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INTERNAL REVENUE SERVICE
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OFFICE OF
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MEMORANDUM FOR District Counsel, Delaware-Maryland (Baltimore, MD)
Attn: Robin W. Denick

FROM: Chief, Branch 2, Office of Associate Chief Counsel
(Employee Benefits & Exempt Organizations)

SUBJECT: Advice regarding when to issue a Notice of Determination Concerning Worker Classification Under Section 7436 with respect to a worker who is a corporate officer

You have asked for technical advice concerning when it is appropriate to issue a notice of determination concerning worker classification under section 7436 (hereinafter "notice of determination") with respect to a worker who is a corporate officer. You note that there is confusion over this issue because some Service personnel are making the issuance of a notice of determination dependent upon taxpayer's eligibility for participation in the Classification Settlement Program. We welcome the opportunity to provide some written guidance in this area, as similar questions have been arising in other forums recently.

1. General Information about Notices of Determination

Section 7436 of the Internal Revenue Code of 1986 creates new Tax Court review rights concerning certain employment tax determinations. Specifically, section 7436 provides the Tax Court with jurisdiction to review determinations by the Service that workers are employees for purposes of subtitle C of the Code, or that the person for whom services are performed is not entitled to treatment under section 530 of the Revenue Act of 1978. A prerequisite to Tax Court review is that the taxpayer receive a notice of determination. See Notice 98-43, 1998-33 I.R.B. 13.

The statutory language of section 7436(a)(1) describes the Tax Court's power to review petitions only if:

> in connection with an audit of any person, there is an actual controversy involving a determination by the Secretary as part of an examination that—
>
> > (1) one or more individuals performing services for such person are employees of such person for purposes of subtitle C, or
> >
> > (2) such person is not entitled to the treatment under section 530 of the Revenue Act of 1978 with respect to such an individual . . .

From the statutory language used to describe the court's power, we see that four requirements must be met before the court can hear a taxpayer's case. Accordingly, those four requirements must be met before issuing a notice of determination.

The first requirement for issuing a notice of determination is that an audit has been conducted. When the Service concludes that employment taxes are due as a result of math errors or that workers should be classified as employees on the basis of the evaluation of a form SS-8 or a private letter ruling, no Tax Court review of that conclusion is available under section 7436 and no notice of determination should be issued. We are assuming from your request that you are seeking advice in the situation where an audit has taken place.

The second, third, and fourth requirements for issuing a notice of determination involve the scope of the "actual controversy" language of the statute. The second requirement is that there must be economic consequences that result from the Service's determination that workers are employees. If there is no tax liability at stake and the issue is purely "academic," no notice of determination should be issued because the Tax Court will not have jurisdiction over the case. We are assuming from your request that you are seeking advice for the situation where there are economic consequences resulting from the Service's determination, i.e., that the Service proposes an assessment of tax.

The third requirement for issuing a notice of determination is that the Service's proposed assessment must be for employment taxes described in subtitle C (sections 3101 to 3510) of the Internal Revenue Code of 1986. Subtitle C contains provisions describing taxes under the Federal Insurance Contributions Act (FICA), the Federal Unemployment Tax Act (FUTA), the Railroad Retirement Tax Act (RRTA) and the provisions requiring employers to withhold federal income taxes from wages. Thus, even if an audit involves the determination whether workers should be classified as employees, if the result of the audit is to disqualify a retirement plan, rather than to propose an assessment of employment

taxes under subtitle C of the Code, no notice of determination should be issued. We are assuming from your request that you are seeking advice for the situation where an assessment of employment taxes is proposed.

The fourth requirement for issuing a notice of determination is that there is an actual controversy involving a determination by the Service that taxpayer is not entitled to treatment under section 530 of the Revenue Act of 1978 and that there is an actual controversy involving a determination by the Service that the workers at issue are taxpayer's employees. As a matter of policy, the Service does not issue a notice of determination until the Service has made a determination on both issues. See Notice 98-43, supra at 13. Moreover, the Service examines eligibility for section 530 treatment before turning to whether the workers should be classified as employees. The statutory language provides, however, that the Court has jurisdiction over each controversy in the alternative. Thus, if taxpayer concedes in the Tax Court that it is not entitled to section 530 treatment, the court will nevertheless have jurisdiction over the classification issue. Similarly, if the taxpayer concedes in the Tax Court that the workers are employees, but asserts that it is entitled to treatment under section 530, the court will have jurisdiction over the section 530 issue.

