EFFECTIVE DATE

(11-09-2023)

PURPOSE

(1) This transmits a revision to IRM 4.23.5, Employment Tax, Technical Guidelines for Employment Tax Issues.

MATERIAL CHANGES

(1) This IRM was revised to reflect the following material changes:

Item	Subsection	Change
a.	IRM 4.23.5.1.3	Added paragraph (3) that states the Chief, Employment Tax, is responsible for ensuring examiners follow the guidance included in this IRM.
b.	IRM 4.23.5.1.5	Added and deleted acronyms for clarity and use.
c.	IRM 4.23.5.1.6	Updated Taxpayer Bill of Rights (TBOR) content in paragraph (3) and Taxpayer Advocate Service (TAS) information in paragraph (4). Added disclosure and privacy provisions in paragraph (5).
d.	IRM 4.23.5.3.4.1	Added paragraph (4) to reflect the guidance provided in CCA 202038010 and all succeeding paragraphs were renumbered.
e.	IRM 4.23.5.5.1	Corrected paragraph (4) by placing unanchored instruction into the bullet list. Included additional resources in paragraph (6)
f.	IRM 4.23.5.8	Clarified paragraph (2) that Indian Tribal Governments (ITG) is to be contacted through Specialist Referral System (SRS).
g.	IRM 4.23.5.13.2	Added paragraph (2) to reminded examiners to review Schedule R (Form 941) information in the EUP. All succeeding paragraphs were renumbered.

Item	Subsection	Change
h.	IRM 4.23.5.16.1.1	Corrected the title of subsection from “Section 409A” to “IRC 409A.” Added paragraph (8) to provide a link to additional resources,
i.	IRM 4.23.5.16.3	Corrected references throughout the subsection and added note to paragraph (3) regarding abatement provisions of IRC 3402(d).
j.	IRM 4.23.5.17	Split paragraph (2) into two paragraphs ((2) and (3)) and all succeeding paragraphs were renumbered.
k.	IRM 4.23.5.19	Changed the phrase “Virtual Currency” to “Digital Asset” based on communication from with Deputy Commissioner - Services & Enforcement Office Digital Assets Initiative (DAI) team. The decision was made to use the term Digital Assets and not Virtual Currency, or like terms.
l.	IRM 4.23.5.20.1	Split paragraph (1) into two paragraphs ((1) and (2)) and all succeeding paragraphs were renumbered.
m.	IRM 4.23.5.21	Revised and clarified paragraph (4).
n.	IRM 4.23.5.22	Added new paragraphs (3) and (4) to incorporate Interim Guidance Memorandum SBSE 04-0222-0001, Interim Guidance on FinCEN Access, dated February 2, 2022. All succeeding paragraphs were renumbered. Revised paragraph (5) (formerly paragraph (3)). Revised paragraph (8) (formerly paragraph (6)) for examiners without access to the FCQ System to follow the procedures provided in IRM 4.26.4.5.4, Gatekeeper or Super User Procedures, paragraph (3).

Item	Subsection	Change
o.	IRM 4.23.5.23	Expanded information and procedures regarding IRC 41 or commonly known as Research Credit due to changes in Inflation Reduction Act of 2022.
p.	IRM 4.23.5.24	Added subsection to incorporate Interim Guidance Memorandum SBSE-04-1122-0059, Interim Guidance for Examination of COVID-19 Credits and Deferrals, dated November 8, 2022. The memorandum provided information regarding certain tax credits eligible employers may claim against applicable employment taxes to provide economic relief due to the COVID-19 pandemic.

(2) Editorial changes made throughout the IRM for clarity. Reviewed and updated grammar, plain language, titles, IRM references, IRS organization or organization terminology to business unit and reorganized content.

EFFECT ON OTHER DOCUMENTS

IRM 4.23.5, dated August 14, 2020, is superceded.. This IRM incorporates the following Interim Guidance Memorandum:
SBSE-04-1122-0059, Interim Guidance for Examination of COVID-19 Credits and Deferrals, dated November 8, 2022.
SBSE 04-0222-0001, Interim Guidance on FinCEN Access, dated February 2, 2022.

AUDIENCE

This section contains instructions and guidelines for all Large Business & International (LB&I), Tax Exempt/Government Entities (TE/GE), and Small Business/Self-Employed (SB/SE) employees dealing with employment tax issues.

Richard L. Tierney
Director, Examination
Small Business/Self-Employed Division

4.23.5
Technical Guidelines for Employment Tax Issues

Table of Contents

4.23.5.1
(11-22-2017)
Program Scope

(1) **Purpose**: This section details technical guidelines for selected employment tax issues.

(2) **Audience**: This section contains instructions and guidelines for all Large Business & International (LB&I), Tax Exempt/Government Entities (TE/GE), and Small Business/Self-Employed (SB/SE) employees dealing with employment tax issues.

(3) **Policy Owner**: Director, Specialty Examination Policy of the Small Business/Self-Employed Division.

(4) **Program Owner**: Program Manager - Employment Tax Policy. The mission of Employment Tax Policy is to establish effective policies and procedures, to support compliance with employment tax laws.

(5) **Primary Stakeholders**:

- Employment Tax – Workload Selection and Delivery (SE:S:D-CE:E:HQ:ECS:S:ETEGCS:EWSD).
- Specialty Examination - Employment Tax (SE:S:DCE:E:SE:ET).
- Specialty Examination Policy, Employment Tax Policy (SE:S:D-CE:E:HQ:SEP:EMTP).
- Other areas that may be affected by these policies and procedures include Independent Office of Appeals (Appeals), Counsel, SB/SE Examination, LB&I, and TE/GE.

4.23.5.1.1
(11-22-2017)
Background

(1) The Internal Revenue Service (IRS) administers the employment taxes imposed by Chapters 21 through 25 of the Internal Revenue Code (IRC) and the self-employment taxes imposed by Chapter 2. An important phase of administration of employment taxes, including the self-employment tax, is interpreting the sections of the IRC applicable to these taxes, that is, issuing rulings and technical advice that clarify the intent of these sections. The IRS refers questions relating to:

a. Eligibility for and computation of social security benefits to the Social Security Administration, Baltimore, Maryland, or to their nearest local field office.
b. Unemployment benefits to the appropriate State Unemployment Compensation Board.
c. Railroad employee retirement benefits to the Railroad Retirement Board, Chicago, Illinois.

(2) In carrying out these duties, the IRS shares with these agencies a joint responsibility for administering the tax aspects of these programs. This requires close coordination between the IRS and these agencies at the national level to assure uniform interpretation and application of the various provisions of the law.

(3) Revenue Agents (RA), Revenue Officer Examiners (ROE), Tax Compliance Officers (TCO), Tax Specialists, and Indian Tribal Government (ITG) specialists make determinations with regard to tax liabilities for Railroad Retirement Tax Act (RRTA), Federal Insurance Compensation Act (FICA), Federal Unemployment Tax Act, (FUTA), and federal income tax withholding (FITW). Three conditions must be present for a tax liability for employee wages:

a. The relationship of employer-employee must exist.

b. The remuneration paid by the employer must constitute “wages” for purposes of the tax.
c. The employee must perform services that constitute “employment” as defined by the respective IRC Adopted the reviewer’s recommendation..

4.23.5.1.2
(11-22-2017)
Authority

(1) Employment tax provisions are found at IRC Subtitle C:

- Chapter 21, Federal Insurance Contributions Act (FICA),
- Chapter 22, Railroad Retirement Tax Act (RRTA),
- Chapter 23, Federal Unemployment Tax Act (FUTA),
- Chapter 24, Federal Income Tax Withholding (FITW), and
- Chapter 25, General Provisions relating to employment taxes and collection of income taxes at source.

(2) The Employment Tax Program is governed by Policy Statements and other internal guidance that apply to all IRS personnel regardless of operating division. The Policy Statements found in IRM 1.2.1, Servicewide Policies and Authorities, Servicewide Policy Statements, apply to all employment tax issues and examinations. Examiners should review these Policy Statements to properly perform their examination duties.

(3) A website, Search Servicewide Delegation Orders, located at *https://irm.web.irs.gov/imd/del/search.aspx* provides a searchable list of Servicewide Delegation Orders issued by the Commissioner of the Internal Revenue, or on their behalf by either of the deputy commissioners. Delegation Orders pertaining to each IRS business process can be found in IRM 1.2.2 , Servicewide Policies and Authorities, Servicewide Delegations of Authority.

(4) IRM 4.23 provides Servicewide instructions for all operating divisions with employees involved with the correct filing, reporting, and payment of employment taxes. IRM 4.23 serves as the foundation for consistent administration of employment taxes by various IRS operating divisions. By providing one source of authority for all operating divisions, the IRS greatly reduces philosophical and procedural inconsistencies.

4.23.5.1.3
(11-09-2023)
Responsibilities

(1) Director, Specialty Examination Policy, is responsible for the procedures and updates addressed in this IRM.

(2) Director, Examination Specialty Tax, is responsible for examination operational compliance.

