Employment Tax Update -
Review of Current Litigation

By Debra Kawecki and Leonard Henzke

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Overview

Purpose

There have been a number of articles in Continuing Professional Education texts concerning tax issues arising from the employer-employee relationship. In particular, for a thorough background in employment tax issues, please refer to the 1992 CPE text Topic M. Recently, the 2001 CPE contained two articles addressing employment related issues, *Medical Residents Refund Claim Training* at Topic A and the fringe benefit section of *An Introduction to I.R.C. 4958* at Topic H.

Employer classification and withholding problems constitute some of the most important issues in exempt organization examinations. Exempt Organizations examiners need to keep abreast of recent developments in this area. The purpose of this article is not to restate the prior articles. Its purpose is to provide an update of case law and law review articles over the last five years. There is much litigation in this area, particularly in the context of the classification of employees. Each topic contains a quick review of the area of law. Where possible, the explanations have been taken from Publication 15 and 15A containing Circular E, employment tax information for employers.

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Overview, Continued

Glossary

FICA - Federal Insurance Contributions Act
FUTA - Federal Unemployment Tax ACT
Collection of Income Tax at the Source of Wages - WT/withholding
Self-Employment Contributions Act.-SECA

Employee Classification - Control vs. Independence

Introduction

An employer must generally withhold income taxes, withhold and pay social security and Medicare taxes, and pay unemployment tax on wages paid to an employee. An employer does not generally have to withhold or pay any taxes on payments to independent contractors.

Misclassification of exempt organization employees as independent contractors often leads to substantial loss of revenue to the government and loss of social security benefits to Exempt Organizations staff.

Common Law Rules

To determine whether an individual is an employee or an independent contractor under the common law, the relationship of the worker and the business must be examined. All evidence of control and independence must be considered. In any employee-independent contractor determination, all information that provides evidence of the degree of control and the degree of independence must be considered.

Facts that provide evidence of the degree of control and independence fall into three categories:

- behavioral control,
- financial control, and
- the type of relationship of the parties

Introduction to Behavioral Control Factors

Factors that show whether the business has a right to direct and control how the worker does the task for which the worker is hired include the type and degree of instructions and training the business gives the worker:

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Employee Classification - Control vs. Independence, Continued

Factor: Business Instructions to Employees

An employee is generally subject to the business' instructions about when, where, and how to work. Examples of types of work instructions include:

- when and where to do the work,
- what tools or equipment to use,
- what workers to hire or to assist with the work,
- where to purchase supplies and services,
- what work must be performed by a specified individual, and
- what order or sequence to follow.

Factor: Business Instructions to Employees, continued

The amount of instruction needed varies among different jobs. Even if no instructions are given, sufficient behavioral control may exist if the employer has the right to control how the work results are achieved. A business may lack the knowledge to instruct some highly specialized professionals; in other cases, the task may require little or no instruction. The key consideration is whether the business has retained the right to control the details of a worker's performance or instead has given up that right.

Factor: Training Given Employees

An employee may be trained to perform services in a particular manner. Independent contractors ordinarily use their own methods.

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Employee Classification - Control vs. Independence, Continued

Financial Factors Control

Facts that show whether the business has a right to control the business aspects of the worker's job include:

- *The extent to which the worker has unreimbursed business expenses*. Independent contractors are more likely to have unreimbursed expenses than are employees. Fixed ongoing costs that are incurred regardless of whether work is currently being performed are especially important. However, employees may also incur unreimbursed expenses in connection with the services they perform for their business.
- *The extent of the worker's investment*. An independent contractor often has a significant investment in the facilities he or she uses in performing services for someone else. However, a significant investment is not necessary for independent contractor status.
- *The extent to which the worker makes services available to the relevant market.* An independent contractor is generally free to seek out business opportunities. Independent contractors often advertise, maintain a visible business location, and are available to work in the relevant market.

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Employee Classification - Control vs. Independence, Continued

Financial Factors Control, continued

- *How the business pays the worker.* An employee is generally guaranteed a regular wage amount for an hourly, weekly, or other period of time. This usually indicates that a worker is an employee, even when the wage or salary is supplemented by a commission. An independent contractor is usually paid by a flat fee for the job. However, it is common in some professions, such as law, to pay independent contractors hourly.

- *The extent to which the worker can realize a profit or loss*. An independent contractor can make a profit or loss.

- *Type of relationship*. Facts that show the parties' type of relationship include:

  - *Written contracts* describing the relationship the parties intended to create.

  - *Whether the business provides the worker with employee-type benefits,* such as insurance, a pension plan, vacation pay, or sick pay.

- *The permanency of the relationship*. If a worker is engaged with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is generally considered evidence that there was intent to create an employer-employee relationship.

- *The extent to which services performed by the worker are a key aspect of the regular business of the company*. If a worker provides services that are a key aspect of the employer's regular business activity, it is more likely that the employer will have the right to direct and control his or her activities. For example, if a law firm hires an attorney, it is likely that it will present the attorney's work as its own and would have the right to control or direct that work. This would indicate an employer-employee relationship.

Employee vs. Independent Contractor - Recent Case Law

Cite	**<u>Veterinary Surgical Consultants, P.C. v. Commissioner</u>, 117 T.C. No. 14 (Oct. 15, 2001).**
Facts	The taxpayer was an S Corporation. Its sole shareholder was a veterinarian. All of the S Corp. income came from the services of the veterinarian. The taxpayer claimed that the individual was not its employee and that it properly distributed its net income to its sole shareholder as dividends.
Law	The court stated that: For Federal employment tax purposes, section 3121(d) defines an employee in part as any officer of a corporation. However, there is an exception to employee status for an officer who does not perform any services (or performs only minor services) and who neither receives nor is entitled to receive remuneration.
Holding	The court stated that: Dr. Sadanaga performed substantial services on behalf of petitioner. The characterization of the payment to Dr. Sadanaga as a distribution of petitioner's net income is but a subterfuge for reality: The payment constituted remuneration for services performed by Dr. Sadanaga on behalf of petitioner. Because the court concluded that Dr. Sadanaga was an employee, the court also considered 530 relief (This is relief from employment tax liability pursuant to § 530(a)(2)(C) of the Internal Revenue Act of 1978, Pub.L.No. 95-600, 92 Stat. 2763, 2885-2886. n2 This section provides relief for taxpayers who fail to pay employment taxes when their treatment of workers as independent contractors is based on a "long-standing recognized practice of a significant segment of the industry ....") The Court concluded that relief was not appropriate because the petitioner did not have a reasonable basis for not treating the doctor as an employee.

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Employee vs. Independent Contractor - Recent Case Law, Continued

Cite	**<u>Bobby Hathcock v. Acme Truck Lines, Inc</u>., 262 F. 3d 522 (5th Circuit, Sept. 6. 2001)**
Facts	This is not a tax case but it involves the determination of employee vs. independent contractor status. Acme transported supplies and equipment throughout the country. Mr. Hathcock leased a truck and drove it himself. Acme informed Mr. Hathcock that he would be paid in two checks. One check was for the rental of the truck and one check was for driving the truck. Acme subtracted a fixed percentage of the driver's wages it would deduct from the rental check to cover driver related costs.
Law	The court states that: Hathcock's capacity vis-a-vis Acme when he drove the truck is material. If he were Acme's employee, then he created a portion of Acme's FICA, FUTA, and SUTA tax liability, making Acme's withholdings from Hathcock's driver paycheck not merely proper but mandated by state and federal tax law. Conversely, if Hathcock were an independent contractor when wearing his driver's hat, withholding monies from his rental check to cover Acme's employee expenses would not have been proper.
Holding	The court stated that: When he drove, the terms and conditions of Hathcock's employment were set by Acme. He had to submit to Acme's medical and driving requirements; he was subject to discipline for violation of Acme's personnel policies, including anti-harassment, drug testing, and 401(k) Plan; he was subject to discharge by Acme for violations of the Driver Manual; he was bound to work exclusively for Acme...Even though as the owner-lessor, he possessed a modicum of control, as a driver he possessed none of consequence. Thus, the court concluded that the driver was an employee and the deduction from his wages was appropriate.

