Chapter 10

Employment Taxes and Worker Classification

Form **941 for 2017: Employer's QUARTERLY Federal Tax Return**
(Rev. January 2017) Department of the Treasury — Internal Revenue Service

Form **945**
Department of the Treasury
Internal Revenue Service

Annual Return of Withheld Federal Income Tax
▶ For withholding reported on Forms 1099 and W-2G.
▶ For more information on income tax withholding, see Pub. 15 and Pub. 15-A.
▶ Go to *www.irs.gov/Form945* for instructions and the latest information.

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I-9 Compliance

- Form I-9, Employment Eligibility Verification
  - Not an IRS form; handled by Immigration and Customs Enforcement of the Department of Homeland Security ("ICE")
  - But collected as part of hiring process
  - *Buffalo Transportation, Inc. v. U.S.*, No. 15-3959-ag (2nd Cir. 12/22/16)
    - ICE audit
    - 81 violations – did not retain long enough for former employees
    - 54 violations – obtained late for current employees

I-9 Rules

- I-9 Section 1 must complete by time of hire
- I-9 Section 2 must complete within 3 business days of start of work
- Keep forms for later of:
  - 3 years from start of work
  - 1 year from termination date

https://www.uscis.gov/i-9-central/about-form-i-9
https://www.uscis.gov/system/files_force/files/form/i-9-paper-version.pdf

Buffalo Transportation, Inc. v. U.S.,

- ICE assessed penalty of $794.75 per violation ($109,675.50 total)
- BT appealed to ALJ
- ALJ agreed, but reduced penalty to
  - $600/violation for former employees
  - $500/violation for current employees
  - Rationale – BT is small business, no bad faith, and had not hired any unauthorized workers.
  - BT appeals to 2nd Circuit
    - Holds for ICE
- I-9 compliance is important!

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IRS Employment Tax Project and GAO

- IRS Employment Tax National Research Project
  - 3-year project started Feb 2010
  - No results yet
  - Should help IRS update tax gap and audit focus
  - GAO studies, issued report April 2017
    - Recommends IRS get its report issued in 2017

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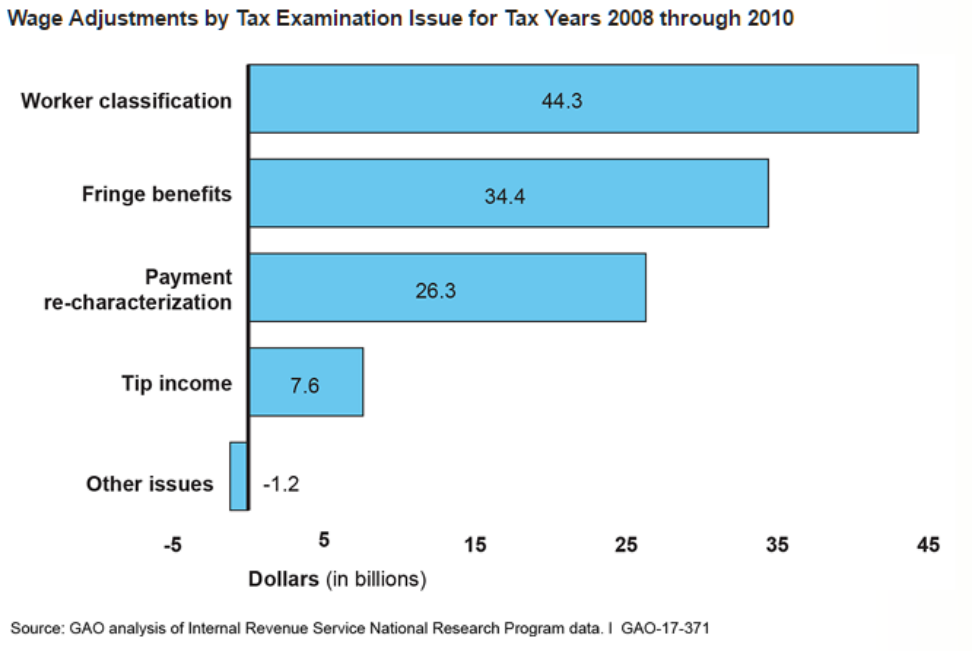

http://www.gao.gov/products/GAO-17-371

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Worker Reclassification and §3402(d)

- *Mescalero Apache Tribe*, 148 TC No. 11 (4/5/17)
  - TC – no disclosure issue for IRS to help get Form 4669 information to reduce employer tax liability under §3402(d).
  - M was able to obtain forms from all but 70 workers.
- CCA 201723020 (6/9/17)
  - Basically, don't need to follow *Mescalero.*
  - Ck with TEGEDC Area Counsel and IRM.
- NTA blog post of 9/7/17
  - What!?
  - CCA indicates taxpayer rights issue
  - If IRS won't help, reach out to local t/p advocate
- Note: Often, §3509 will apply for reclassification.