(3) Chief, Employment Tax, is responsible for ensuring examiners follow the guidance included in this IRM.

4.23.5.1.4
(11-22-2017)
Program Objectives and Review

(1) Program Goals: The processes and procedures provided in this IRM are consistent with the objectives or goals for Employment Tax - Examination that are addressed in IRM 1.1.16.5.3.3, Employment Tax Examination, and for Employment Tax Policy, found in IRM 1.1.16.5.5.2.2, Employment Tax Policy.

(2) Program Effectiveness: Program goals are measured with Employment Tax Embedded Quality Performance Reports that monitor whether quality attributes are applied uniformly and consistently.

(3) Annual Review: Program Manager of Employment Tax Policy is responsible for reviewing the information in this IRM annually to ensure accuracy and promote consistent tax administration.

4.23.5.1.4.1
(11-22-2017)
Program Reports

(1) Program Reports: Information regarding the reporting of program objectives are included on, but not limited to, the following reports submitted to the Director, Specialty Exam Policy:

- Headquarters Examination Monthly Briefing,
- Program Manager Monthly Briefing,
- Examination Operational Review, and
- Business Performance Reviews.

(2) Quarterly Business Performance Review (BPR) provides updates on the status of the Whistleblower claims in Operating Division SME status.

4.23.5.1.5
(11-09-2023)
Acronyms

(1) The following table lists commonly used acronyms and their definitions:

Acronym	Definition
ARP	American Rescue Plan Act of 2021, P.L. 117-2, 135 Stat. 4
CARES	Coronavirus Aid, Relief, and Economic Security Act, P.L. 116-136, 134 Stat. 281
CAWR	Combined Annual Wage Reporting
CEC	Corporate Executive Compliance
CNMI	Commonwealth of Northern Mariana Islands
CFOL	Corporate Files On-Line
CPEO	Certified Professional Employer Organization
CSP	Classification Settlement Program
EIN	Employer Identification Number
EFTPS	Electronic Federal Tax Payment System
EOE	Exempt Organizations Examinations
ESPP	Employee Stock Purchase Plans
ETER	Employment Tax Examiner's Report
ET-WSD	Employment Tax - Workload Selection and Delivery unit
EUP	Employee User Portal

Acronym	Definition
FFCRA	Families First Coronavirus Response Act, P.L. 116-127, 134 Stat. 178
FICA	Federal Insurance Contributions Act
FMV	Fair Market Value
FITW	Federal Income Tax Withholding
FSL-ET	Federal, State and Local Governments Employment Tax
FTS	Fast Track Settlement
FUTA	Federal Unemployment Tax Act
IDRS	Integrated Data Retrieval System
IMF	Individual Master File
ISO	Incentive Stock Option
ITG	Indian Tribal Governments
LB&I	Large Business & International
LCC	Large Corporate Compliance Program
OD-SME	Operating Division - Subject Matter Expert
PEO	Professional Employer Organization
PLR	Private Letter Ruling
PMFOL	Payer Master File On Line
PSP	Payroll Service Providers
RA	Revenue Agent
ROE	Revenue Officer Examiner
RRTA	Railroad Retirement Tax Act
SB/SE	Small Business/Self-Employed
SECA	Self-Employment Tax Contributions Act
SERP	Supplemental Executive Retirement Plan
SME	Subject Matter Expert
SSA	Social Security Administration
TAS	Taxpayer Advocate Service

Acronym	Definition
TAM	Technical Advice Memorandum
TBOR	Taxpayer Bill of Rights
TCJA	Tax Cuts and Jobs Act
TCO	Tax Compliance Officer
TE/GE	Tax Exempt/Government Entities
TEGEDC	Tax Exempt/Government Entities Division Counsel
WB	Whistleblower
WO	Whistleblower Office

4.23.5.1.6
(11-09-2023)
Related Resources

(1) The following table lists the primary sources of guidance:

Source	Title	Description of Guidance
IRM 4.23	Employment Tax IRM	IRM sections owned by SB/SE Examination - Specialty Policy. Provides Servicewide instructions for employees of all operating divisions involved with the correct filing, reporting, and payment of employment taxes. IRM 4.23 serves as the foundation for consistent administration of employment taxes by various IRS operating divisions.
IRM 25.21.4	Affordable Care Act - IRC 6056 Non-Filer and IRC 4980H Compliance Process	IRM section owned by SB/SE Examination - Specialty Policy. This section contains instructions and guidelines for all Small Business/Self Employed (SB/SE) employees dealing with IRC 6056 and IRC 4980H.

Source	Title	Description of Guidance
IRM 25.2.1	General Operating Division Guidance for Working Whistle-blower Claims	Provides procedures and guidance for all IRS personnel to follow when dealing with Whistleblower claims and information.

(2) Helpful information sources include:

- The SBSE Employment Tax Small Business Knowledge Base (main page) is located at*https://irsgov.sharepoint.com/sites/ETD-KMT-KB014*.
- The Specialist Referral System home page: *https://srs.web.irs.gov/*.
- A list of SB/SE Employment Tax Policy Analysts, their contact information and program assignments, are found at: *Employment Tax Policy Contacts*.
- The IRS Whistleblower Program home page is located at *https://irsgov.sharepoint.com/sites/WO*.

(3) The Taxpayer Bill of Rights (TBOR) lists rights that already existed in the IRC, putting them in simple language and grouping them into 10 fundamental rights. Employees are responsible for being familiar with and acting in accord with taxpayer rights. See IRC 7803(a)(3) . For additional information about the TBOR, see *www.irs.gov/taxpayer-bill-of-rights* or *https://irsgov.sharepoint.com/sites/IRSSource/SitePages/Taxpayer-Bill-of-Rights.aspx*.

(4) The Taxpayer Advocate Service (TAS) is an independent organization within the IRS, led by the National Taxpayer Advocate. Its job is to protect taxpayers' rights by striving to ensure that every taxpayer is treated fairly and knows and understands their rights under the TBOR. TAS offers free help to taxpayers, including when taxpayers face financial difficulties due to an IRS problem, when they are unable to resolve tax problems they have not been able to resolve on their own, or when they need assistance to address an IRS system, process, or procedure that is not functioning as it should. TAS has at least one taxpayer advocate office located in every state, the District of Columbia, and Puerto Rico.

(5) Examiners will consider the disclosure and privacy provisions when preparing agreed and unagreed case reports. For further information, see the Privacy, Government Liaison and Disclosure (PGLD) maintained knowledge base at *https://irsgov.sharepoint.com/sites/ETD-KMT-KB003*.

4.23.5.2
(08-14-2020)
IRC 7436

(1) Under IRC 7436, proposed adjustments in employment tax examinations are reviewable by the Tax Court when there is a controversy involving a determination by the IRS that:

- One or more individuals performing services for the taxpayer are employees of the taxpayer, or
- The taxpayer is not entitled to treatment under Section 530 of the Revenue Act of 1978 (section 530 relief).

(2) The Tax Court may decide whether the determination by the IRS is correct and the proper amount of employment tax, penalties and additions to tax, under such determination.

(3) The law provides that any employment tax liability that results from determinations of IRC 7436 issues cannot be assessed unless the taxpayer has been given an opportunity to file a petition for Tax Court review of the IRS's determinations. See IRM 4.23.5.2.1, Classification of Employment Tax Issues, for guidance on when an employment tax issue is an IRC 7436 issue.

(4) Taxpayers must be informed they have the right to have the Tax Court review the IRC 7436 issues before any agreement is obtained. Therefore, examiners must use the proper agreement form for agreed cases or follow proper procedures for unagreed cases based on whether an issue is an IRC 7436 issue or a non-IRC 7436 issue. See IRM 4.23.10, Employment Tax - Report Writing Guide for Employment Tax Examinations, for report writing procedures. See IRM 4.23.22, Employment Tax - Unagreed Employment Tax Case Procedures, for unagreed procedures.

4.23.5.2.1 (11-22-2017) **Classification of Employment Tax Issues**

(1) Generally, employment tax examination issues are divided into "wage issues" or "worker classification issues." The proper identification of the type of issue is essential for determining the examination procedures and the tax rates applicable to the issue.

(2) For all worker classification issues, examiners must determine whether:

a. The taxpayer has met the requirements of section 530,
b. IRC 3509 rates will be used to compute the tax adjustment,
c. The taxpayer is eligible for a Classification Settlement Program (CSP) offer.

(3) For all wage issues:

a. Section 530 relief is not applicable,
b. IRC 3509 rates are not applicable, and
c. CSP is not applicable.

(4) Wage Issues: Generally, when a taxpayer treated workers as employees by issuing Forms W-2, Wage and Tax Statement, for wages, and the issues being examined are considered to be additional compensation that should have been reported as wages, the issue is classified as a "wage issue." Examples of wage issues include:

a. Payments under a non-accountable plan,
b. Compensation paid to employees in property (for example, stock, stock options),
c. Payment of non-qualified deferred compensation,
d. Severance payments to former employees, and
e. Fringe benefits not excludable by a specific IRC section or that fail to meet the statutory requirements for exclusion from wages.

