



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
Washington, D.C. 20224

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: Officer Compensation and IRC Section 3509, 7436 and Section  
530 of the Revenue Act of 1978

The purpose of this memorandum is to provide guidance and clarify instances where the above areas of the law apply in officer compensation cases. This memorandum serves as interim guidance. IRM section 4.23.8.5 will be updated to reflect these procedures by March 22, 2008.

**IRC Section 7436**

If, in an employment tax audit, the Service determines that an individual performing services for the taxpayer is an employee or that the taxpayer is not entitled to relief treatment under Section 530 of the Revenue Act of 1978, the Service is prohibited from assessing the proposed tax until it issues a Notice of Determination of Worker Classification (NDWC) and the taxpayer either exhausts its Tax Court remedies or fails to pursue them (or until the taxpayer signs the appropriate waiver of restrictions on assessment).

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 so 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. Consequently, 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); we must follow the provisions of IRC Section 7436 and, following normal appeal procedures, issue a Notice of Determination of Worker Classification (NDWC).

See the following:

**Chief Counsel Advice, IRS CCA 200009043 (Jan. 4, 2000), March 3, 2000 Released** --Advice regarding when to issue a Notice of Determination of Worker Classification with respect to a corporate officer. See item 2, pages 4-6.

**Notice 2002-5, [2002-1 C.B. 320](#)**, --Updated Procedures for Processing Employment Tax Cases Involving Worker Classification and Section 530 of the Revenue Act of 1978 Under Section 7436 of the Internal Revenue Code.

### **IRC Section 3509**

IRC Section 3509 provides for reduced rates for income tax withholding and the employee portion of FICA when an employer fails to deduct and withhold those taxes because it treated the employee as "not being an employee." 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, the taxpayer will not be entitled to the reduced rates of Section 3509.

The rates under Section 3509(a) are 1.5% of the employee's wages for income tax withholding and 20% of the employee's portion of the FICA tax.

The percentages are doubled under Section 3509(b)(1) for employers that fail to meet the information return requirements of Sections 6041(a), 6041A, or 6051, without reasonable cause. Therefore, if Form 1099-MISC or other appropriate information return was not filed, the lowest rates allowable in officer compensation cases would be Section 3509(b) rates.

Section 3509(c) provides that the reduced rates of Section 3509(a) and (b) do not apply if there is intentional disregard of rules and regulations. Quite often, in officer compensation cases, we can make this argument. Officers who perform services for a corporation are employees by statute under Sections 3401(c) and 3121(d)(1). Therefore, if an officer is aware of this and performs substantial services for the corporation but deliberately structures his pay as distributions in lieu of a salary (wages), the corporation may have intentionally disregarded rules and regulations. This will have to be developed on a case by case basis. Examiners who do not allow Section 3509 rates under Section 3509(c) must develop the facts to support their position and address it in the report.

See the following:

**Chief Counsel Advice, IRS CCA 200038045 (September 22, 2000)** --This Chief Counsel Advice addresses this issue in question 4.

### **Section 530 of the Revenue Act of 1978**

Section 530 of the Revenue Act of 1978 provides relief from employment taxes when certain conditions are met—(1) the taxpayer did not treat the individual as an employee, (2) required Federal tax returns reflect the taxpayer's treatment of the individual as a non-employee, (3) the taxpayer had a reasonable basis for not treating the individual as an employee, (4) the taxpayer did not treat any individual in a substantially similar position as an employee. See IRM 4.23.5.2.

Section 530 must be considered when there is 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). In any event, examiners must address Section 530 in officer compensation cases.

### **Classification Settlement Program (CSP)**

The provisions of IRM 4.23.6.7(5) and 4.23.6.8(7) have not changed. Corporations that treat officers as independent contractors and that have filed Form 1099-MISC may be entitled to a CSP offer. However, cases which do not involve a worker reclassification and merely involve reclassifying distributions as wages will not be offered a CSP Agreement.

The above guidance is effective immediately. If you have any questions, please contact Senior Program Analysts, Rick Schampers or Anita Bartels.

Attachment

cc: [www.irs.gov](http://www.irs.gov)

## Significant Officer Compensation Court Cases

**Nu-Look Design, Inc. v. Commissioner**, T.C. Memo 2003-52, aff'd 356 F.3d 290 (3d Cir. 2004); cert. denied, 543 U.S. 821 (2004). Tax Court jurisdiction under section 7436. Corporate shareholder/officer performed more than minor services for the taxpayer for which he received remuneration, therefore he was an employee under § 3121(d)(1). No reasonable basis for failure to treat officer as employee; therefore, no relief under Section 530.

**TCS Auto Wholesale, Inc. v. Beene and United States**, 2002 U.S. Dist. LEXIS 14595; 2002-2 U.S. Tax Case. (CCH) P50,545; 90 A.F.T.R.2d (RIA) 5279 (E.D. Wash. 2002). In District Court, Government initially took the position that taxpayer was not entitled to a Notice of Determination of Worker Classification (giving Tax Court jurisdiction) for the corporate officer, but later conceded that taxpayer was entitled to a Notice.

**TCS Auto Wholesale, Inc. v. Beene and United States**, 2002 U.S. Dist. LEXIS 20707; 2002-2 U.S. Tax Case. (CCH) P50,752; 90 A.F.T.R.2d (RIA) 6754 (2002). Taxpayer's motion for attorney's fees was denied because the Government's position was substantially justified. The court noted that at the time there was considerable confusion over the meaning of Section 7436 and the notice of determination requirement as to an owner.

**Fred R. Esser, P.C. v. United States**, 750 F. Supp. 421 (D. Ariz. 1990). The sole officer/shareholder (attorney) of a service corporation would declare yearly dividends but did not pay himself a wage. The court found intentional disregard under Section 3509 "in light of the established law in this area." Officers of closely held corporations are employees. The attorney was the sole incorporator, president, secretary, sole member of the board of directors, and the only attorney providing legal services for the corporation.

**Spicer Accounting, Inc. v. United States**, 918 F.2d 90 (9th Cir. 1990). Taxpayer accounting corporation contended that amounts paid to the accountant/stockholder were dividends since payments made to stockholders in a subchapter S corporation were not wages. In the alternative, taxpayer asserted that the accountant was an independent contractor. The court rejected both arguments. Because payments received by the accountant were for substantial services rendered, these payments were "wages" subject to FICA and FUTA taxes. The court also found that there was no evidence that the accountant was an independent contractor. Finally, the court held that Section 530 relief did not apply because taxpayer's treatment of the accountant as a stockholder, not as an employee, was unreasonable.

**Significant Officer Compensation Court Cases-continued**

**Veterinary Surgical Consultants, PC v. Commissioner**, 117 T.C. 141 (2001), aff'd in unpublished opinion sub nom. Yeagle Drywall Co. v. Commissioner, 54 Fed. Appx. 100 (3d Cir. 2002), cert. denied, 539 U.S. 943 (2003). Veterinarian was taxpayer's sole shareholder and served as its president and only officer. All of the taxpayer's income came from the services provided by the individual, who was the taxpayer's sole shareholder, president, and only officer. Section 530 relief was not available because petitioner had no reasonable basis for not treating individual as an employee.

**Joseph M. Grey Public Accountant, P.C. v. Commissioner**, 119 T.C. 121 (2002), aff'd in unpublished opinion, 93 Fed. Appx. 473 (3d Cir. 2004), cert. denied, 543 U.S. 821 (2004). Accountant/officer/shareholder was employee of corporation. Section 530 relief did not apply because taxpayer had no reasonable basis for not treating individual as an employee.