Sometimes, during the audit or on appeal, a taxpayer concedes both the classification issue and the section 530 treatment issue, and the taxpayer signs a closing agreement that contains the following explicit language waiving the restrictions on assessment contained in sections 7436(d)(1) and 6213:

> I understand that, by signing this agreement, I am waiving the restrictions on assessment provided in sections 7436(d) and 6213(a) of the Internal Revenue Code of 1986.

See Notice 98-43, supra at 14. If such a waiver is signed, then there is no "actual controversy involving a determination" that the workers are employees or that the taxpayer is not entitled to section 530 treatment. As a result of the explicit waiver of the restrictions on assessment of employment taxes based on worker classification, the fourth requirement for a notice of determination is not met and no notice of determination should be issued. Following a validly executed waiver (as described above), the employment taxes can be assessed without issuing a notice of determination.

But, if taxpayer concedes only one of the issues during the audit or on appeal, and continues to contest the other issue (so that a waiver of the restrictions on assessments is not signed in a closing agreement), an actual controversy is deemed to exist with respect to both determinations. This is true because regardless of the position taken during an audit or an appeal, taxpayer is entitled to a de novo review of the Service's determinations by the Tax Court. Since taxpayer is legally permitted to raise both issues in its petition, even if it conceded one issue

before a notice of determination is issued, a notice of determination must be issued with respect to both determinations (classification and section 530 treatment).

Also, a controversy exists with respect to the two determinations (classification and section 530 treatment) where a taxpayer is silent about its views concerning either determination. This may occur if taxpayer is not available to discuss the case with the examiner or if taxpayer is generally uncooperative. Thus, silence is deemed to create a controversy concerning the determinations.

Finally, there sometimes is confusion about whether there is an actual controversy with respect to the Service's determination that the workers at issue are taxpayer's employees. For example, if the taxpayer asserts that the workers are independent contractors or lessees but the Service asserts that they are employees, there is an actual controversy concerning the Service's determination that the workers are employees and a notice of determination should be issued.

A different result occurs, however, where the taxpayer is already treating the workers as employees by withholding income taxes and the employee portion of FICA tax, by paying the employer's portion of employment taxes with respect to wages and by issuing forms W-2 to the workers. Even though a controversy arises concerning whether a portion of the payments to the workers constitutes "wages" subject to employment tax, since the taxpayer is already treating the workers as employees, there is no "actual controversy involving a determination . . . that . . . one or more individuals performing services for such person are employees." Thus, where the workers are being treated as employees by the taxpayer, no notice of determination should be issued.

2. Issues involving Corporate Officers

In the context of employment tax examinations involving payments to corporate officers, confusion can arise with respect to whether there is an "actual controversy involving a determination . . . that . . . one or more individuals performing services for such person are employees." A common situation is where an individual is both an independent contractor for a corporate taxpayer and serves as an officer of that corporation, and the taxpayer treats all payments to the individual as payments to an independent contractor. That is, the taxpayer files forms 1099 with respect to all payments to that individual, and files no form W-2 with respect to that individual. At the audit, the Service determines that a portion of the payments to the corporate officer are for services performed in his capacity as a corporate officer and proposes an assessment of employment taxes with respect to the payments that constitute remuneration for services performed in the capacity as a corporate officer. The taxpayer asserts that no payments made to that individual are for services performed in that person's capacity as an officer because all payments are made to the individual in his capacity as an independent contractor for the corporation. In such a situation, since the taxpayer does not treat the

individual as an employee, a controversy exists whether the individual is an employee. See § 3.03, Rev. Proc. 85-18, 1985-1 C.B. 518 (interpretation of term "treat"). As a result, a notice of determination should be issued.

Nor does that result change if the taxpayer admits during the audit that the individual is an employee but argues that no remuneration was received by that individual for services as an officer. Since the taxpayer has not been treating the individual as an employee, and the Service determines that the individual is performing services in his capacity as an employee, that disagreement constitutes an actual controversy involving a determination that the worker is performing services as an employee, and a notice of determination should be issued.

Some Service personnel have asserted that because corporate officers are "statutory employees," a notice of determination need not be issued. But nothing in the statutory language of Code section 7436 makes the Tax Court's power to review worker status limited to a determination based on the common law analysis of worker status. See also § 3.09, Rev. Proc. 85-18, supra (definition of employee for purposes of section 530 treatment is not limited to IRC § 3121(d)(2)). The Tax Court has the power to review determinations made under statutory provisions establishing worker status. Thus, whether the Service's determination is based on the common law or a statutory provision that provides that an individual is deemed an employee (e.g., IRC § 3121(d)(1), (3)) or a statutory provision that provides that an individual is deemed to not be an employee (e.g., IRC § 3506, § 3508), so long as there exists an actual controversy involving whether a worker is an employee (and the other requirements of section 7436 are met), a notice of determination should be issued.