(5) Worker Classification Issues: Generally, when a taxpayer did not treat workers as employees, the examination of whether the payments are subject to employment taxes is considered a worker classification issue, i.e., the payments are subject to employment taxes if the examiner determines that the workers should have been treated as employees. If the taxpayer failed to issue a Form

W-2 to the worker and only issued a Form 1099-MISC, Miscellaneous Income, Form 1099-NEC, Nonemployee Compensation, (or any other form in the family of Forms 1099 - see Caution below), the issue is generally considered a worker classification issue. However, when the worker received both a Form W-2 and Form 1099-MISC and/or Form 1099-NEC in the same calendar year, determining whether the issue is a worker classification issue is based on the facts of the particular case.

Note: If the issue concerns the individual (i.e., whether the individual was treated as an employee), it is generally a worker classification issue. If the issue concerns a payment, it is generally a wage issue.

Caution: A Form 1099-MISC or a Form 1099-NEC as the required information return will be most common. However, a taxpayer may instead use Forms 1099-K, 1099-B, 1099-C, 1099-R, or other information return; the same analysis applies.

4.23.5.2.1.1
(11-22-2017)
Type of Issues – Two Types of Returns Issued

(1) When the taxpayer has issued both a Form W-2 and a Form 1099 to a worker in the same calendar year, the examiner must consider whether the Form 1099 amounts represent additional compensation to the worker:

a. For the same services the worker performed as an employee, or
b. For separate and distinct services that are unrelated to the services provided by the worker as an employee.

(2) If the taxpayer reported payments on both Form W-2 and Form 1099 and the payments were for the same services but represent payments made during distinct periods of time during the calendar year, the issue is generally a worker classification issue. The examiner will determine whether the worker should have been treated as an employee for the period of time the worker was treated as a non-employee.

Caution: When the payment reported on Form 1099 can clearly be identified as additional compensation for the same services the worker performed as an employee, such as a taxable fringe benefit or a bonus, the issue is a wage issue. This is because the analysis relates to whether the payment meets the definition of wages or is excludable under a specific IRC section.

(3) If the worker was performing separate and distinct services and the taxpayer considered the worker to be an employee for one service and a non-employee for the other service, it is a dual status issue. Facts must be developed to determine whether the worker was actually performing separate and distinct services or whether the Form 1099 amounts represent compensation for the same services.

4.23.5.2.2
(11-22-2017)
IRC 7436 Issues

(1) "IRC 7436 issues" is an "umbrella" term that includes:

a. **Worker classification:** Whether a worker is an employee.
b. **Section 530:** Whether a taxpayer is entitled to section 530 relief.
c. **Wage issues subject to IRC 7436:** Where a taxpayer raises either a worker classification or a section 530 argument with respect to a wage issue.

(2) The issue for Tax Court jurisdiction is not whether there is a reclassification of workers, but whether there is an "actual controversy" involving a worker classification or a section 530 determination.

(3) Worker classification issues **are always** IRC 7436 issues.

(4) Some wage issues will be IRC 7436 issues and some will not. Wage issues are IRC 7436 issues if:

a. The payment was reported on Form 1099,
b. The taxpayer raises worker classification arguments with regard to the wage issue, or
c. The taxpayer raises section 530 arguments with regard to the wage issue.

(5) The following situations illustrate when an employment tax issue falls under IRC 7436:

a. When Form 1099-MISC or Form 1099-NEC is issued and an employment tax adjustment is proposed for the payment on, the issue will fall under IRC 7436 regardless of whether worker also received Form W-2 in the audit year and regardless of the purpose of the payment reported on the Form 1099-MISC or Form-1099 NEC. The issuance of a Form-1099 MISC or Form 1099-NEC for the payment is an implicit argument that the worker is not an employee with respect to the payments reported on the Form 1099-MISC or Form 1099-NEC, thus creating an "actual controversy" under IRC 7436.
b. Worker received Form W-2 for audit year and received additional payments not reported on any information return, but taxpayer raises a worker classification or section 530 argument for why the additional payments are not wages. The taxpayer's argument creates an "actual controversy" under IRC 7436.

(6) The following situation demonstrates when an employment tax issue does not fall under IRC 7436:

Example: Worker received Form W-2 for audit year and received additional payments not reported on any information return, but taxpayer does not raise a worker classification or section 530 argument for why the additional payments are not wages or is silent as to reason why the additional payments are not wages. Since this is a wage issue without the taxpayer raising an argument that would create a worker classification or section 530 controversy, this wage issue would not be reviewable by the Tax Court.

(7) The following example demonstrates when an employment tax issue generally would be considered to fall under IRC 7436:

Example: A taxpayer is paying the worker for current services with no information reporting and the examiner determines that the worker is an employee. This is generally a worker classification issue reviewable by the Tax Court. But if the payment is for past services (such as severance pay, backpay, or is otherwise based on services or employment status in prior years), the examiner will contact TEGEDC for guidance to determine whether under the particular facts, the issue is reviewable by the Tax Court under IRC 7436.

(8) An issue initially identified as a wage issue will usually not be considered to be an IRC 7436 issue at the beginning of the audit unless the payment was reported on Form 1099-MISC or Form 1099-NEC. Examiners will likely not identify a wage issue as an IRC 7436 issue until later in the examination as facts are developed and taxpayers present their positions on the issue by raising a worker classification or section 530 argument. Examiners will **not raise** a worker classification or section 530 argument with the taxpayer in a wage issue unless the taxpayer brings it up during the audit. If the issue is identified as a wage issue and the taxpayer did not report the payment on Form 1099-MISC or Form 1099-NEC, or raise a worker classification or section 530 argument with regard to the payments, then the issue will remain a wage issue not subject to IRC 7436.

(9) If the taxpayer fails to raise a worker classification or section 530 argument with respect to a wage issue during the audit but raises either of these issues in a protest to a 30-day letter, the issue will **then** be considered an IRC 7436 issue. Examiners must consider the taxpayers' arguments and develop the issue further to address these arguments before sending the case to Appeals.

(10) Just because an issue falls under IRC 7436 does not mean it is a worker classification issue to which section 530, IRC 3509 rates, and CSP apply. If the issue is a wage issue that is subject to IRC 7436, examiners will need to address that section 530, IRC 3509, and CSP are not applicable.

(11) Backup withholding adjustments are generally not IRC 7436 issues. If a taxpayer raises a section 530 argument with respect to a proposed backup withholding adjustment, contact TEGEDC for guidance on whether to follow IRC 7436 procedures.

(12) Combined Annual Wage Reporting (CAWR) examinations address issues on cases in which the taxpayer filed Forms W-2 and withheld employment taxes but failed to file employment tax returns and pay the appropriate employment taxes. Generally, CAWR cases are not IRC 7436 issues. If a taxpayer raises a worker classification or section 530 argument with respect to a proposed CAWR adjustment, contact TEGEDC for guidance on whether to follow IRC 7436 procedures.

(13) When examiners encounter situations in which the taxpayer used a Professional Employer Organization (PEO) or Certified Professional Employer Organization (CPEO) to pay wages to the employees, any employment tax adjustments assessed against the taxpayer may or may not be subject to IRC 7436 depending on the facts of the specific case. Examiners will contact TEGEDC for guidance on these cases to determine whether these are IRC 7436 issues.

4.23.5.3 (11-22-2017) **Section 530 of the Revenue Act of 1978**

(1) Section 530 of the Revenue Act of 1978 provides employers with relief from federal employment tax obligations if certain requirements are met. It terminates the employer's, **not the worker's**, employment tax liability under IRC Subtitle C:

- Chapter 21, Federal Insurance Contributions Act (FICA),
- Chapter 22, Railroad Retirement Tax Act (RRTA),
- Chapter 23, Federal Unemployment Tax Act (FUTA),
- Chapter 24, Collection of Income Tax at Source on Wages, and
- Chapter 25, General Provisions Relating to Employment Taxes.

(2) If a taxpayer is relieved of liability under section 530(a)(1) of the Act, any liability for interest or penalties attributable to that liability is forgiven automatically. This relief from interest and penalties applies whether charged directly against the taxpayer or personally against a corporate taxpayer's officers. See Rev. Proc. 85-18,1985–1 C.B. 518.

(3) Under section 530(d), relief does not apply to certain technically-skilled workers who provide services under a three-party arrangement.

(4) Section 530(e) clarifies that the first step in any worker classification examination involving whether a taxpayer has employment tax obligations of an employer with respect to workers is determining whether the taxpayer meets the requirements of section 530. If so, the taxpayer will not have an employment tax liability with respect to the workers at issue.

(5) Section 530 relief can apply with respect to any employees defined in IRC 3121(d), IRC 3306(i), and IRC 3401(c). See section 3.09 of Rev. Proc. 85–18.

