days of notice and demand (IRC § 6651(a)(3)).	25% of total taxes under A., B., C. and D. (penalty is 0.5% per month of underreporting, up to 25%); penalty can be avoided by simply paying within 10 days of notice and demand.
G. Penalty for negligence, disregard of rules or regulations, and substantial understatement of tax (IRC § 6662).	20% of underpayment of employment taxes. IRC § 6664(c)(1) provides that the penalty may not be imposed with respect to the portion of an underpayment if the taxpayer acted in good faith and there was reasonable cause for the underpayment.
H. Penalties for incorrect or untimely Form W-2. (1) Incorrect Form W-2 to IRS (IRC § 6721). (2) Incorrect Form W-2 to employee (IRC § 6722).	For 2024 returns filed in 2025, $330 per W-2, up to maximum of $3,987,000 (Rev. Proc. 2023-34) for all such failures in the aggregate for the year ($60 per W-2, with $664,500 annual cap if corrected within 30 days of the required filing date, or $120 per W-2 with $1,993,500 annual cap if corrected on or before Aug. 1) or, in case of intentional disregard, greater of 10% of incorrectly reported amount or $660 (with no annual cap).
I. Penalty for willful failure to furnish Form W-2 or willful furnishing of false or fraudulent W-2 (IRC § 6674).	$50 per W-2.
J. Interest is charged on the entire assessment of taxes and penalties (IRC § 6601(a) - (b)). The interest rates, fixed by IRS regulations and rulings, are higher than market rates (IRC §§ 6601 and 6621). Interest is NOT charged in the "first" payroll tax audit (Reg. § 31.6205-1(a)).	Varies by quarter based on 3 percentage points (or 5 percentage points for large corporate underpayments) over the federal short-term interest rate.

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