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Employee vs. Independent Contractor - Recent Case Law, Continued

Cite	**<u>Charles R. Clarke, D.B.A., Maxi's Today's Hair v. Commissioner</u>, T.C. Summary Opinion 2001-127 (August 17, 2001)**
Facts	Pursuant to IRC 7463(b), this opinion can not be treated as precedent. Petitioner, with no experience, purchased a nonoperating beauty salon. During the first quarter of 1994, the beauticians were treated as employees. During the rest of 1994 no taxes were withheld at all. Petitioner set fees and provided all of the equipment. He could also terminate employees.
Law	The court stated that: The right of control is ordinarily the crucial factor in determining whether an employer-employee relationship exists...To retain the requisite control over the details of an individual's work, the principal need not stand over the individual and direct every move made by the individual; it is sufficient if he has the right to do so.
Holding	The court concluded that the beauticians were employees. The court stated that: Petitioner had the authority to terminate a beautician for unsatisfactory services because the beautician "made the entire place look bad". Furthermore, despite the fact that beauticians could set their own work schedule, petitioner required beauticians to adjust their schedules to ensure walk-in customers could be served. 530 relief was not available because the petitioner has treated the beauticians as employees in the first quarter.

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Employee vs. Independent Contractor - Recent Case Law, Continued

Cite	**Van Camp & Bennion v. US, 251 F.3d 862 (9th Circuit, June 8, 2001).**
Facts	Van Camp and Bannion were law partners. They did not pay employment and withholding taxes on their income. The lower court found Bannion was an independent contractor because he did not have a role in management and Van Camp was an employee because he did. The issue in this appeal is whether Van Camp performed de minimis managerial services.
Law	The court stated that: Because Van Camp performed only de minimis services as an officer, the corporation asserts that section 31.3121(d)-1(b) applies under the "dual capacity" doctrine, which treats a corporate officer as an employee only if the officer provides substantial services in his capacity as an officer.
Holding	The court states: The corporation has not shown clear error in the district court's finding that Van Camp exercised sole authority to make major corporate decisions. This finding supports the conclusion that Van Camp was an employee because 'fundamental decisions regarding the operation of the corporation...are customarily made by corporate officers or other employees.' This case also contains an interesting discussion of reasonable cause to abate penalties. The lower court refused to consider ill health and financial difficulties as grounds for abatement. This court remanded and held, in a case of first impression in the circuit, that financial difficulties may constitute reasonable cause.

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Employee vs. Independent Contractor - Recent Case Law, Continued

Cite	**<u>Robert Patrick Day v. Commissioner</u>, 80 T.C.M. 834 (December 13, 2000)**
Facts	Petitioner was a sole proprietor engaged in hauling freight with drivers he hired. He paid no federal employment tax. The petitioner supplied the trucks and maintained them. If repairs were needed, he authorized them. He required his drivers to keep in contact with him by cell phone.
Law	The court cited the regulations under IRC 3121(d)(2): For purposes of employment taxes, the term "employee: includes "any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee...The regulations provide that Generally, such relationship exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details an means by which that result is accomplished.
Holding	The court found that the drivers were employees because of the degree of control exercised by the petitioner. This opinion is well reasoned and is very informative. The petitioner claimed 530 protection based on the theory of an industry practice to treat drivers as independent contractors. He did not prevail because his only proof was the way he had been treated when he was a driver.

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Employee vs. Independent Contractor - Recent Case Law, Continued

Cite	**<u>Ralph Disimone v. Allstate Insurance Company</u>, 2000 U.S. Dist. Lexis 18097(Dist. Ct. ND CA. , November 7, 2000).**
Facts	This is not a tax case but it hinges on the determination of employee or independent contractor status. It is an appeal to the D.C. for the Northern District of California. It involves a suit by insurance agents trying to stop Allstate's efforts to reclassify insurance agents as independent contractors. In an other case the Tax Court and U.S. Court of Appeals for the Eleventh Circuit had held them to be independent contractors. The agent in this case paid most of his business expenses, leased his own office space, and operated the office with his own funds. He was solely responsible for hiring and supervising the personnel working in his office and established and paid their salaries.
Law	The court stated that: Under California law, the principal test of an employment relationship is whether the person to whom the service is rendered has the right to control the manner and means of accomplishing the result desired.
Holding	The court concluded that the plaintiff/agents were independent contractors. The factors that weigh in favor of finding that Plaintiffs are employees, i.e. the long-term nature of Plaintiffs' relationships with Defendant, the fact that Plaintiffs' work is part of Defendant's regular business, and the degree of control that Defendant does exercise over Plaintiffs' business decisions and sales activities, are insufficient to overcome the strong indicia of Plaintiffs' status as independent contractors detailed above.

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Employee vs. Independent Contractor - Recent Case Law, Continued

Cite	**Anthony S. D'Acquisto v. Commissioner, 80 T.C.M. 149 (August 4, 2000)**
Facts	Petitioner claimed to be an independent contractor capable of claiming Schedule C business expense deductions. Petitioner worked as a voice actor. For radio and television commercials, petitioner's agents negotiated the terms based upon the actors' unions' fee schedule. The Service determined that he was an employee to the various companies that he worked for.
Law	The court stated that: The right of control is ordinarily the crucial factor in determining whether an employer-employee relationship exists.
Holding	The court found that the petitioner was an employee based on the following rationale. Petitioner failed to establish that he had sufficient control over the relationship at the time service was rendered ,to be classified as an independent contractor. According to petitioner's own testimony, upon acceptance of a job, the hiring company provided a script and instructed petitioner to read it according to the company's specifications...Petitioner argues that having the right to pick and choose the jobs of his choice demonstrates he had control over this services. However, petitioner failed to establish the details of control he had over the engagement agreement once petitioner accepted a job.

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Employee vs. Independent Contractor - Recent Case Law, Continued

Cite	**Consolidated Flooring Services and Monroe Schneider Associates-Texas v. United States, 85 A.F.T.R.2d 2196 (Ct. Claims for Federal Claims, June 8, 2000).**
Facts	Plaintiff withheld taxes from the wages of carpet installers and did not withhold taxes from the wages of helpers. In a prior decision, it was determined that the carpet installers were independent contractors and the workers were employees. The issue here is whether the overpayment of taxes for the carpet installers can offset the amount due for the workers.
Law	The court states that: The court finds that under 26 U.S.C. section 3402(d), it is the obligation of plaintiff to show that the helpers paid the employment taxes themselves in order to be relieved of the obligation to withhold taxes for them.
Holding	The court states: In conclusion, the Court finds that because the installers were held to be independent contractors in this case, the taxes withheld from their wages in error by plaintiff must be returned to the installers by the IRS. Thus there is no windfall to the IRS. Plaintiff may not use the amount of those taxes to offset plaintiff's obligation as employer to withhold taxes from the wages of the helpers who were determined in this case to be statutory employees.