4.23.5.3.1
(11-22-2017)
Section 530 Relief

(1) Section 530 is a relief provision that **must** be considered as the **first step** in any case involving worker classification. Relief is available to taxpayers that are under examination or involved in administrative (including Appeals) or judicial proceedings with respect to assessments or proposed assessments based on employment status reclassification.

(2) Section 530 applies only to worker classification issues. Section 530 does not apply to wage issues. However, if a wage issue is determined to be an IRC 7436 issue, the examiner must address section 530. See IRM 4.23.5.2.2, IRC 7436 Issues, for guidance on when a wage issue is subject to IRC 7436. Also, refer to IRM 4.23.5.3.2, Addressing Section 530 for IRC 7436 Wage Issues, for guidance on addressing section 530 for IRC 7436 wage issues.

(3) The taxpayer need not concede or agree to the determination that the workers are employees for section 530 relief to be available.

(4) The examiner must first explore the applicability of section 530 even if the taxpayer does not raise the issue. It is not necessary for the taxpayer to claim section 530 relief for it to be applicable.

(5) Pub 1976, Do You Qualify for Relief under Section 530?, must be provided to the taxpayer before initiating any worker classification or IRC 7436 wage issue examination.

a. This publication can be provided with the appointment letter or during the initial interview of an employment tax examination if a worker classification or IRC 7436 wage issue is identified during pre-exam or if worker classification is the reason for the examination.

Note: The examiner may not know whether a wage issue is an IRC 7436 issue until later in the examination after the taxpayer raises either a worker classification or section 530 argument with respect to the issue. Publication 1976 will be provided to the taxpayer at the time the examiner determines that the wage issue is an IRC 7436 issue.

b. If a worker classification or IRC 7436 wage issue arises during the course of an income tax or tax-exempt examination, the publication must be provided at that time.

c. Notate how and to whom the publication was delivered in Form 9984, Examining Officer's Activity Record, in the case file.

4.23.5.3.2
(11-22-2017)
Addressing Section 530 for IRC 7436 Wage Issue

(1) For wage issues that are subject to IRC 7436, section 530 needs to be addressed in two ways:

1. The examiner must explain in the workpapers that section 530 is not applicable because this is a wage issue, and
2. The examiner must also explain whether the statutory requirements for relief would have been met if section 530 were applicable to the issue.

(2) "Is Not Applicable": Section 530 only applies to worker classification issues and never applies to wage issues. Raising section 530 in regard to a wage issue creates the controversy that makes the issue fall under IRC 7436. However, section 530 is not applicable because it is still a wage issue.

(3) Although the examiner must explain the IRS's position that section 530 applies only to worker classification issues, the examiner must still address the merits of section 530 as an alternative argument in case the Tax Court decides that section 530 is applicable to that wage issue.

Note: Although a taxpayer will rarely meet the requirements of section 530 on the merits with respect to a wage issue subject to IRC 7436, it is possible that the taxpayer could meet the three requirements. In such a case, since the primary position is that the taxpayer is not entitled to relief because section 530 is not applicable to a wage issue, the employment tax adjustment would still be made.

4.23.5.3.3
(11-22-2017)
Establishing Section 530 Relief

(1) The taxpayer must meet two consistency requirements before the relief provisions of section 530 apply. The relief applies only if:

a. All federal tax returns, including information returns such as Form 1099-MISC or Form 1099-NEC required to be filed with respect to the worker for the period, are timely filed and filed on a basis consistent with the taxpayer's treatment of the worker as not being an employee. See discussion at IRM 4.23.5.3.3.1, Consistency Requirement—Reporting Consistency, and
b. The treatment of the worker as not being an employee is consistent with the treatment by the taxpayer (or predecessor) of all workers holding substantially similar positions. See discussion at IRM 4.23.5.3.3.2, Consistency Requirement—Substantive Consistency.

(2) In addition to the consistency requirements, the taxpayer must have had a reasonable basis for not treating the worker as an employee. See discussion at IRM 4.23.5.3.3.3, Section 530 - Reasonable Basis, and following subsections.

(3) Examiners must address and develop all three requirements of section 530 even if the taxpayer fails one of them.

Example: If the examiner initially determines that the taxpayer fails the reporting consistency test, the examiner must still address and develop the substantive consistency and reasonable basis tests even though failing the reporting consistency test is sufficient to deny the taxpayer section 530 relief.

(4) The examiner should work with the taxpayer to determine what information is needed to decide whether the taxpayer has met the requirements for section 530 relief. Exercise caution to ensure requested information is both relevant and reasonable.

(5) Under the section 530(e)(4) "Burden of Proof" provision, the IRS will bear the burden of proving that the taxpayer's treatment is inaccurate. The burden of proof does **not** shift to the IRS if the taxpayer relied on some other reasonable basis. A prima facie case means that the taxpayer has presented evidence that will allow the taxpayer to prevail unless the government presents other evidence that contradicts and overcomes the taxpayer's evidence. The taxpayer establishes a prima facie case by meeting:

- The reporting consistency requirement,
- The substantive consistency requirement,
- One of the three reasonable basis safe havens, **and**
- The taxpayer has fully cooperated with reasonable requests from the examiner. .

(6) If the examiner determines that the taxpayer is entitled to section 530 relief, the examination of the worker classification issue will be discontinued. The taxpayer will continue to file the required federal tax returns (such as Form 1099-MISC or Form 1099-NEC) with respect to the workers.

(7) Comments on Form 4318-ET, Employment Tax Examination Workpapers, Standard Audit Index Number (SAIN) lead sheet, "Section 530 Lead Sheet Worker Classification Issues," Form 5773, EP/EO Workpaper Summary Continuation Sheet, or other similar workpapers, will explain the basis for allowing or denying the relief. In unagreed cases, address the section 530 relief issue in the Employment Tax Examiner's Report (ETER) in the same manner as any other unagreed issue (issue, statement of facts, law, taxpayer position, and conclusion). See IRM 4.23.10.16.1, Preparing Explanation of Adjustments.

4.23.5.3.3.1 (11-22-2017) Consistency Requirement—Reporting Consistency

(1) The first requirement a taxpayer must meet to obtain section 530 relief is timely filing of all required federal tax returns, including information returns such as Form 1099-MISC or Form 1099-NEC with respect to the worker for the period, on a basis consistent with the treatment of the worker by the taxpayer as not being an employee.

(2) This provision applies on a period-by-period basis. That is, if a taxpayer in one year fails to file all required returns but in a subsequent year files all required returns on a basis consistent with the treatment of the worker as not being an employee, then the taxpayer may qualify for section 530 relief for the subsequent period. See Rev. Rul. 81-224, 1981-2 C.B. 197 and *General Investment Corp. v. United States*, 823 F.2d 337 (9th Cir. 1987).

(3) This provision also applies on a worker-by-worker basis. That is, if a taxpayer filed information returns for some workers but not others, then the taxpayer may qualify for section 530 relief for the workers who were issued information returns but not for the workers the taxpayer failed to issue information returns.

(4) If a taxpayer is not required to file, section 530 relief will not be denied on the basis that the return was not filed. Rev. Rul. 81-224 addresses specific questions about timely filing of Form 1099-MISC or Form 1099-NEC. It provides that:

a. Taxpayers that do not file timely all federal tax returns, including information returns such as Form 1099-MISC or Form 1099-NEC consistent with their treatment of the worker as not being an employee, may not obtain section 530 relief for that worker for that period.
b. Taxpayers that mistakenly, in good faith, file the wrong type of Form 1099 may still be entitled to section 530 relief.

(5) The best sources for determining whether Forms 1099-MISC or Forms 1099-NEC were filed timely are Corporate Files On-Line (CFOL) and the Integrated Data Retrieval System (IDRS). Campuses maintain information on the Payer Master File, which records the taxpayer's history of filing information returns. These transcripts can be requested internally using Command Code PMFOL.

4.23.5.3.3.2
(08-31-2012)
Consistency Requirement—Substantive Consistency

(1) The taxpayer (or a predecessor) must not have treated the worker, or any worker holding a substantially similar position, as an employee for any period after 1977. Rev. Proc. 85-18, section 3.03, provides guidelines for determining whether a taxpayer treated an individual as an employee for a period of time.

(2) The determination of whether workers hold substantially similar positions requires consideration of the relationship between the taxpayer and those individuals, including the degree of supervision and control. Differences in managerial responsibilities and differences in reporting requirements should be taken into account, along with differences in job duties, the contractual relationship, and the provision of employee benefits.

(3) The determination of what is substantially similar work is based on analysis of the facts. The day-to-day services that workers perform and the method by which they perform those services are relevant in determining whether workers, treated as independent contractors, hold substantially similar positions to workers treated as employees.

4.23.5.3.3.3
(12-10-2013)
Section 530 — Reasonable Basis

(1) In addition to the consistency requirements, the taxpayer must have had a reasonable basis for not treating the worker as an employee. It is the intent of Congress that the reasonable basis requirement should be construed liberally in favor of the taxpayer.

