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SMALL BUSINESS/SELF-EMPLOYED DIVISION

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MEMORANDUM FOR EMPLOYMENT TAX TERRITORY MANAGERS, GROUP
MANAGERS AND SPECIALISTS

FROM: John Tuzynski /s/ *John Tuzynski*
Chief, Employment Tax Operations

SUBJECT: Interim Guidance - Officer Compensation: IRC Sections 3509 and
7436, and Section 530 of the Revenue Act of 1978

The purpose of this memorandum is to clarify the law with respect to officer compensation cases. IRM Section 4.23.8.5 will be updated to reflect these procedures by July 6, 2010.

IRC Section 7436: In any officer compensation case where the corporation does not treat the officer's compensation as wages (does not file Form W-2 for the officer), examiners should follow the provisions of IRC Section 7436 and, following normal appeal procedures, issue a Notice of Determination of Worker Classification (NDWC).

For Section 7436 to apply, the determination with respect to worker classification must involve an actual controversy. Where the taxpayer treated the individual as an employee, by filing Form W-2 for example, there is no controversy, and the provisions of Section 7436 do not apply. However, where the taxpayer did not treat the individual as an employee, there is an actual controversy. This is the case even if the individual is a corporate officer and despite the fact that the IRC specifically defines an officer of a corporation as an employee for employment tax purposes. IRC Sections 3401(c), 3121(d)(1) and 3306(i).

When a corporate officer performs services for a corporation and the corporation does not treat the officer's compensation as wages, a controversy regarding whether the officer is an employee exists, whether the corporation treats the officer as an independent contractor, partner, lessee, or recipient of royalty, dividend, or loan payments. The officer may have received a Form 1099-MISC, Schedule K-1, or no information return at all.

IRC Section 3509: The tax rates under IRC Section 3509 are required to be used in all reclassification cases unless there has been intentional disregard to treat the worker as an employee. When making a determination regarding the applicability of Section 3509 in any reclassification case, including officer compensation cases, examiners should consider Section 3509(c) first.

Although IRM 4.23.8.5 specifically mentions independent contractor, Section 3509 could apply in any situation where the worker is being treated as other than an employee. For example, an officer who performs services, receives no compensation, and takes his earnings as corporate distributions. However, a taxpayer is not entitled to the reduced rates of Section 3509 if the taxpayer intentionally disregarded the employment tax requirements. Thus, in the case of a corporation treating an officer as other than an employee, if there is intentional disregard of the requirement to deduct and withhold employment taxes, the taxpayer will not be entitled to the reduced rates of Section 3509.

If IRC 3509 applies for an officer due to the fact that there was no intentional disregard of the requirement to deduct employment taxes, and the officer was treated as an independent contractor but did not receive a Form 1099-MISC or other appropriate information return listed under Section 3509(b)(1), the tax is computed using Section 3509(b) rates.

However, if the employer fails to meet the applicable reporting requirements but the failure is due to reasonable cause and not willful neglect, the lower rates under IRC 3509(a) will be used. Thus, if the employer establishes reasonable cause for not filing the information returns required under Sections 6041(a), 6041A, and 6051; i.e., the officer's payment was treated as a distribution and he receives a Schedule K-1, then the lower rates under IRC 3509(a) will be used.

Facts and circumstances should be carefully and thoroughly examined to determine the reason the officer was not treated as an employee. Quite often, in officer compensation cases, there is intentional disregard of rules and regulations. Intentional disregard occurs when a taxpayer who knows or should know of a rule or regulation chooses to ignore its requirements. See Hansen v. Commissioner, 820 F.2d 1464, 1469 (9th Cir. 1987), cited in Crowd Management Services, Inc. v. United States, 889 F.Supp. 1313 (D. Ore. 1995). Officers who perform services for a corporation are employees by statute under Sections 3401(c), 3121(d)(1), and 3306(i). Therefore, if a corporation is aware of this and an officer performs substantial services for the corporation but the corporation deliberately structures the officer's pay as distributions or loan repayment in lieu of a salary (wages), the corporation may have intentionally disregarded rules and regulations. Esser, P.C. v. United States, 750 F. Supp. 421 (D. Ariz. 1990).

Examiners who do not allow Section 3509(a) or (b) rates under Section 3509(c) must develop the facts to support their position and address it in the report. This will be developed on a case-by-case basis. Note that reliance on the preparer is not always a valid defense. The taxpayer must show he received advice from his counsel, that he relied on it in good faith, and that any such reliance was reasonable. See Accardo v. Commissioner, 942 F.2d 444 (7th Cir. 1991) (penalty for negligent underpayment under § 6653(a)), citing Betson v. Commissioner, 802 F.2d 365, 372 (9th Cir. 1986).

Also refer to Chief Counsel Advice, IRS CCA 200038045 (September 22, 2000): Question 4 of this Chief Counsel Advice addresses the application of section 3509 rates when a corporate officer has been misclassified.

Section 530 of the Revenue Act of 1978: Examiners must address Section 530 in all officer compensation cases. Section 530 must be considered when there is a controversy involving whether individuals are employees. If a corporation treats an officer as an independent contractor and files Form 1099-MISC, the reporting consistency requirement of Section 530(a)(1)(B) is met. Likewise, if the corporation pays distributions, and files Schedule K-1, then the reporting consistency requirement is met. Generally, the taxpayer will have difficulty overcoming the reasonable basis requirement of Section 530 since officers who perform services for the corporation are employees by statute under Sections 3401(c), 3121(d)(1), and 3306(i).

Classification Settlement Program (CSP): Corporations that treat officers as independent contractors and have filed the required Form 1099-MISC on a consistent basis may be entitled to a CSP offer. The provisions of IRM 4.23.6.7(5) and 4.23.6.8(7) have not changed. Note that a CSP is not available where no Form 1099 is filed, even if Schedule K-1 was issued treating the officer as a partner. IRM 4.23.6.8(6). Further, cases which do not involve a worker reclassification and merely involve reclassifying distributions as wages will not be offered a CSP Agreement.

This guidance is effective immediately. If you have any questions, please contact Ed Hutzmann, Policy Analyst, SB/SE Employment Tax, Specialty Programs.

cc: www.irs.gov