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Employee vs. Independent Contractor - Recent Case Law, Continued

Cite	**<u>Leb's Enterprises, Inc. v. U.S.</u>, 85 A.F.T.R.2D 886 (Dist. Ct. ND Ill, January 26, 2000)**
Facts	Leb's operates a vehicle transportation business in which various companies hire the service to move their vehicles. Leb had two main contracts. Under each contract some drivers were treated as employees and some were treated like independent contractors.
Law	The court cited Rev. Rul. 87-14, which provided a 20 point method for analyzing employer-employee relationships. (1) Instructions; (2) Training; (3) Integration: (4) Services Rendered Personally; (5) Hiring, Supervising and Paying Assistants; (6) Continuing Employer's Premises; (10) Order or Sequence Set; (11) Oral or Written Reports; (12) Payment by Hours, Week, or Month; (13) Payment of Business and/or Transportation Expenses; (`14) Furnishing of Tools and Materials; (15) Significant Investment; (16) Realization of Profit or Loss; (17) Working for More Than One Firm at a Time; (18) Making Service Available to General Public; (19) Right to Discharge; and (20) Right to Terminate.
Holding	The court found that the drivers were employees. While it is true that Leb's did not have specific training sessions or have set hours for the workers, it is clear from all the evidence that Leb's had considerable control over the workers...Leb's provided the workers with detailed written instructions about the process and procedures involved in delivering the vehicles to their destination.

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Employee vs. Independent Contractor - Recent Case Law, Continued

Cite	**Western Management, Inc. v U.S., 45 Fed. Cl. 543 (January 21, 2000).**
Facts	Plaintiff professional services corporation had one full-time attorney, who was also president. Employment taxes were not withheld nor were Form 1099s issued. Attorney Kovacevich made all of the major decisions for the corporation as well as performing the day-to-day management.
Law	The court stated that: Plaintiff corporation's reliance on the legislative history regarding the definition of "employee" in FUTA to show that Congress did not intend to include officers who did not do work for the corporation supports rather than defeats the government's argument. The government argues that Mr. Kovacevich is a statutory employee of the plaintiff corporation because he in fact did more than minor work for the plaintiff corporation.
Holding	The court concluded that Mr. Kovacevich was an employee for the following reasons: Mr. Kovacevich's control was manifested in many ways. He undisputedly directed all of the legal work performed by plaintiff corporation's employees. Plaintiff corporation further stipulates that Mr. Kovacevich approved all hires for plaintiff corporation and was responsible for firing any of plaintiff corporation's employees. Mr. Kovacevich also determined the salaries and bonuses of plaintiff corporation's employees and conducted informal performance reviews. The court denied the plaintiff's request for 530 relief because the plaintiff did not file Form 1099 for Mr. Kovacevich.

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Employee vs. Independent Contractor - Recent Case Law, Continued

Cite	**303 West 42nd St. Enterprises, Inc. v. Internal Revenue Service, 181 F. 3d 272 (2nd Circuit, June 18, 1999).**
Facts	Plaintiff was the operator of an adult entertainment facility. At issue here is the employment tax treatment of exotic dancers who dance in individual booths which they rent from the plaintiff. There are two fees per performance. Coins are deposited in a token box and the totals are shared between Show World and the performers. The customer pays the second fee directly to the performer. The District Court found the performers to be employees of Show World. The Appeals Court accepted the employee designation. The appeal involves the issue of whether 530 relief is available.
Law	The court stated that: By its terms, section 530 states that the reasonable basis requirement may be established through proof of reliance on the classification practice of a "significant segment" of the industry.
Holding	The District Court rejected the claim for 530 relief. It relied on Springfield v U.S., 873 F. Supp. 1403(So. Dist. CA 1994) to require that a significant segment of the industry follow a practice in order to find 530 relief. The court stated that: Indeed, shortly after the District Court issued its opinion, Congress clarified the statute by amending section 530 to add that "in no event shall the significant segment requirement of [530(a)(2)(C)] be construed to require a reasonable showing of the practice of more than 25 percent of the industry." The case was remanded to consider whether there was an industry practice., see 86 Aftr 2nd 5363 for a good discussion of section 530 concluding that only New York practice needed to be taken into consideration.

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Employee vs. Independent Contractor - Recent Case Law, Continued

Cite	**Jerry G. McLaine and Martin Anderson t/d/b/a/ J.M. Leasing Co. v. U.S., 83 A.F.T.R. 1225 Dist. Ct. WD PA, February 4, 1999)**
Facts	The plaintiff was in the long distance hauling business. It treated certain drivers as employees and certain drivers as owner/operator independent contractors. Certain drivers would lease trucks from the plaintiff with an option to buy. The owner-operators were responsible for all maintenance, repairs, insurance, license, registration fees and inspections. Unlike the employees, the owner/operators were not trained by plaintiff, they set their own hours and took time off without asking the plaintiff, they designed their own routes, pay their own expenses and have a greater choice regarding what they haul.
Law	The court states that: The instant dispute revolves around ...whether the owner/operators hold "substantially similar positions" to plaintiff's employees. The question is one of facts and the burden is on the taxpayer, or the party claiming Section 530 protection, to establish that he or she meets the requirements set forth therein by a preponderance of the evidence...Here it is undisputed that the individuals employed at J.M. Leasing and those designated as independent contractors both haul freight; both receive their job assignments from plaintiff's dispatchers on a daily basis; both submit driver's logs and bill of lading; and both haul the freight in trailers provided by plaintiff bearing the name "Warren C. Sauers."
Holding	Despite all of the similarities between the employees and the owner operators, the court concluded that the issue of how to classify these workers was factual and should be left to a jury to determine.

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Employee vs. Independent Contractor - Recent Case Law, Continued

Cite	**<u>Michael D. Weber; Barbara L. Weber v. Commissioner</u>, 60 F. 3d 1104 (4th Circ.,July 31, 1995)**
Facts	The petitioner was a minister working for a large denominational church. He claimed business expenses on Schedule C as a self-employed person. The Tax Court had determined that the minister was an employee. The Court looked to the book of discipline of the Methodist Church. The Discipline listed the duties to be performed by a minister and provided that the local pastor is under the direct supervision of an elder. The minister was assigned by the bishop to a local church and could not refuse an appointment. If a local church is not available the Annual Conference will pay the minister's salary.
Law	The court stated: The threshold level of control necessary to find employee status is generally lower when applied to professional services than when applied to nonprofessional services.
Holding	The court affirmed the Tax Court. It found that: Petitioner received many benefits that we find are typical of those provided to employees rather than independent contractors, some of which follow. Each local church made contributions on behalf of petitioner to a pension plan. Petitioner continued to receive his salary while on vacation. If needed, petitioner would have been entitled to disability leave and paternity leave. If he could not be assigned to a local church, he would receive a guaranteed salary from the annual conference.

Employee vs. Independent Contractor - Recent Law Review Articles

Introduction	Law review articles can be very helpful. If you find one on point to your question, you will usually find a well reasoned review of the pertinent case law. If you view your law review article through LEXIS, all of the cases will be hotlinked and thus, readily available.

Cite	***Rethinking the Weighted Factor Approach to the Employee Versus Independent Contractor Distinction in the Work for Hire Context*, 3 U.Pa. J. Lab. & Emp. L. 333(Winter 2001).**
Synopsis	This is a good discussion of the independent contractor issue in both tax and nontax contexts. The article makes it clear that the courts use different methods of drawing the distinction between employees and independent contracts in order to effectuate the intent of different laws such as tax, copyright, and pension.

Cites **1st Law Review Article** **2nd Law Review Article**	***Note: Independent Contractor Or Employee: Vizcaino v. Microsoft Corp.*, 35 Hous. L. Rev. 1775 (Spring 1999).** ***Employee Benefits: Vizcaino v. Microsoft*, 13 Berkely Tech. L.J. 483 (1998)**
Synopsis	These two law review articles are commenting on the same case. Vizcaino is an interesting case. Certain Microsoft workers were hired as independent contractors and signed documents waiving certain benefits. After a number of years, the IRS reclassified the workers as employees. The workers then wanted to participate in the benefits they had waived.