(2) A taxpayer will be treated as having a reasonable basis for not treating a worker as an employee if the treatment was in reasonable reliance on one of three safe havens:

a. Judicial precedent, published rulings, technical advice with respect to the taxpayer, or a letter ruling to the taxpayer. See IRM 4.23.5.3.3.4, Safe Haven – Judicial Precedent or Published Rulings.
b. A past IRS audit of the taxpayer in which there was no assessment attributable to the treatment (for employment tax purposes) of the individuals holding positions substantially similar to the position held by this individual. See IRM 4.23.5.3.3.5, Safe Haven – Prior Audit.
c. A long-standing recognized practice of a significant segment of the industry in which the taxpayer was engaged. See IRM 4.23.5.3.3.6, Safe Haven – Industry Practice.

(3) To satisfy one of the safe havens, a taxpayer must demonstrate that it actually and reasonably relied on the safe haven in treating the workers as non-employees for the period at issue. The taxpayer must have relied on the

asserted reasonable basis during the periods in issue, at the time the employment decisions were being made. See *Nu-Look Design, Inc. v. Commissioner*, T.C. Memo. 2003-52, aff'd., 356 F.3d 290 (3d Cir. 2004).

(4) A taxpayer that fails to meet any of the three "safe havens" may nevertheless be entitled to relief if the taxpayer can demonstrate, in some other manner, any reasonable basis for not treating the worker as an employee. See IRM 4.23.5.3.3.7, Other Reasonable Basis.

4.23.5.3.3.4
(12-10-2013)
Safe Haven—Judicial Precedent or Published Rulings

(1) To qualify for the judicial precedent safe haven, a taxpayer must have reasonably relied on a particular judicial precedent or published ruling or on technical advice relating to the taxpayer or a letter ruling to the taxpayer. For judicial precedent or a published ruling, the facts must be similar to the situation of the taxpayer.

(2) The taxpayer must have relied on the judicial precedent or published ruling during the periods in issue, at the time the employment decisions were being made. The reliance does not necessarily have to have taken place when the taxpayer first engaged the workers, but it must have been before the tax period at issue. See *Nu-Look Design, Inc. v. Commissioner*, T.C. Memo. 2003-52, aff'd., 356 F.3d 290 (3d Cir. 2004) and *Peno Trucking, Inc. v. Commissioner*, T.C. Memo. 2007-66, rev'd in unpublished opinion, 296 Fed.Appx. 449, 2008 WL 4463765 (6th Cir. 2008).

(3) State court decisions and rulings of agencies other than IRS do not constitute judicial precedent. Under some circumstances, however, state court decisions and federal agency rulings may be the basis for findings that the taxpayer reasonably relied on some other reasonable basis. This distinction, that state court decisions may qualify as other reasonable basis rather than judicial precedent, is important because the burden of proof may shift to the IRS if the taxpayer establishes a prima facie case for "judicial precedent" but not for "other reasonable basis."

4.23.5.3.3.5
(11-22-2017)
Safe Haven—Prior Audit

(1) To qualify for the prior audit safe haven, a taxpayer must show that it reasonably relied on a prior IRS audit of the taxpayer in which there was no assessment attributable to the taxpayer's treatment, for employment tax purposes, of individuals holding positions substantially similar to the position held by the individual whose treatment is at issue. See section 530(a)(2)(B).

(2) For examinations that began after December 31, 1996, the prior IRS audit must have included an examination for employment tax purposes of the status of the individual involved or any individual holding a position substantially similar to the position held by the individual involved.

(3) For examinations that began before January 1, 1997, the prior IRS audit does not have to have been an audit for employment tax purposes as long as the audit entailed no assessment attributable to the business's treatment, for employment tax purposes, of workers holding positions substantially similar to the position held by the workers whose treatment is at issue. The business need only show that, at the time of the earlier examination, it was treating the same type of workers as those at issue in the present audit as other than employees, and that the treatment went unchallenged or was sustained by the IRS.

(4) A taxpayer does not meet this test if, in the conduct of a prior examination, an assessment attributable to the taxpayer's treatment of the worker was offset by other claims asserted by the taxpayer. Nor can the taxpayer rely on a prior audit if the current working relationship between the taxpayer and the workers is significantly different from their working relationship at the time of the audit.

(5) The audit must have included an examination of the taxpayer's books and records.

a. Inquiry or correspondence from a Campus or an SS-8 unit is not treated as a past examination.
b. Applications for status determination, such as an application for recognition for exemption from income tax as an exempt organization or an application for a determination letter for an employee benefit plan made on Form 5300, Application for Determination for Employee Benefit Plan, or Form 5309, Application for Determination of Employee Stock Ownership Plan, do not constitute an examination.
c. An examination of an employee benefit plan or consideration of Form 5500, Annual Return/Report of Employee Benefit Plan, generally does not constitute an examination because the plan is not the taxpayer that employs the workers. However, an examination of the taxpayer's pension plan that leads to an examination of the taxpayer's books (i.e., such as payroll records to determine whether coverage requirements have been met) may create a safe haven for the taxpayer.

(6) The prior examination safe haven is limited to past examinations conducted on the taxpayer itself. Therefore, a taxpayer is not entitled to relief based upon a prior examination of any of its workers. Nor would a subsidiary corporation usually be entitled to relief based upon a prior examination of its separately filing parent corporation.

(7) If a previously examined taxpayer begins conducting a new line of business, that taxpayer is not entitled to relief based upon the examination of the original line of business. However, if there has only been a change of form and the successor entity is in the same line of business, the taxpayer could qualify for section 530 relief based on other reasonable basis.

4.23.5.3.3.6
(12-10-2013)
Safe Haven—Industry Practice

(1) To qualify for the industry practice safe haven, the taxpayer must show that it reasonably relied on a long-standing recognized practice of a significant segment of its industry. An industry generally consists of businesses located in the same geographic or metropolitan area which provide the same product or service and compete for the same customers.

(2) Section 530(e)(2)(B) clarifies that 25 percent of the taxpayer's industry (determined without taking the taxpayer into account) is deemed to constitute a significant segment of the industry. The legislative history notes that a lower percentage may be a significant segment, depending on the facts and circumstances.

(3) Section 530(e)(2)(C) provides that practices that have existed for more than 10 years are long-standing. The legislative history notes that the 10-year rule is merely a safe haven. A shorter period may be long-standing, depending on the facts and circumstances.

(4) A claim of reliance on industry practice necessarily requires that the business knew of the industry practice at the time the employment decisions were being made for the periods at issue. The long-standing industry practice must have existed at that time to be relied upon.

(5) Whether the taxpayer relied on industry practice can generally be established by several types of evidence. Examine taxpayer records, such as corporate minutes or unanimous consents in lieu of director's meetings, to determine whether any written record exists that shows the reason for treatment of workers as independent contractors. Interview the workers themselves to determine what reasons were given to them by the taxpayer when establishing their status as independent contractors.

4.23.5.3.3.7
(11-22-2017)
Other Reasonable Basis

(1) A taxpayer that fails to meet any of the three "safe havens" may still be entitled to relief if it can demonstrate that it relied on some other reasonable basis for not treating a worker as an employee. The legislative history indicates that reasonable basis should be construed liberally in favor of the taxpayer. H.R. Rep. No. 95-1748 (1978).

(2) Reliance on an attorney or accountant may constitute a reasonable basis. The taxpayer need not independently investigate the credentials of the attorney or accountant to determine whether such advisor has any specialized experience in the employment tax area. However, the taxpayer should establish at a minimum, that it reasonably believed the attorney or accountant to be familiar with taxpayer's tax issues and that the advice was based on sufficient relevant facts furnished by the taxpayer to the adviser. If other evidence clearly shows that the adviser was not qualified, the mere holding of a law or accounting license would not make the reliance on the advice of the attorney or accountant reasonable. Advice could not have been relied upon unless it had been furnished at the time the employment decisions were being made for the periods in issue. See *In re Compass Marine Corporation,* 146 B.R. 138 (Bkrpcy E.D. Pa. 1992). In that case, it was held that advice from its labor counsel issued three years after the treatment does not support the treatment.

(3) Prior state administrative action (for example workers' compensation decisions) and other federal determinations (for example determinations under the Federal Labor Standards Act (Wage and Hour Division)) may or may not constitute a reasonable basis. This will depend on whether they use the same common law rules that apply for federal employment tax purposes. If the state or federal agency uses the same common law standard and interprets it similarly, its determination may constitute a reasonable basis. If the state or federal agency uses a different statutory standard or interprets the common law standard differently, its determinations should not constitute other reasonable basis.

(4) Although a Private Letter Ruling (PLR) or Technical Advice Memorandum (TAM) issued to the taxpayer's predecessor does not qualify as judicial precedent, the business may qualify for relief under other reasonable basis if there has merely been a change in the form of the business. The successor must be in the same line of business.