Some Service personnel have questioned whether an actual controversy can exist concerning the status of a corporate officer, in particular, since Code section 3121(d)(1) specifically states that "the term 'employee' means any officer of a corporation" and Code section 3401(c) provides that "[t]he term 'employee' includes a corporate officer." They assert that since the statute classifies the corporate officer as an employee, it is impossible to have a valid controversy over the issue, so that no notice of determination should be issued. But the regulations under the statutory provisions clarify that there are circumstances under which the officer will not be considered an employee. Section 31.3121(d)-1(c) of the Employment Tax Regulations provides:

> Generally, an officer of a corporation is an employee of the corporation. However, an officer of a corporation who as such does not perform any services or performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any remuneration is considered not to be an employee of the corporation. . . .

See also Treas. Reg. § 31.3401(c)-1)(f). Thus, where a taxpayer is asserting that the corporate officer at issue performs no services or only minor services as a corporate officer and that the officer is not entitled to remuneration in his capacity as a corporate officer, a disagreement can exist under the regulations as to whether the person is to be deemed an employee of the corporation. Because a valid legal disagreement can exist with respect to the services that are being compensated, there can exist a controversy involving the determination that an individual who is a corporate officer is an employee. So, if the other requirements for a notice of determination are met, a notice of determination should be issued despite the fact that the employment tax statutes include officers as employees.

Some Service personnel have questioned whether a notice of determination should be issued in situations involving an owner of a closely-held corporation who also performs services for the corporation. For example, the officer of a closely-held corporation is already receiving wages as an employee, but because the individual is also an owner, the corporate officer/owner is receiving profit distributions as well. In the audit, the Service determines that some of the payments characterized by taxpayer as profit distributions should be characterized as wages, subject to employment taxes. Even though the taxpayer objects to the change in the characterization of the payments, such a situation does not involve a controversy whether the individual officer/owner is an employee. The taxpayer is already treating the individual as an employee by withholding income taxes and the employee's portion of FICA, by paying the employer's portion of employment taxes with respect to some payments and by issuing forms W-2 with respect to the individual. When the Service determines that some of the payments are wages rather than profits, the controversy involves the proper characterization of the payments, not the proper status of the individual. Thus, when the Service asserts that additional payments to an employee should be treated as wages, the fourth requirement of section 7436 is not met and no notice of determination should be issued.

Occasionally, a closely-held corporation makes payments to its owner/officer, with some payments treated as remuneration for services in his capacity as an independent contractor for the corporation and some payments as profit distribution of the corporation. Taxpayer issues forms 1099 with respect to the payments, but no forms W-2 are issued and no employment taxes are withheld or paid. If the audit reveals that the individual is performing some services in his capacity as a corporate officer and has received remuneration for those services, then the Service determines that pursuant to Treas. Reg. § 31.3121(d)-1(c), the individual is an employee with respect to the services performed in his capacity as an officer. Since taxpayer is not already treating the individual as an employee, a controversy exists whether the owner/officer is an employee of the corporation, and a notice of determination must be issued.

Sometimes during the audit or appeals process, a taxpayer will agree with the Service that a corporate officer who was not treated as an employee by the taxpayer should have been classified as an employee with respect to a portion of the payments to that individual. Yet, the taxpayer disagrees with the Service as to the amount of the payments that should be treated as wages. In such circumstances, an actual controversy involving a determination by the Service that the individual is an employee does exist (because taxpayer was not treating the individual as an employee and the Service determined he was an employee) and a notice of determination must be issued. But since the taxpayer does not intend to challenge the determination that the officer is an employee, taxpayer may wish to settle that issue and waive his right to Tax Court review in the manner set forth in Notice 98-43, 1998-33 I.R.B. 13, 14. If the taxpayer explicitly waives the restrictions on assessment provided in Code sections 7436(d) and 6213(a), a notice of determination need not be issued. But if taxpayer does not wish to sign the waiver, a notice of determination must be issued.