Cite	***Note: Identifying an Independent Contractor for Tax Purposes: Can Clarity and Fairness Be Achieved?* 84 Iowa L. Rev. 163 (October, 1998).**
Synopsis	This is a very good survey of the tax issues. It also explains the consequences to society when workers become independent contractors. It discusses 530 relief and explains that it is incomplete relief because income tax is still owed and there are still consequences to certain fringe benefit arrangements.

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Employee vs. Independent Contractor - Law Review Articles, Continued

Cite	***Tax Treatment of A New Animal: Health Care Providers Who Are Neither Employees Nor Independent Contractors*, 18 Va. Tax Rev. 301 (Fall 1998).**
Synopsis	This article discusses the changing employment role of the physician in a managed care system. The physician may not be able to make independent decisions and thus, may no longer be classified as an independent contractor.

Cite	***Independent Contractor or Employee? Misplaced Reliance On Actual Control Has Disenfranchised Artistic Workers Under the National Labor Relations Act*, 16 Cardozo Arts & Ent. LJ 303 (1998).**
Synopsis	The title pretty much says it all. The writer feels that the control test may be inappropriate in artistic settings where the payor commissions the work. For example, if the payor commissions an artist to paint a picture, the payor may choose the subject of the picture and determine certain other details. This may look like control for purposes of concluding that the artist is an employee but in reality, the artist is in almost complete control of the artistic rendering. The article writer feels the artist in this situation should be classified as an independent contractor. This article should be read along with D'Acquisto, supra. In that case the court determined that the voice over actor was an employee because his employers had control over the script and the method of delivery.

Cite	***Comments: Congressional Campaign Workers: Independent Contractors or Employees? Politics, Taxes, and the Limits of the Internal Revenue Service's Authority Over Employment Classification*, 8 Admin. L.J. Am. U. 371 (Summer 1994).**
Synopsis	This article contains a lengthy discussion of 530 relief. The writer believes that Congress should reform this area by starting with its own campaign staffs.

Wages

Wages Subject to Federal Employment Taxes

Wages subject to Federal employment taxes include all pay an employer gives an employee for services performed, subject to specific exceptions. The pay may be in cash or in other forms. It includes salaries, vacation allowances, bonuses, commissions, and fringe benefits. Also, compensation paid to a former employee for services performed when they were employed is wages subject to employment taxes.

Wages Not Paid in Money

If in the course of a trade or business, employees are paid in a medium, that is neither cash nor a readily negotiable instrument such as a check, these are considered payments "in kind." Payments in kind may be in the form of goods, lodging, food, clothing, or services. Generally, the fair market value of such payments at the time they are provided is subject to income tax withholding and social security, Medicare, and FUTA taxes.

Importance to Exempt Organizations Examiners

Wages are usually subject to income, FICA, and FUTA taxes. Non-wage income is frequently not subject to withholding taxes, and is sometimes taxed at a lower rate or not taxed at all. Moreover wages are included in the IRC 4958 excess benefit computation, while some other forms of payment may not be.

Wages - Recent Case Law

Baseball Cases	
Cite 1	**Cleveland Indians Baseball Company v. U.S., 14 Fed. Appx. 425 (June 25, 2001)**
Cite 2	**The Phllies v. U.S., 153 F.Supp. 2d 612 (Dist. Ct. ED PA, May 24, 2001**
Cite 3	**St. Louis Cardinals, L.P. v. U.S., 88 A.F.T.R. 2d 5185 (Dist. Ct. ED MO, May 11, 2001).**
Cite 4	**U.S. v. Cleveland Indians Baseball, 532 U.S. 200 (April 17, 2001)**
Cite 5	**San Francisco Baseball Associates, L.P. a/k/a San Francisco Giants v. U.S., 87 A.F.T.R. 2D 455 (Dist. Ct. ND CA, March 2, 2000)**
Overview	These cases stem from a settlement agreement between the baseball players and the team owners. The employment tax issue was: Were the settlement payments wages and if so, which year(s) are the payments allocated to, the years earned or the year paid? In the San Francisco Giants case, the court ruled the payments were wages and subject to employment taxes. The court found the settlements were salary based and therefore considered wages. Later courts looked at the issue of which year the "wages" would be allocated to, either the year paid (1994) or the years earned, (1986 and 1987). This issue was litigated because the tax rate and FICA wage base increased from the years in dispute, 1986 and 1987, to the year the settlement was paid, 1994. Additionally, recipients of the settlement payments would typically owe less FICA if the wages were subject to employment tax in 1986 and 1987 because they were still playing baseball in those years and therefore had other wages to get them over the FICA wage base. The Supreme Court resolved this issue in favor of the government, finding that the payments were wages in the year paid.

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Wages - Recent Case Law, Continued

Cite	**North Dakota State University v. U.S., 255 F. 3d 599 (8th Circuit, June 18, 2001)**
Overview	NDSU offered an early retirement program to its tenured faculty and certain high level administrators. To participate in the program, an employee had to agree to give up all rights to tenure. Tenure is the right to continuous academic employment. The District Court decided that the administrators had received wages because the administrators were at-will employees without tenure. The District Court treated the tenured faculty differently because they were viewed as having property rights that they had relinquished. The Appeals Court agreed with the District Court that the tenured faculty had not received wages subject to employment tax but had received payments in exchange for the relinquishment of property rights. See AOD CC 2001-8 December 31, 2001), with respect to this case. The IRS has indicated that it disagrees with the Court's decision. Although we disagree with the decision of the court, we recognize the precedential effect of the decision to cases appealable to the Eighth Circuit, and therefore will follow it within that circuit only with respect to cases that have the exact facts as this case; that is, cases involving payments to college or university professors made in exchange for the relinquishment of their tenure rights. We will continue to litigate our position in cases having different facts in the Eighth Circuit, and in all cases in other circuits.

Cite	**WSB Liquidating Corporation v. Commissioner, 81 T.C.M. 1007 (January 19, 2001).**
Overview	This case involves the characterization of payments from the petitioner (a corporation). The petitioner was formed and operated by a husband and wife, and the payments at issue were made to the wife/employee subsequent to their divorce. The petitioner characterized the payments as wages, thus taking deductions. The Service argued that the payments were a substitute for alimony. The petitioner argued that the payments were to compensate for prior under compensation. The court concluded that the payments were a substitute for alimony. One factor that weighed against the petitioner was the court's conclusion that the former wife had been overcompensated in the past.

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Wages - Recent Case Law, Continued

Cite 1	**Reiber Abrahamsen and Malfrid Abrahamsen, et al v. U.S., 228 F. 3d 1360 (Federal Circuit, September 28, 2000)**
Cite 2	**Marie N. Abbott v. U.S., 76 F. Supp. 2d 236 (Dist. Ct. ND NY, December 3, 1999).**
Overview Case 1	The issue in this case is whether payments to the appellants are considered severance payments subject to employment taxes or settlement payments viewed as a settlement and not subject to employment taxes. The appellants were former employees who had received lump-sum payments at the end of their employment. The Court held that the payments were wages, severance payments, because they were not related to claims against the former employer and they were calculated based on each employee's salary.
Case 2	On very similar facts, Case 2 also decided that the payments were wages.

Cite	**Jeffery B. Fleck, L.P.A. v. U.S., 86 A.F.T.R.2d 5757 (Dist. Ct. ND OH, July 25, 2000)**
Overview	This attorney tried some creative accounting to cut his employment tax bill in half. In year one, the plaintiff paid an employee, who also happened to be its sole shareholder for two years of employment. At the time of the prepayment, the shareholder loaned to the plaintiff a slightly higher amount. The purpose of this was to halve employment tax by satisfying the employment tax limits for the first year and paying no employment tax for the second year. The plan did not work.

Cite	**HB & R. v. U.S., 229 F. 3d 688 (8th Circuit, October 12, 2000).**
Overview	The plaintiff employer paid airfare for employees who chose to live away from a remote work site. The remote worksite is "inhospitable" and there were no "residential communities" available in the vicinity. The Court determined that the travel expenses were ordinary and necessary for the business of the plaintiff and were not wages subject to withholding and employment tax.