4.23.5.3.4
(12-10-2013)
Effect of Section 530 on Workers

(1) Generally, a worker status determination for a class of worker is not made by an examiner if the firm is entitled to section 530 relief with respect to those workers. However, workers may be determined to be employees through some other means such as an employee plans examination. In addition, workers may request a determination of their individual status by filing a Form SS-8, Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding. See IRM 4.23.3.3.3 , SS-8 Program, for additional information.

(2) It is important to remember that even if an employer is entitled to section 530 relief, workers determined to be employees in paragraph (1) are employees for other purposes of the IRC. Section 530 only terminates the liability of the employer for the employment taxes but has no effect on the employees' status. It does not convert workers from the status of employee to the status of self-employed (non-employee). The workers are still considered employees for income tax and qualified benefit plan eligibility purposes. Therefore, the employer must consider these workers as employees in determining whether its pension, profit-sharing, or stock-bonus plan satisfies the qualification requirements of IRC 401(a).

(3) The workers determined to be employees in paragraph (1) remain liable for the employee share of FICA tax with respect to all wages received. See Rev. Proc. 85-18, section 3.08, and Treas. Reg. 31.3102-1(c). See also Rev. Rul. 86-111, 1986-2 C.B. 176.

(4) Where workers determined to be employees in paragraph (1) have filed and paid their tax under the Self-Employment Tax Contributions Act (SECA), they may file a claim for refund for the difference between SECA tax and the employee share of FICA, if applicable. However, they may owe additional tax if the employee share of FICA exceeds the SECA that they actually paid. The specific tax effect will depend on a number of factors, including the amount of expenses deducted on Schedule C (Form 1040), Profit or Loss From Business, (if any) and whether the expenses are allowable as a deduction on Schedule A (Form 1040), Itemized Deductions, as employee business expenses (for years prior to 2018).

(5) As an employee, the worker generally cannot deduct unreimbursed business expenses on Schedule C (Form 1040) but must deduct them as miscellaneous itemized deductions on Schedule A (Form 1040), subject to the two-percent limitation under IRC 67. This sometimes results in liability for the alternative minimum tax. Further, the worker cannot adopt or maintain a self-employment retirement plan. Finally, certain benefits provided by the taxpayer to a worker as an employee may be excludable from income by the employee due to specific IRC exclusions provided only to employees (for example employer provided accident and health insurance).

(6) Notice 989, Commonly Asked Questions When IRS Determines Your Work Status is "Employee", is mailed to taxpayers who submit a Form SS-8 to determine their exact employment tax status (i.e., employee or independent contractor), along with the appropriate SS-8 Determination Program Letter. The notice contains information for Form 1040, U.S. Individual Income Tax Return, filers if their status is changed from non-employee to employee.

4.23.5.3.4.1
(11-09-2023)
State and Local Employees

(1) Workers covered under a Section 218 Agreement are employees for purposes of FICA. See IRC 3121(d)(4). This classification is not made under rules found in the IRC or the regulations; the classification is made by the Social Security Act. For additional information refer to IRM 4.75.21.10, General Guidance Related to State and Local Government Entities, and IRM 4.75.21.11, Contacting SSA Regional Office on Section 218 Coverage Issues.

(2) There is no provision in Chapter 24, Collection of Income Tax at Source, similar to IRC 3121(d)(4), which provides that workers covered under a Section 218 Agreement are employees. The IRS has jurisdiction over the determination of whether state and local workers are employees for FITW purposes.

(3) The common law rules are used to determine the status of a state or local government worker who is not covered under a Section 218 agreement. Section 530 relief is available for these workers, if the requirements for section 530 relief are satisfied.

(4) A worker at issue that is included under a Section 218 agreement (Section 218 workers) does not prohibit the application of section 530 relief if the state or local government meets all the requirements of section 530.

(5) In determining whether a taxpayer meets the requirements for section 530 relief with respect to Section 218 workers, examiners will contact the TEGEDC for technical assistance.

4.23.5.3.4.2
(12-10-2013)
Workers Not Covered by Section 530

(1) Section 530(d) provides that section 530(a) relief is not available in the case of a worker who, pursuant to an arrangement between the taxpayer and a client, provides services for that client as any of the following:

- Engineer
- Designer
- Drafter
- Computer programmer
- Systems analyst
- Other similarly skilled worker engaged in a similar line of work.

(2) Section 530(d) applies only to the taxpayer in a three-party situation, namely, the taxpayer providing workers to a client. The intent of Congress was to classify, under the common law rules, workers retained by taxpayers to provide technical services without regard to section 530. Section 530(d) does not change anyone from an independent contractor to an employee. The examiner must still look at the common law rules.

4.23.5.4
(11-22-2017)
Independent Contractor or Employee

(1) For federal tax purposes, a worker providing services to a service recipient may be an independent contractor, an employee, a statutory employee, a statutory non-employee, a partner, and so on. However the difference between an employee and any other type of worker is an important issue and has the potential to change the tax responsibilities of both the service recipient and the worker.

(2) Any worker classification can be valid. However, how a firm classifies a worker is **not a choice**: For federal employment tax purposes, federal law determines whether a worker is an employee, independent contractor, or another category. Publication 1779, Independent Contractor or Employee, provides basic infor-

mation about the three categories of evidence used to determine whether workers are employees or independent contractors.

4.23.5.5
(02-01-2003)
Developing the Facts

(1) Employment status cannot be determined simply by looking at job titles. Facts must be developed to make a correct determination. When developing the facts, consider the following:

a. In making a determination, look at the entire relationship between a taxpayer and a worker. The relationship often has several facets, some indicating the taxpayer has control, while others indicate it does not.
b. Control is a matter of degree. Even in the clearest case of an independent contractor, the worker is constrained in some way. Conversely, employees may have autonomy in some areas.

(2) It is important to first understand the work that is being performed and the business context in which it is being performed. The examiners need to identify and evaluate evidence. This is a critical point in case development. The types of evidence that help to determine control in the common law employer-employee relationship are listed in Exhibit 4.23.5-1, Determining the Right to Direct or Control.

(3) To make a correct determination regarding the employment status of the worker, examiners need to consider the evidence of both autonomy and the right to control.

(4) In determining whether a worker is an employee:

a. First, apply the common law factors. See IRM 4.23.5.6, Categories of Employees.
b. If the facts do not support a position that a worker is a common law employee, then apply the rules under IRC 3121(d)(3) to determine if the worker is a statutory employee. See Exhibit 4.23.5-3, Statutory Employees.
c. If a statutory employee relationship exists, the employer and employee are liable for their respective shares of FICA. Employers of statutory employees described in IRC 3121(d)(3)(A) (agent drivers) and IRC 3121(d)(3)(D) (traveling or city salespersons) are also liable for FUTA. Statutory employees are not subject to FITW.

(5) When an employer-employee relationship exists, it is of no consequence whether the employee is designated as a trustee, agent, independent contractor, or other title. Additionally, signing a contract does not always indicate the worker is self-employed. What does govern is the substance of a particular relationship, and consequently taxpayers cannot contract away their employment tax liabilities. See Exhibit 4.23.5-4, Employer-Employee Relationship Cases, for assistance.

4.23.5.5.1
(11-09-2023)
Supplemental Procedures When Contacting Workers

(1) In an examination of an employer to determine worker status, the examiner may need to interview workers and question them with regard to the three categories of evidence used to determine a worker's status for federal tax purposes. When this occurs, the examiner may use questions based on Form SS-8 to assist in the determination. However, the actual Form SS-8 is **not** to be used or provided to the workers or the employer.

(2) Additional questions may be required to be developed by the examiner for specialty job categories or to establish controlling factors known to be important in applicable rulings and/or court cases.

(3) Examiners are required to provide notice to a taxpayer prior to making any third-party contacts with respect to that taxpayer. **Effective August 15, 2019**, Pub 1, Your Rights as a Taxpayer, will no longer satisfy the advance notice requirement of IRC 7602(c)(1). Thus, in all cases involving third-party contact notices provided after August 15, 2019, or in which contacts with third parties will occur after August 15, 2019, a notice meeting the new requirements must be provided, and no contact with a third-party can be made until the 46th day following the date of the notice.

(4) General notice procedures now require employees to:

- Intend at the time notice is issued to contact persons other than the taxpayer,
- Issue advance notice of third-party contacts (see (5) following),
- Specify that the time period is not to exceed one year. However it may be re-issued at the end of the one-year time period for an additional one-year time period, and
- Wait 45 days before contacting a third-party.

(5) Notice is made by using Letter 3164-E, Third Party Contact, or other notice letter designated by the examiner's organization. The notice must include the tax period(s) at issue and the time period, not to exceed one year, within which the IRS intends to make the contacts. If necessary, the notice may be reissued.

(6) Additional information is available at:

- IRM 25.27.1, Third Party Contact - Third Party Contact Program
- IRM 4.10.1, Overview of Examiner Responsibilities
- IRM 4.10.2, Pre-Contact Responsibilities
- IRM 4.23.3.6.6.1, Third-Party Contacts
- IRM 4.11.57, Examining Officers Guide - Third Party Contacts

(7) Document the case history/activity record with the date of mailing or personal delivery of the notice requirements in (3) above, as well as the date that Form 12175, Third Party Contact Report Form, was prepared and forwarded to the Third Party Contact Coordinator. See IRM 4.23.3.6.4, Scheduling the Initial Appointment, and IRM 4.23.3.6.5, Contact With Taxpayers, for additional requirements.