Finally, some Service personnel have questioned whether section 530 treatment is available to taxpayers who have not treated corporate officers as employees. Section 530 treatment is available "if the taxpayer did not treat an individual as an employee." § 530(a)(1). There is nothing in the language of section 530 that prevents a taxpayer from obtaining section 530 treatment when the Service determines that its corporate officers are employees.

Confusion may have arisen from the statutory language of section 530(c)(2), which provides that the term "employment status" means

> the status of an individual, under the usual common law rules applicable in determining the employer-employee relationship. . ..

But the term "employment status" is not used in section 530(a) or any other portion of section 530 that establishes a taxpayer's right to relief from employment taxes. Rather "employment status" is a term used in two places in section 530. First, it appears in section 530(b), which prohibited the Service from issuing guidance on employment status under the common law. The term "employment status" also appears in section 530(e)(1), which establishes that before an audit relating to employment status can begin, the Service must provide the taxpayer with a written notice of section 530. So, if a taxpayer has not treated an officer as an employee, but the taxpayer meets the various requirements for relief from employment taxes under section 530 of the Revenue Act of 1978, the taxpayer will be entitled to section 530 treatment.

3. Harmony with Classification Settlement Program

In your request for assistance, you indicate that some Service personnel try to make the issuance of a notice of determination dependent on whether a taxpayer is eligible for the CSP. They try to reduce the two programs into one rule: if the case involving payments to a corporate officer is eligible for the CSP and does not settle, a notice of determination should be issued, whereas if that case is not eligible for the CSP and does not settle, no notice of determination should be issued. There is no such rule. The two procedures are based on different legal standards and are not dependent upon each other.

The Classification Settlement Program (CSP) establishes procedures that will allow businesses and tax examiners to resolve worker classification cases as early in the administrative process as possible, by creating standard settlement agreements in worker classification cases. See IR 96-7, 1996 IRB LEXIS 76 (Announcement of CSP); FS-96-5, 1996 IRB LEXIS 75 (Fact sheet on CSP); Employment Tax Handbook, § 104, Chapter 6 (Procedures for CSP). Since the cases in the CSP all involve a determination by the Service that a worker is an employee and that the taxpayer is not entitled to section 530 treatment, the principles discussed above concerning notices of determination should be applied to those cases.

But the requirements for the CSP are not identical to those for issuing a notice of determination. Thus, one must be careful not to fuse the two concepts together. For example, section 104.6.7(5) of the Employment Tax Handbook states:

> (5) Corporate Officers: If a business treated a corporate officer as an independent contractor and timely filed a Form 1099, the business is eligible for CSP. Except in cases where 6.8(7) applies.

Thus, if a business has issued Forms 1099 for payments to a corporate officer, the case is eligible for the CSP. And if taxpayer does not agree to the CSP settlement and the four requirements for a notice of determination are met, a notice of determination should be issued. But, if no forms 1099 were issued, the case is not eligible for the CSP. Employment Tax Handbook, § 104.6.6.8(1). Yet, because the case involves a determination that the officer is an employee and that the business is not entitled to section 530 treatment, a notice of determination may be appropriate if the four requirements for issuing a notice of determination are met. There simply is no uniform rule joining these two procedures.

To be sure, both the CSP and the principles governing notices of determination make distinctions between (1) the classification of a person from independent contractor to employee and (2) the characterization of payments from profit distribution to wages. Section 104.6.8(1) of the Employment Tax Handbook

provides that the CSP program is not available for issues other than worker classification and section 104.6.8(7) specifically excludes:

> (7) Wage issues: Cases which involve reclassifying officer/shareholder distributions as wages will not be included in CSP. This is most often seen in S Corporations.

If an officer who was also a shareholder were already treated as an employee by the taxpayer and the Service determined that some profit distributions should be characterized as wages, the case would not be eligible for the CSP program and no notice of determination would be issued because no controversy would exist involving whether the worker was an employee.

The rules are not alike, however, in the situation where the officer who was also a shareholder was not already treated as an employee by the taxpayer and the Service determined that some profit distributions should be characterized as wages. Pursuant to section 104.6.8(7) of the Employment Tax Handbook, such a case would not be eligible for the CSP program. But, since the individual had not been treated as an employee by the taxpayer, a notice of determination would be appropriate if all four requirements were met.

So, please be careful not to link the two concepts together. The CSP rules of Chapter 6 of the Employment Tax Handbook should be applied independently of the requirements for issuing a notice of determination described above.

We hope this discussion will be helpful to you. If you have any questions, please contact me at 202-622-6040.