Responsible Party

Who is the Responsible Party?

An individual who has a responsibility to collect employee taxes and forward the taxes to the Service is termed a "responsible party" If the taxes are not paid, the responsible party may be liable for the taxes as well as penalties. For the penalty to be assessed, there must be a willful failure to collect and pay over the taxes. Responsible parties can include officers or employees of a corporation, creditors who purchase a business, bookkeepers, consultants, volunteer members of a board of trustees, and lenders.

The Service can choose the person it will collect from. The Service can determine whom to assess based on available resources or ease of collection.

Importance to Examiners

Exempt organization officials sometimes fail to collect and pay over their taxes. If the organization does not or cannot pay the taxes, it is important for Exempt Organizations examiners to assess IRC 6672 penalties against the responsible parties as described in the statute.

Responsible Party - Recent Case Law

Cite	**<u>Harry Hunison and Bud Vigue v. Commissioner</u>, 89 A.F.T.R.2d 461(Dist. Ct. Alaska, December 17, 2001).**
Facts	The plaintiffs were partners in the operation of a hotel. The Wickershams partnership was made the manager of the hotel. It had an option to purchase the hotel and ultimately did. During the period, prior to the sale, ultimate authority rested with the partnership. After the sale, the Service determined that there were employment taxes owing. The partnership argues that it was not the responsible party for the payment of employment taxes.
Law	The court stated that: Employer is defined in I.R.C. 3401(d) I.R.C. in relevant part as: For purposes of this chapter, the term “employer” means the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person, except that- (1) If the person for whom the individual performs or performed the service does not have control of the payment of the wages for such services the term “employer”***means the person having control of the payments of such wages...
Holding	The court held that the partnership was a responsible party for the payment of employment taxes. The court stated: Here there was no agreement that the plaintiffs were prohibited from being involved in the day-to-day operations of the Cordova Hotel and Bar. Furthermore, they maintained full signatory authority over the bank accounts. The fact that they delegated that authority to the Wickershams and called the Wickershams “managers” did not change the legal status of the parties.

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Responsible Party - Recent Case Law, Continued

Cite	**Diane M. Keohan v. U.S., 138 F. Supp. 2d 62 (Dist. Ct. MA, March 19, 2001).**
Overview	The plaintiff was an employee of a masonry business. Her husband was the sole proprietor of the business. The business failed to pay employee payroll taxes when it ran into financial difficulties. The plaintiff claimed that she was not a responsible party for purposes of being liable for the taxes. The court concluded that she was a responsible party, stating; The Court finds by a preponderance of the evidence that when Plaintiff signed her own paychecks each week with full knowledge that the Business was not paying its trust fund taxes over to the government that she made a choice to accept the salary from the Business rather than influencing the Business to pay its tax obligations to the United States.

Cite	**U.S. v William K. Hankins, 88 AFTR2d 60225 (Dist. Ct. SD IN, August 29, 2001).**
Overview	The US alleged that Mr. Hankins owed over $100,000 in unpaid payroll taxes. He was the president and 100% shareholder of a credit bureau that did not pay employment taxes. The question to be decided is whether Mr. Hawkins can be held to be a responsible person within the meaning of IRC 6672(a). Under section 6672(a), an individual may be held liable for unpaid withholding taxes if: (1) he or she was a “responsible person” for collection, accounting, and payment of the employer’s taxes, and (2) he or she “willfully" failed to do so. The only argument by Mr. Hankins was that his disability check was being taken away and that he was ill. The Court did not find that these arguments were germane to the issue of “responsible party”.

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Responsible Party - Recent Case Law, Continued

Cite	**William P. Remington v. U.S., 210 F. 3d 281 (5th Circ., April 13, 2000).**
Overview	This appeal presents the question whether Texas state partnership law is preempted by 26 U.S.C. Section 6671 and 6672. Plaintiff was a partner in a law firm. He discovered that employment taxes had not been paid. He submitted the returns but did not pay the tax. The plaintiff's argument is that the IRS cannot proceed against a general partner under state law to collect the payroll taxes. The Court reasoned that Congress wanted IRC 6671 to be an additional avenue for collecting payroll taxes.

Cite	**U.S. v. William H. Thayer, 201 F.3d 214 (3rd Circ., December 28, 1999).**
Overview	William Thayer and his wife were convicted of twenty counts of criminal liability for willful failure to pay over federal withholding and FICA taxes in violation of 26 U.S.C. Section 7202 and 18 U.S.C. Section 2. The Thayers were the sole owners of two corporations. They accurately reported their FICA liabilities on Form 941 but they failed to turn over any money. In addition they had filed claims for tax refunds. Thayer claimed that he was not the responsible party and he was only required to account for the taxes, not actually pay them. IRC 7202 applies to any one who "willfully fails to collect or truthfully account for and pay over" employment taxes. It was a question of first impression whether a person who collects and accounts for but does not pay over taxes has failed to account for and pay over those taxes. Court answered in the affirmative by upholding the Thayer's convictions.

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Responsible Party - Recent Case Law, Continued

Cite	**P.J. Winter v. U.S., 196 F. 3d 339 (2nd Circuit, November 8, 1999).**
Facts	This case arises out of the failure of Atlas Protective Services to remit federal withholding taxes to the IRS and the effort to hold various owners, officers, and employees personally liable. Atlas and Penn were owned and operated by the same group of people. Through a clerical error, the IRS credited two quarters of payments for both entities to only one entity. At one point before the error, an independent auditor had certified that Penn was current in its employment tax obligations and that Atlas had a sizable credit. The entity with the credit, Atlas, was the one that was credited in error. Atlas tried, to no avail to have its overpayments returned. It finally, on the advice of accountants, tried self-help by failing to pay its current liabilities as a self-help offset. This resulted in the present penalty litigation.
Law	The Court stated that: In determining whether an individual is a “responsible person” within the meaning of section 6672(a), ‘the determinative question is whether the individual has significant control over the enterprise’s finances.’...No single factor is dispositive in evaluating whether an individual has significant control; rather, the determination must be made in light of the totality of the circumstances. The relevant circumstances include whether the individual: (1) is an officer or member of the board of directors, (2) owns shares or possesses an entrepreneurial state in the company, (3) is active in the management of day-to-day affairs of the company, (4) has the ability to hire and fire employees, (5) makes decisions regarding which, when and in what order outstanding debts or taxes will be paid, (6) exercises control over daily bank accounts and disbursement records, and (7) has check-signing authority.
Holding	The court found that there was at least one responsible party, and possibly two, but it remanded the case for the lower court to redetermine the willfulness issue because there were legitimate factual questions.

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Responsible Party - Recent Case Law, Continued

Cite	**L. Karl Kittlaus v. U.S., 41 F. 3d 327 (7th Circuit, November 30, 1994).**
Overview	Plaintiff was one of the general partners of Inn Investors, owners of Stillwater Ramada Motel. Investors entered into a contract with HCI whereby HCI was to manage the motel. HCI has complete responsibility for hiring, discharging, promoting and supervising the staff. The unusual feature of the contract was that Investors was precluded from involvement in the day-to-day operation of the motel. IRS levied plaintiff's condo resulting in the current litigation over plaintiff's status as a responsible party. The Court did not find that the plaintiff was a responsible party stating, "Regardless of how "control" is defined, it is clear that the management agent, not the partnership, possessed it over the payment of wages.

Accountable Plan

Rules

Payments made by an employer to an employee are not considered wages if they meet the accountable plan rules. To be an accountable plan, the reimbursement or allowance arrangement must require the employees to meet all three of the following rules. See Treas. Reg. section 1.162-2.