4.23.5.6
(02-01-2003)
Categories of Employees

(1) IRC 3121(d) contains four separate and independent categories of employees:

- Common law employee,
- Corporate officer,
- Certain statutory employee, and
- Employee covered by an agreement under Section 218 of the Social Security Act.

Note: See Exhibit 4.23.5-2, Employment Tax Treatment for Various Categories of Workers

4.23.5.7
(02-01-2003)
Common Law Standard

(1) The common law rules for determining employment status are described in Treas. Reg. 31.3121(d)–1(c). Under common law, a worker is an employee when the person for whom the services are performed has the right to control and direct the individual who performs the services. This control reaches not only the result to be accomplished, but also the details and means by which that result is to be accomplished. Note that the right to control must be present but need not actually be exercised. Also, note that courts have held that the degree of supervision necessary to demonstrate control is only "such supervision as the nature of the work requires." *McGuire v. United States*, 349 F. 2d 644, 646 (1965 9th Cir.).

4.23.5.7.1
(12-10-2013)
Control Test

(1) To determine whether the control test is satisfied in a particular case, the facts and circumstances must be examined. Ask questions about the relationship between the worker and the taxpayer to ascertain control.

(2) The 20 factors listed in Rev. Rul. 87-41 may still be used for reference purposes, but the primary method is to consider every piece of information in a case that helps to decide the extent to which the taxpayer does or does not retain the right to control the worker. The evidence tends to fall into three main categories:

1. Behavioral control,
2. Financial control, and
3. Relationship of the parties.

Note: See Exhibit 4.23.5-1, Determining the Right to Direct or Control.

(3) There are four important points to remember:

1. There is no "magic number" of relevant evidentiary factors.
2. Whatever the number of factors used, the factors merely point to facts to be used in evaluating the extent of the right to direct and control.
3. As in any examination, all relevant information needs to be explored before answering the legal question of whether the right to direct and control associated with an employment relationship exists.
4. The evidence the examiner gathers must be factual and well-documented. It must support the examiner's determination.

(4) The pieces of information that are important to help determine employee status change over time because business relationships change over time. What might have been a crucial piece of evidence in 1985 on which to base a decision about whether a taxpayer retained the right to control a worker may not carry the same weight for making an employee status determination currently.

Example: The fact that a delivery driver was required to wear a uniform bearing the name of the retail business demonstrated control indicative of an employee relationship. Today, these requirements may be established to provide customers with some assurance that the worker can be safely allowed entry to the home or business. In other words, the wearing of the uniform today may have less to do with the degree of control exercised by the taxpayer over the worker than it had in the past.

4.23.5.7.2
(12-10-2013)
Common Law Employees

(1) For FICA, FUTA, and FITW, the term “employee” includes any individual who, under the usual common law rules for determining the employer-employee relationship, has the status of an employee. Therefore, with certain exceptions, the imposition of employment taxes always involves the employer-employee relationship issue and requires the application of the common law rules to the specific facts and circumstances of each taxpayer. This application is the basis for determining the employment status of an individual worker or a group of workers.

(2) In a case requiring an employer-employee relationship determination, the examiner will compile information bearing on the three main categories of evidence. Evaluating such evidence will generally enable the examiner to resolve the employer-employee relationship question by applying law, regulations or a clearly applicable ruling.

(3) For treatment of special types of employment and special types of wage payments, refer to Pub 15, (Circular E) Employer’s Tax Guide, for quick research on an issue. The IRC, regulations, revenue rulings, court decisions, and any other pertinent research are the best authority for any issues being proposed. Also, refer to Exhibit 4.23.5-2, Employment Tax Treatment for Various Categories of Workers for a quick reference regarding the tax treatment by the employer of FICA, FUTA, and FITW of wages earned by the various types of workers.

(4) If an employer-employee relationship exists, the designation or description of the parties as anything other than that of employer-employee is immaterial. Contractual designation of a worker as an independent contractor cannot outweigh evidence regarding the actual relationship between worker and taxpayer. Questions arising in employer-employee relationships which cannot be resolved by the examiner can be referred for technical advice, in accordance with IRM 4.23.15, Employment Tax - Technical Advice From the Office of Chief Counsel.

4.23.5.7.3
(11-22-2017)
Corporate Officers

(1) Corporate officers are specifically included within the definition of an employee under FICA, FUTA, and FITW purposes. See IRC 3121(d)(1), IRC 3306(i), and IRC 3401(c). The common law standard is not applicable, as the regulations provide that an officer of a corporation is generally an employee of the corporation. However, Treas. Reg. 31.3121(d)-1(b) provided a narrow exception - an officer is not considered to be an employee of the corporation if two requirements are met:

a. The officer does not perform any services or performs only minor services, and
b. The officer is not entitled to receive, directly or indirectly, any remuneration.

(2) The officer must meet both requirements to be excepted from employee status. In determining whether services performed by a corporate officer are considered minor or nominal, examine:

- The character of the service,
- The frequency and duration of performance, and
- The actual or potential importance or necessity of the services in relation to the conduct of the corporation’s business.

Note: Refer to Rev. Rul. 74–390, 1974–2 C.B. 331.

(3) A director of a corporation, acting in the capacity of a director, is not an employee of the corporation for those services, even if that worker also serves as an employee or officer of the corporation for other services. Therefore, part of the compensation paid to this worker can be for services rendered as an independent contractor (director) and part of the payments can be for services rendered as an employee. Refer to Rev. Rul. 58–505, 1958–2 C.B. 728.

(4) Examine all payments to the officer, such as amounts labeled as draws, loans, dividends, or other distributions to determine whether the payments are potentially wages for FICA, FUTA, and FITW purposes. Refer to Rev. Rul. 74–44, 1974–1 C.B. 287.

(5) Examiners must address section 530 in all officer worker classification 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 or Form 1099-NEC, the reporting consistency requirement of section 530(a)(1)(B) is met. Likewise, if the corporation pays distributions and provides Schedule K-1 (Form 1120-S), Shareholder's Share of Income, Deduction, Credits, etc., consistent with this treatment, then the reporting consistency requirement is met. Generally, the taxpayer will have difficulty satisfying the reasonable basis requirement of section 530 since officers who perform services for the corporation are employees by statute under IRC 3121(d)(1), 3306(i) and 3401(c).

(6) Officer worker classification compensation cases that involve whether certain payments are wages may be eligible for inclusion in the CSP. For additional information, and examples of the determination of reasonable compensation, see IRM 4.23.6.9, CSP and Officer Compensation Procedures.

4.23.5.7.3.1
(11-22-2017)
Corporate Officers and IRC 7436

(1) The determination of whether officer compensation issues are IRC 7436 issues generally depends on whether the officer received Form W-2 for the audit year.

(2) In any officer worker classification compensation case where the corporation does not treat the officer's compensation as wages (does not file Form W-2 for the officer), examiners will follow the provisions of IRC 7436 and, following normal appeal procedures, issue a Letter 3523, Notice of Employment Tax Determination under IRC 7436, if unagreed.

(3) For IRC 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 IRC 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. See IRC 3121(d)(1), IRC 3306(i), and IRC 3401(c).

(4) 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, Form 1099-NEC, Schedule K-1 (Form 1120-S), or no information return at all.

(5) In situations where the officer received wages reported on Form W-2 and other payments are being recharacterized as wages, the issue is generally not considered an IRC 7436 issue. Since the officer received wages reported on Form W-2, the taxpayer is considered to have treated the officer as an employee. Thus, there is no controversy under IRC 7436 because the issue is only the amount of reasonable compensation subject to employment taxes. However, if the taxpayer raises a section 530 argument in regard to the payments being recharacterized as wages or argues that the payments were made for services performed as a non-employee, then a controversy is raised making this an IRC 7436 issue.

4.23.5.7.3.2
(11-22-2017)
Officer Compensation Issue Development

(1) The application of IRC 3509 rates, interest-free adjustments, and the assertion of penalties (including the negligence penalty) all depend on whether or not the taxpayer intentionally disregarded the applicable employment tax laws. For officer compensation issues, it is the examiner's responsibility to show the taxpayer had prior knowledge that payments for services made to an officer is to be considered wages before the examiner can make a proper determination on the applicability of:

- IRC 3509,
- Interest-free adjustments, and
- Assertion of penalties (including the negligence penalty).

(2) To be allowed to file as a small business corporation, the taxpayer must submit and have approved by the IRS, Form 2553, Election by a Small Business Corporation. When Form 2553 is accepted, a Transaction Code (TC) "090" is posted to the module and will be reflected on the BMFOLE. The posting of TC "090" causes a CP Notice 261, Notice Of Acceptance As An S-Corporation, to be sent to the taxpayer.