Form **4669** (December 2014)	Department of the Treasury - Internal Revenue Service **Statement of Payments Received**

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Backup Withholding for Contractors

In re Quezada, No. 16-10467 (Bk Ct, WD Texas, 6/12/17)

- Q hired contractors for masonry contracts
- 2005-2008 – IRS assessed $1.2 million for missing back-up w/h for missing TINs
  - 28% w/h required if no TIN
  - Alternatively, get Form 4669 from each contractor to show paid taxes
- Q wanted discharge in BK and holding that SL had passed.
- Ct – if no Form 945 filed, statute remains open
- Q says - use my 1040 statute date
- Ct – weak position, not enough info from Q

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Direct Sellers and IRC §3508

- CCA 201652020 (12/23/16)
  - §3508 – Direct sellers and qualified real estate agents are statutory non-employees
  - CCA – covers sellers of both tangible and intangible consumer products
    - Despite prop reg from 1986 (never finalized) where preamble says term doesn't include sellers of intangible products such as insurance and cable TV subscription.
    - Cases contrary to the prop reg exist
- *Queries*: Why not update the reg rather than just a CCA? Will Congress expand §3508 to address worker classification (such as add freelancers)?

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PEO as Statutory Employer?

- *Paychex Business Solutions, LLC, et al*, (MD FL, 6/22/17)
  - PEO found to be statutory employer under 3401(d)
  - Ok to sue IRS for refund of overpaid FICA
    - P treated start of client contract as start of FICA wage base so overpaid FICA taxes to IRS
      - Filed 941-X but IRS rejected them
- Contrast – CCA 201742025 (6/16/17)
  - PEO failed to pay taxes to IRS
  - T agreed it was the common law employer
  - Contract terms did not indicate PEO was in control of wage payment as required under §3401(d)

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Surgery Center, Medical Practice and SE Tax (§469 issue too)

- *Hardy*, TC Memo 2017-16 (1/17/17)
  - H, plastic surgeon
  - PALs from other sources
  - Owns 12.5% interest in surgery ctr, performs 11% of his work there, not involved in mgmt., patients billed by the center.
  - Treated income as follows:
  - 2006 & 2007 – nonpassive income
  - 2008 & 2009 – passive income, SE tax
  - 2010 – passive income, no SE tax

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Court holds for H (mostly)

- Center (LLC) is separate from his medical practice
  - Doesn't manage it, not required to use it.
  - IRS can't force grouping if H grouping is reasonable.
- No SE tax owed
  - H is like limited partner (§1402(a)(13))
  - Not like lawyers in *Renkemeyer* (TC 2011)
  - Not relevant that he performs surgery there – not tied to his distributive share as it was in Renkemeyer.
- Should have amended 2006 & 2007 to use $120K of PAL in those years; can't use it now.

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Lessons from *Hardy*

- Is the SE tax conclusion correct? Was H like a ltd ptr or just not required to do any work for the LLC?
  - Contrast to *Methvin*, TC Memo 2015-81, where M did not work, but was considered a general partner.
- CPA realized in filing 2008 return that in 2006 and 2007 was passive activity income
  - Should have amended returns.
  - Caused H to lose $120,000 of PAL.
  - Earlier confusion stemmed from K-1 reporting (Trade or business and SE tax)
    - But partner is one who needs to determine proper categorization and SE application.
  - Query: Did court get it right on MP? 1.469-5(f)(1) says MP counts if in any capacity. H's surgery work at LLC generated income for it. Seems to count as MP for the LLC. Might also change the conclusion that H is like a ltd partner.