1. The employee must have paid or incurred deductible expenses while performing services as an employee.

2. The employee must adequately account for these expenses within a reasonable period of time.

3. The employee must return any amounts in excess of expenses within a reasonable period of time.

Importance to Exempt Organizations Examiners

Knowledge of the accountable plan rules are necessary to correctly determine compensation for purposes of IRC 4958 because payments made to employees or independent contractors under an accountable plan are not wages and are not subject to income tax, FICA or SECA taxes.

Accountable Plan - Recent Case Law

Cite	**<u>Shotgun Delivery, Inc. v. U.S</u>., 269 F. 3d 969 (9nth Circ., October 16, 2001).**
Facts	Shotgun operates a messenger and courier service. It employed drivers using their own vehicles to make pick-ups. The drivers were paid a commission of 40% of the delivery charge. The first check paid the drivers at minimum wage. The second check (mileage check) was the 40% less the amount paid in the first check. Shotgun did not deduct employment taxes from the mileage checks, maintaining that its reimbursement scheme constituted a tax-exempt accountable plan.
Law	The court stated the law as: The Internal Revenue Code permits employers to reimburse certain business expenses incurred by employees and exempts the reimbursed amounts from the withholding requirements and the payment of employment tax...To be eligible for favorable tax treatment, such reimbursements must be pursuant to arrangements—called “accountable plans”—that require employees to (i) substantiate the expenses, and (ii) refund any reimbursement in excess of eligible expenses...In addition...reimbursements under an accountable plan must be for deductible expenses and have a business connection...
Holding	The decision was for the Service. The court felt that Shotgun’s compensation scheme led to arbitrary results. In addition, it felt that the purpose of its payment method was to shelter as much income from withholding taxes as possible.

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Accountable Plan - Recent Case Law, Continued

Cite	**Worldwide Labor Support of Mississippi v. U.S., 2001 U.S. Dist. LEXIS 8186 (Dist. Ct. SD MS, May 15, 2001).**
Facts	Worldwide was in the business of providing temporary skilled labor to industrial and commercial businesses. Caterpillar, Inc. had experienced a massive strike so Worldwide provided many workers. Worldwide paid a reimbursement to workers living more than 100 miles from the job site. The per diem was an hourly payment that increased the longer the worker was employed by Worldwide. The payments were made for regular hours and for overtime, so two employees away from home the same time would receive different per diem payments depending on how many hours they had worked. The Service maintained that the payments were compensation because they did not satisfy the accountable plan rules. The court agreed with the Service. It found that the accountable plan rules had not been satisfied because there were no business connections, substantiation, or reimbursement because similarly situated employees received different allowances. In addition, the Court analyzed the facts according to the withholding rules.
Law	The Court cited the analysis under section 31.3401(b) of the regulations contained in Stubbs, Overbeck & Assoc., Inc. v. U.S., 445 F. 2d 1142 (5th Circ., 1971). 1. Whether the per diem rate was the same for every employee regardless of the employee's hourly wage; 2. Whether the per diem payments were made only to employees working away from his or her home area. 3. Whether the per diem payments were used as a substitute for compensation for services. 4. Whether the per diem payments were separately designated on employee's paychecks.
Holding	The Court concluded that the payments failed at least 1 and 3. Not all employees received the same compensation. In addition, the more hours worked in a day, the more payment received. This constituted a disguised form of compensation.

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Accountable Plan - Recent Case Law, Continued

Cite	**Trucks, Inc. v. U.S., 234 F. 3d 1340 (11th Circuit., December 11, 2000).**
Facts	This is an appeal of a grant of summary judgement for the government. The Appeals Court needed to decide whether the issues should be fully litigated. The plaintiff trucking company paid per diem based on "load revenue". Load revenue is calculated primarily by the number of miles driven. The company claimed that is was standard business practices to reimburse based on load revenue. The Appeals Court felt that standard business practices could be reasonable basis to satisfy the business connection test, distinguishing this situation from Shotgun. The Court considered a modification to the substantial rule.
Law	The Court stated that: In a series of publications, the Commissioner exempted employers that reimburse their employees on a flat rate per diem allowance from this substantiation requirement if the employer's plan meets certain criteria. The definition of a "per diem allowance" eligible to bypass this requirement is a payment under a reimbursement of other expense allowance arrangement that meets the requirements specified in section 1.62-(c)(1) of the regulations that is: (1) paid with respect to ordinary and necessary business expenses incurred, or which the payor reasonably anticipates will be incurred, by an employee for lodging, meal, and/or incidental expenses for travel away from home in connection with the performance of services as an employee of the employer, (2) reasonably calculated not to exceed the amount of the expenses or the anticipated expenses, and (3) paid at the applicable Federal per diem rate, a flat rate or stated schedule or in accordance with any other service-specified rate or schedule. Rev. Proc. 90-60, 1990-2 C.B. 651 section 3.01.
Holding	The court felt that a jury trial was necessary to determine if the second and third criteria had been met.

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Accountable Plan - Recent Case Law, Continued

Cite	**<u>Trans-Box Systems, Inc.</u>, 86 A.F.T.R. 2d 5015 (9nth Circ., April 14, 2000).**
Overview	This case concerns automobile allowance payments made by Trans-Box to courier service drivers driving their own cars. Trans designated 55% of the drivers' wages as automobile allowance. This plan clearly did not comply with the requirements for an accountable plan. The petitioner argued that it substantially complied even if it not literally comply. The court determined that the rules of IRC 62(c) (requirements for a plan to be treated as reimbursement) were substantive rather than procedural, so literal compliance was required.

<u>Airplane Cases</u>	
Cite 1	**<u>American Airlines, Inc. v. U.S., 204 F. 3d 1103</u> (Federal Circ.,February 24, 2000)**
Cite 2	**<u>United Airlines v. U.S.</u>, 88 A.F.T.R 2d 5459 (August 10, 2001)**
Cite 3	**<u>UAL Corporation and Subsidiaries v. Commissioner</u>, 82 T.C.M. 4130 (July 13, 2001)**
Overview	In the first two cases, the issue was whether per diem payments paid by the airlines to the flight crew were wages subject to withholding. The argument made by the Service was that the payments were not fringe benefits because the payments were not made for expenses that were "reasonably expected" to occur. In <u>United Air Lines</u> the Court concluded that the taxpayer did have a reasonable basis resting in part on the testimony of flight crew that expenses exceeded the per diem. The issue in <u>UAL</u> was different although the facts were similar. In this case, the Service argued that the taxpayer could not deduct the per diem payments because they were not compensatory. The court rules for the taxpayer. The court states that, "We conclude that United paid the per diem allowances to the employees for services rendered. We reach this conclusion from the certainty that United would not have paid the per diem allowances to the employees but for: (1) The bona fide employer/employee relationship and (2) the need to pay those allowances in order to secure the employees' services.

IRC 274

Overview

IRC 162 permits a deduction for all ordinary and necessary expenses. IRC 274 disallows certain deductions for entertainment and travel expenses. The purpose of IRC 274 was to eliminate deductions for lavish expenditures.

Importance to Exempt Organizations Examiners

Deductions disallowed by IRC 274 usually constitute taxable wages to the employee receiving the fringe benefit. The disallowed deductions would be taken into consideration in computing compensation for purposes of IRC 4958 and should be reported on' Form 1040.

IRC 274 - Recent Case Law

Cite	**<u>Sutherland Lumber-Southwest, Inc. v. Commissioner</u>, 114 T.C. 197 (March 28, 2000), affirmed at 255 F. 3d 495 (8th Circ. 2001).**
Facts	Petitioner was in the lumber business. It also owned an aircraft that was used in a number of different ways. For one tax year at issue, the aircraft's use was allocated as follows: • Air charter service (30%) • Travel related to the directors' position (23%) • Other business and charitable purposes (18%) • Vacation travel (24%) • other use (5%) The Service argued that IRC 274 applied and that IRC 274(e)(2) limited the petitioner's deductions to the value of the benefits received by employees with respect to the vacation flights.
Court's Summary	The Court provided the following amplification of the issue: The parties' cross-motions for partial summary judgment involve employee fringe benefits. Normally, answers to such matters may be found in section 61, 162, 132 and related sections. Here, however, we are confronted with the more vexing combination of those sections with section 274, which provides special rules for disallowance of certain deductions in connection with entertainment, amusement, or recreation activities. Simplifying matters, the parties agree that the value of the vacation use of the aircraft is reportable by the employees as compensation and that petitioner is entitled to deduct some amount in connection with that same use. We considered whether petitioner, under section 274, may deduct its aircraft operating costs in full or whether petitioner's deduction is limited to that amount reportable as compensation by the employees. In this regard, the parties agree that, without considering section 274, petitioner has correctly deducted its expenses incurred.

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IRC 274 - Recent Case Law, Continued

Sutherland Lumber-Southwest, Inc.v. Commissioner, Continued

Law	The court also stated that: Although section274(a) is designed generally to prohibit deductions for certain entertainment-related expenses, section 274(e)(2) provides that the deduction disallowance provision of section 274(a) will not apply to: Expenses treated as compensation.---Expenses for goods, services, and facilities, to the extent that the expenses are treated by the taxpayer, with respect to the recipient of the entertainment, amusement, or recreation, as compensation to an employee on the taxpayer's return of tax under this chapter and as wages to such employee for purposes of chapter 24 (relating to withholding of income tax at source on wages)
Holding	The court held that IRC 274(e)(2) acts to except the deductions in controversy from the effect of section 274, and, accordingly, petitioner's deduction for operation of the aircraft is not limited to the value reportable by its employees. The Court of Appeals was in full agreement with the Tax Court and added no new analysis of its own.

Cite	**Nat'l Bancorp of Alaska v. Commissioner, 82 T.C.M.369 (August 1, 2001).**
Overview	The taxpayer's wholly owned subsidiary owned an airplane that was used partly for business and partly for entertainment of certain employees. The employees entertainment use of the airplane was treated as fringe benefit compensation. The taxpayer deducted the entire cost of operating the airplane. The Service argued that the deduction should be limited by IRC 274(a)(1). As in Sutherland, the Court found that there was no limitation because the benefit had been treated as compensation to the employee.

IRC 274 - Recent Law Review Articles

Cite	***Taxing the CEO's Jet: Federal Taxation of Corporate and Private Aircraft Ownership and Operations*, 66 J. Air L. & Com. 1605 (Fall 2001)**
Synopsis	This is a very extensive discussion of private aircraft ownership by corporations. It contains a lengthy discussion of IRC 274 as well as Sutherland, supra.. The article indicates that Sutherland is being appealed by the Service. The article writer states that, "... reliance on the Tax Court's opinion in Sutherland prior to a final disposition in the case may entail a significant degree of risk."

Cite	***The Entertainment Facility Rules of Section 274 and Corporate-Owned Condominiums,* 9 Akron Tax H. 97 (1992).**
Synopsis	The article sets up an example involving the shared use of a vacation condo and examines the consequences to the deductibility of expenses after the enactment of IRC 274. The article is well laid out and should be helpful for anyone dealing with dual use entertainment facilities. The author states that, "If a corporate-owned vacation condominium is found to be an entertainment facility, then the condominium will be treated the same for tax purposes as a personal residence. If deductions are disallowed under section 1.274-2 of the regulations with respect to any portion of a facility, then such portion shall be treated as an asset which is used for personal, living, and family purposes."

Unreasonable Compensation

Determining Compensation

Determining whether compensation is reasonable depends on all of the facts and circumstances. The analysis will take into account, in part, the nature of the services provided, the type of entity, and its size. All forms of compensation will be included such as salary, bonuses, retirement plan contributions, fringe benefits and personal use of the entity's property.

- For a C Corp the issue is often whether the compensation received by principal officers is actually disguised dividends. Paying dividends in the form of compensation would lower the overall tax bill.

- The issue for an S Corp is often the under compensation of key employees in an effort not to pay withholding and employment taxes.

Importance to Exempt Organizations Examinnters

IRC 4958 requires examiners to determine whether compensation received by disqualified persons constitutes an excess benefit. Cases decided under IRC 162 set forth important principles for evaluating reasonableness. Notice that the courts in different federal circuits use slightly different standards.

Examiners and their compensation experts should be aware of the standards used in the governing circuit. In the most recent Tax Court decision you will read on this issue, the Tax Court has adopted a new standard of review.

Unreasonable Compensation - Recent Case Law

Cite	**<u>Haffner's Service Stations, Inc. v. Commissioner</u>, T.C. Memo. 2002-38 (February 11, 2002).**
Facts	The taxpayer was a family controlled gasoline and home heating business. The business was started in the early 1940's. John and Emma created and controlled the business. Eventually, it was run by a grandchild named Haff. Also working in the business was Louise and Emile, John and Emma's daughter and son-in-law. The family is involved in litigation over the disposition of John and Emma's will. Haff was clearly in full control of petitioner. Louise and Emile performed various clerical functions. At issue here are large bonuses paid by Haff to himself, Lousie and Emile totaling over $600,000. The Service did not contest the Haff bonus because of the critical role he played in the company.
Law	The taxpayers assert that the independent investor test should be used. This test was adopted by the Seventh Circuit and would do away with the multi-factor approach. The court stated that: Recently, the Court of Appeals for the Seventh Circuit has expressed its disagreement with a multifactor test, opting instead to rest its analysis of the reasonableness of compensation primarily on whether an independent investor would have approved of the amount of compensation paid to the employee...The court observed that the Courts of Appeals for the Second and Ninth Circuits have concluded somewhat differently by requiring that the various factors of the traditional test be analyzed from the perspective of an independent investor...Our jurisprudence has also applied a multifactor test through the lens of an independent investor, in the setting of a case that was not appealable to a circuit...We follow that jurisprudence here and apply the multifactor test through the lens of an independent investor.
Holding	The court stated that: Having rejected (the expert's) conclusion in its entirety, and having rejected much of his rationale, we now turn to the various factors on reasonable compensation and analyze them seriatim through the eyes of a hypothetical independent investor. The court concluded that the bonuses were not warranted because Emile and Louise performed clerical type functions, their work for the petitioner was not fundamental, their loss would not have caused harm to the petitioner, and petitioner's success did not hinge on them.

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Unreasonable Compensation - Recent Case Law, Continued

Cite	**B & D Foundation, Inc. v. Commissioner, 82 T.C.M. 692 (October 3, 2001).**
Facts	Petitioner is a corporation engaged in the business of pouring concrete for foundations. Mr. and Mrs. Myers were its president and vice president. They provided all of its management and administrative services. At times, petitioner employed 35-40 construction workers. From 1987 to 1996, Mr. Myers' compensation increased from $30,000 to $749,500 and Mrs. Myers' increased from $6,750 to $364,300. The Service claimed that the latter salary payments were excessive and should not be fully deductible for income tax purposes. The court stated: This is yet another case in which a closely held C corporation—whose shareholders have never elected pass-through treatment under subchapter S—faces the burden of justifying the deductibility for U.S. corporation income tax purposes of amounts paid to them as compensation that respondent claims to be unreasonable and excessive.