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Lessons from *Hardy* - more

- Court noted can be more than one reasonable way to group activities (§1.469-4)
- Today, must also consider effect of NIIT if T subject to it.
  - Center produces income
    - As non-passive, subject to NIIT.
    - If grouped with medical practice, would be active and not subject to NIIT (but subject to SE tax and 0.9% HI tax for high income).
      - Perhaps can be grouped for §469 but not for SE tax purposes
        - §1.469-1T(d)

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PLLC Attorneys Subject to SE Tax

- *Castigliola*, TC Memo 2017-62 (4/12/17)
  - 3 attorneys were member-managers of professional LLC in Mississippi
  - Per CPA advice, only paid SE tax on their GP which were in line with legal salaries in the area.
    - Did not pay SE tax on their distributions beyond GP.
      - Rationale of CPA – are "limited partners" per §1402(a)(13).
  - Court – NO!
    - Applied *Renkemeyer* (TC 2011)

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PLLC Owners ≠ Limited Partners

- §1402(a)(13) enacted in 1977
  - No definition of "limited partner" in Code or regs
    - So, use "ordinary meaning" in 1977
    - 1977 – few states allowed LLCs
- Does person claiming exemption have position that is "functionally equivalent to that of a limited partner in a limited partnership" per state law?
  - Here, owners had full control of PLLC, made all decisions.
  - Under Mississippi law, would thus not be considered ltd partner.

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Castigliola - continued

- Negligence penalty waived by court
  - Reasonable reliance on CPA

- *Query*: Did the IRS assess a preparer penalty?

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Farm Lease and SE Tax

- *Martin*, 149 TC No. 12 (9/27/17)
  - Significant Tax Court position change in favor of t/p
  - M rented substantial farm and facilities to its separate S corp.
  - Rent at or below fair rent
  - S corp employed labor to enable the rental.
  - M not obligated to perform farm-related activities as condition of lease
  - Tax Court majority – follow *McNamara II* (8th Cir. 2000)

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Review of law

(a) NET EARNINGS FROM SELF-EMPLOYMENT … means gross income derived by individual from any trade or business carried on by such individual, less deductions allowed by this subtitle attributable to such trade or business, plus distributive share of income or loss from any trade or business carried on by partnership; except that in computing such gross income and deductions and such distributive share of partnership ordinary income or loss—

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Review of law

(1) there shall be excluded rentals from real estate and personal property leased with the real estate together with deductions attributable thereto, unless such rentals are received in course of a trade or business as a real estate dealer; except that preceding provisions shall not apply to any income derived by owner or tenant of land if

(A) such income is **derived under arrangement**, between owner or tenant and another individual, which provides that such other individual shall produce agricultural or horticultural commodities on such land, and that there shall be material participation by owner or tenant in production or management of the production of such agricultural or horticultural commodities, and

(B) there is material participation by owner or tenant with respect to any such agricultural or horticultural commodity;

McNamara II (236 F.3d 410 (8th Cir. 2000))

- Separate employment and farm rental agreements.
- Charged fair market rent or less for the rental.
- 8th Circuit: "**Rents consistent with market rates very strongly suggest that rental arrangement stands on its own as independent transaction and cannot be said to be part of an "arrangement" for participation in agricultural production. Although Commissioner is correct that, unlike other provisions, §1402(a)(1) contains no explicit safe-harbor provision for fair market value transactions, we conclude that this is the practical effect of the "derived under" language.**"

Per Tax Court Majority ...

- "Regardless of taxpayer's material participation, if rental income is shown to be less than or equal to market value for rent, income is presumed to be unrelated to any employment agreement."
- M invested about $1.2 million in facilities it rented out. Thus, "this agreement functions as a return on investment rather than a method of income recharacterization."
  - Not setup to avoid SE tax.

Caution – IRS NA to McNamara II

AOD 2003-03 "disagrees with Eighth Circuit's narrow construction of term arrangement because it is inconsistent with common meaning of that term and with Congress intent. Service agrees with Tax Court's analysis regarding common meaning of the term arrangement, and how that term is construed for purposes of other Code provisions. **If, under overall scheme of farming operations it was understood that farmer would materially participate in farm production, and farmer did in fact materially participate, then income received from lessee is subject to self-employment tax.** Service continues to believe that this is correct result regardless of whether the material participation was explicitly called for under the written or oral lease."

Reminder in *Martin* – Interpretation of SE provisions

"These self-employment tax provisions are construed broadly in favor of treating income as earnings from self-employment. … Similarly, rental income exclusion in §1402(a)(1) is to be strictly construed to prevent this exclusion from interfering with congressional purpose of effecting maximum coverage under the Social Security umbrella."