Continued on next page

Unreasonable Compensation - Recent Case Law, Continued

B & D Foundation, Inc. v. Commissioner, continued

Law	The court stated: Compensation paid by a corporation whose stock is closely held (as in the case at hand) is to be given special scrutiny...As the Court of Appeals for the Ninth Circuit has explained, a closely held corporation will normally have an interest to characterize payments to a shareholder-employee as deductible compensation, rather than as nondeductible dividends, and the shareholder-employee and corporation are likely not to be dealing at arm's length...The problem of determining whether a purported compensation payment is actually a disguised dividend, the Court of Appeals further notes, is aggravated when a shareholder-employee is the corporation's sole shareholder. An employee who is sole shareholder not only has complete control over the corporation's operations, but is the only eligible dividend recipient.... In Pepsi-Cola Bottling Co. of Salina, Inc. v. Commissioner, supra 528 F. 2d at 179, the Court of Appeals for the Tenth Circuit, to which this case is appealable, listed nine factors to be considered, with the situation as a whole being considered and no single factor being decisive. These nine factors are: (1) The employee's qualifications; (2) the nature, extent, and scope of the employee's work; (3) the size and complexities of the business; (4) a comparison of salaries paid with the gross income and the net income; (5) the prevailing economic conditions; (6) a comparison of salaries with distributions to shareholders; (7) the prevailing rates of compensation for comparable positions in comparable concerns; (8) the salary policy of the taxpayer as to all employees; and (9) in the case of small corporations with a limited number of officers, the amount of compensation paid to the particular employee in previous years.
Holding	The court analyzed each of the factors as well as expert testimony from both sides. The Service was sustained, the petitioner was disallowed $353,911.

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Unreasonable Compensation - Recent Case Law, Continued

Cite	**Damron Auto Parts, Inc. v. Commissioner, T.C. Memo 2001-197 (July 30, 2001)**
Facts	Petitioner is a family business in the business of recycling and selling used auto parts. The business started small but was innovative and ultimately it was sold in 1998 for $12,500,000. At issue here is the amount of compensation Mr. Damron (petitioner's founder) received in 1993 and 1994. In both years he received compensation greater than $1,000,000.
Law	The court cited very little authority and did not do either a multifactor analysis or an investor review.
Holding	The Court rests its conclusion on the following analysis: Citing petitioner's payment of only one dividend over 16 years, respondent contends that the disallowed payments were not reasonable compensation. Dividend history, however, is only one of many factors in determining reasonableness of compensation...During the years in issue, Mr. Damron performed several functions for petitioner in numerous roles (i.e., purchasing, selling, supervising, etc.) He worked incessantly and exercised sound business judgment which had a direct and significant impact on petitioner's profitability. Mr. Damron transformed petitioner's business from a basic salvage yard to a modern state-of-the-art showroom. Petitioner's facility, according to respondent's expert, "is reported to be the largest of its kind." In addition, our analysis of the return on equity in petitioner reveals that petitioner had a high rate of return despite its failure to pay dividends.

Cite	**Wagner Construction, Inc. v. Commissioner, 81 T.C.M. 1869 (June 29, 2001).**
Overview	This is another closely held corporation in the construction business. The compensation at issue went from $154,456 in 1986 to $1,070,028 in 1995. The Service disallowed $1,084,719 of officers' compensation for 1995. The court did a critical analysis of both sides' experts. The petitioner's expert's analysis was flawed because it treated the principal officer as receiving the salary of 4 full-time employees because he did a variety of jobs. The respondent's expert witness's analysis was flawed because it used salary figures paid by other companies that were not comparable. The court did its own nine-point analysis. The end result came out in between the petitioner's figures and the calculation offered by the Service.

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Unreasonable Compensation - Recent Case Law, Continued

Cite	**<u>Normandie Metal Fabricators, Inc. v. Commissioner</u>, 2001 U.S.App. LEXIS 11752 (2nd Cir. May 30, 2001).**
Overview	The Service alleged that compensation was unreasonable, resulting in a substantial understatement of income tax liability. The Service determined that the corporation was liable for accuracy-related penalties under IRC 6662(a). The Tax Court agreed and was upheld by this court. The lower court used a 5-point analysis that examines compensation from an investor's perspective. This analysis has been previously used in the Second Circuit.

Cite	**<u>Metro Leasing and Development Corporation v. Commissioner</u>, T.C. Memo 2001-119 (May 18, 2001).**
Overview	The petitioner was run by Mr. Valente and his wife, an elderly couple. Mr. Valente owned car dealerships when he was younger. The petitioner's assets consisted of mostly passive investments that were the winding down of Mr. Valente's prior active businesses. For 1995 petitioner deducted $240,435 in compensation to officers that included a bonus of $180,435. The deductibility of this compensation is the subject of the litigation. The Service propounds a five-factor test, as does the petitioner. Unfortunately, the factors are not the same. The petitioner also requested that the independent investor standard be used. The court used a traditional multifactor test as well as the independent investor test. It concluded that the passive nature of the income stream did not warrant the compensation received. It also concluded that the independent investor test would not favor the petitioner.

Cite	**<u>Eberl's Claim Service, Inc. v. Commissioner</u>, 249 F.3d 994 (10th Cir. May 4, 2001).**
Facts	This is an appeal from a Tax Court decision that determined that Kirk Elberl had received excessive compensation. In 1992 he received $4,340,000 and in 1993 he received $2,080,000. Mr. Elberl was founder, president and sole shareholder of the petitioner. The petitioner provided claims adjusters to major insurance companies. There was no doubt that Mr. Elberl had superior qualifications and was indispensable to the petitioner. There were an extraordinary number of major catastrophes in 1992 and 1993 creating a demand for petitioner's services. The Tax Court determined that reasonable compensation for 1992 was $2,340,000 and $1,080,000 for 1993. The Tax Court rejected the IRC 6662 accuracy-related penalty.

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Unreasonable Compensation - Recent Case Law, Continued

Eberl's Claim Service, Inc. v. Commissioner, continued

Tax Court Law	The Appeals court stated: The Tax Court examined twelve factors to determine reasonableness: (1) The employee's qualifications; (2) the nature and scope of the employee's work; (3) the size and complexity of the business; (4) general economic conditions; (5) the employer's financial condition; (6) a comparison of salaries paid with sales and net income; (7) distributions to shareholders and retained earnings; (8) whether the employee and employer dealt at arm's length, and if not, whether an independent investor would have approved the compensation; (9) the employer's compensation policy for all employees; (10) the prevailing rate of compensation for comparable positions in comparable companies; (11) compensation paid in prior years; and (12) whether the employee guaranteed the employer's debt.
Appeals Court Law	The petitioner raised a new argument on appeal. It asked the court to adopt a new approach to determining reasonableness of compensation, the "independent investor" test. The court stated: The independent investor test approaches the issue of reasonableness by asking whether an inactive, independent investor would be willing to compensate the employee as he was compensated...In other words, a salary is entitled to a rebuttable presumption of reasonableness when a hypothetical outside investor in the company would earn a desirable rate of return.
Holding	The Tax Court decision was affirmed. On the issue of abandoning the multifactor test in favor of the "independent investor" test, the court stated: Further, of those Circuits that have embraced an independent investor test, only the Seventh had gone so far as to jettison the mult-factor approach entirely.

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Unreasonable Compensation - Recent Case Law, Continued

Cite	**Labelgraphics , Inc. v. Commissioner, 221 F.3d 1091 (9th Circuit, August 8, 2000).**
Overview	The petitioner, a closely held corporation, paid its president four fold what it had paid him in prior years. The appeals court approved the Tax Court's use of a five-factor test that gave some weight to prior under compensation but did not permit the huge increase that the president received.

Conclusion

The purpose of this article is to provide a survey of current litigation in the employment tax area. There are many more cases that were litigated in this area during this period. The facts of your case may be more similar to a case not mentioned in this article so additional legal research may be beneficial to you. We would like your feedback on whether you found this article useful for the consideration of future updates. Feel free to email the author with your comments (**Debra.J.Kawecki@irs.gov**)