(3) In 2004, language was added to the Notice 261 specifically outlining the taxpayer's obligations related to the payment of compensation made to the shareholder-employee of an S-Corporation. This notice can be used to assist the examiner in making the proper determinations for any officer compensation issue where the business began in calendar year 2005 or later. For 2016, the Notice states:

- You must determine a reasonable salary when a shareholder-employee of an S corporation provides services to the corporation.
- Payments to a shareholder-employee for services provided to an S corporation are wages and subject to employment taxes.
- We may re-characterize distributions paid to a shareholder as salary if the distribution was paid in lieu of reasonable compensation (Rev. Rul. 74-44).

(4) **The examiner must fully develop all the facts in each case before making a final determination.** The examiner cannot rely solely on the TC "090" to assume the taxpayer received the Notice. The examiner must verify the taxpayer received the Notice. If received, the examiner will need to question the taxpayer about why the taxpayer did not follow the information provided regarding payments made to the officer. This will enable the examiner to make a factual determination whether the taxpayer had prior knowledge and intentionally disregarded the law and advice from the IRS when determining whether or not to:

- Compute the tax using the reduced rates of IRC 3509,
- Grant an interest-free adjustment, and/or
- Determine if reasonable basis applies for non-assertion of any penalties, including negligence.

4.23.5.7.4
(11-03-2009)
Statutory Employees

(1) If a worker is not an employee as either a corporate officer or under the common law rules, the worker and the taxpayer may nevertheless still be subject to employment taxes. IRC 3121(d)(3) lists individuals in four occupational groups who, under certain circumstances, are considered employees for FICA tax and, in some instances, employees for FUTA tax, but not for FITW. These workers are referred to as statutory employees:

a. Agent-drivers or commission-drivers,
b. Full-time life insurance salespersons,
c. Home workers, and
d. Traveling or city salespersons.

(2) Workers in these four occupational groups are employees for FICA tax purposes even though they do not meet the common law test if they meet the general and specific requirements for each occupational group.

(3) To qualify as a statutory employee, a worker must first meet general requirements prescribed specifically for the category under which the worker is qualifying. Refer to Treas. Reg. 31.3121(d)–1(d)) and Exhibit 4.23.5-3, Statutory Employees.

(4) By definition, a worker cannot be a statutory employee under IRC 3121(d)(3) if that worker is a common law employee. See *Ewens and Miller, Inc. v Commissioner,* 117 T.C. 263 (2001). This conclusion is supported by the legislative history of IRC 3121(d). See S. Rep. No. 1669, 81st Cong., 2d. Sess. 144 (1950), 1950–2 C.B. 302, 346 - 348, and *Lickiss v. Commissioner*, T. C. Memo 1994–103.

(5) Statutory employees receive a Form W–2 with a check in Box 13, “Statutory Employee”, indicating the status of statutory employee. Income tax is not withheld from statutory employees. As they are not employees for the purpose of deducting trade or business expenses they deduct their expenses on Schedule C (Form 1040) rather than as miscellaneous itemized deductions on Schedule A (form 1040) (for years prior to 2018). See Rev. Rul. 90–93, 1990–2 C.B. 33.

(6) If statutory employees also have earnings from self-employment, they may not use expenses from services as a statutory employee to reduce net earnings from self-employment for SECA proposes, because services as a statutory employee do not constitute the carrying on of a trade or business for purposes of SECA. Statutory employees are required to file a separate Schedule C (Form 1040) for expenses incurred as a statutory employee, separate from a Schedule C (Form 1040) that reports net earnings from self-employment.

4.23.5.7.4.1
(11-22-2017)
Statutory Employee - Employee Benefits

(1) Except for full-time life insurance salespersons, statutory employees remain independent contractors for employee benefit purposes. Thus, they are not eligible to participate in the employee benefit plans sponsored by the taxpayer for employees and cannot enjoy the exclusions from income for amounts paid under accident and health insurance arrangements under IRC 104, IRC 105,

and IRC 106 to the extent that those income tax exclusions apply only to employees. However, statutory employees can establish and maintain their own self-employed retirement plans.

(2) Full-time life insurance salespersons are an exception. They are treated as employees not only for FICA tax purposes, but also for certain employee benefit programs maintained by the taxpayer. See IRC 7701(a)(20). Thus, they may participate in:

- The taxpayer's group term life insurance program under IRC 79,
- The taxpayer's accident and health plans under IRC 104, 105, and 106,
- The taxpayer's qualified deferred compensation or retirement plans under IRC 401(a), and
- The taxpayer's cafeteria plan under IRC 125.

Note: A full-time life insurance salesperson may not base contributions to a self-employed retirement plan on the compensation received from the insurance business.

(3) For additional information on self-employed retirement plans, see Retirement Plans for Self-Employed People, at *https://www.irs.gov/retirement-plans/retirement-plans-for-self-employed-people*.

4.23.5.7.5
(02-01-2003)
Statutory Non-Employees

(1) Workers in three occupations will not be treated as employees for FICA, FUTA, or FITW purposes provided they meet certain qualifications. These workers are referred to as "statutory non-employees."

a. IRC 3508(b)(1) provides that, for all IRC purposes, qualified real estate agents are statutory non-employees.
b. IRC 3508(b)(2) provides that, for all IRC purposes, direct sellers are statutory non-employees.
c. IRC 3506 provides that, for purposes of subtitle C of the IRC relating to employment tax, qualifying companion sitters are statutory non-employees.

4.23.5.7.5.1
(11-22-2017)
Qualified Real Estate Agents

(1) IRC 3508(b)(1) provides that an individual is a qualified real estate agent if the following requirements are met:

a. The worker is a licensed real estate agent.
b. Substantially all of such worker's remuneration for services is directly related to sales or other output rather than to the number of hours worked.
c. A written contract exists between the worker and the taxpayer for which services are being performed which provides that the worker will not be treated as an employee for federal tax purposes.

(2) Proposed Treas. Reg. 31.3508–1(b)(2) defines services performed as a real estate agent and provides examples. Services performed as a real estate agent do not include management of property.

4.23.5.7.5.2
(11-22-2017)
Direct Sellers

(1) IRC 3508(b)(2) provides that a worker is a direct seller if the following qualifications are met:

a. The worker is engaged in the sale of consumer products in the home or in other than a permanent retail establishment; engaged in delivering or distribution of newspapers; or engaged in sale of consumer products for resale in the home or in other than a permanent retail establishment.
b. Substantially all of such worker's remuneration for services is directly related to sales or other output rather than to the number of hours worked.
c. A written contract exists between the worker and the taxpayer for which services are being performed that provides that the worker will not be treated as an employee for federal tax purposes.

4.23.5.7.5.2.1
(11-22-2017)
Newspaper Carriers and Distributors

(1) Qualifying newspaper distributors and carriers are direct sellers. A person engaged in the trade or business of the delivery or distribution of newspapers or shopping news qualifies as a direct seller provided all remuneration is directly related to sales or output, rather than hours worked. Also, the services must be performed pursuant to a written contract that provides the person will not be treated as an employee for federal tax purposes.

4.23.5.7.5.3
(11-22-2017)
Companion Sitters

(1) IRC 3506 provides that a companion sitter will not be an employee of a companion sitting placement service if the companion sitting placement service neither pays nor receives the salary or wages of the sitter. The placement service may be compensated on a fee basis by either the sitter or the individual for whom the sitting is performed. The companion sitter is deemed to be self-employed unless considered to be a statutory or common law employee of the individual for whom the services are performed.

4.23.5.8
(11-09-2023)
Government Entities

(1) The Federal, State and Local Governments Employment Tax office (FSL/ET) is responsible for education and compliance activities affecting government entities. Additional procedures and guidelines for employment tax examinations of federal, state, and local government entities are outlined in IRM 4.75.40, Employment Tax Audit Procedures.

(2) The Indian Tribal Governments office (ITG) has responsibility for employment tax and all other aspects of federal tax administration as it applies to Indian and Alaskan Native tribal governments. Refer to IRM 1.1.23, Indian Tribal Governments. All IRS employees are required to contact ITG through the Specialist Referral System (SRS) (*https://srs.web.irs.gov/*) before making initial contact on Indian tribal government cases. An ITG Specialist will be assigned to assist.

4.23.5.8.1
(11-22-2017)
State and Local Government Employees Coverage

(1) The FSL/ET Area under Exempt Organizations and Government Entities (EO/GE) is responsible for compliance activities affecting government entities. Examination of these entities will not be initiated by other operating divisions without the express written approval of the EO/GE Director.

4.23.5.8.2
(02-01-2003)
Section 218 Agreements

(1) State and local government employees can be covered for social security and Medicare purposes through an agreement between the state and the Social Security Administration (SSA).

(2) Each state's original Section 218 Agreement incorporates the basic provisions, definitions, and conditions for coverage. Additional coverage is provided by modifications. Each modification, like the original Section 218 Agreement, is binding upon all parties. The initiative for securing coverage lies with the state.

(3) Coverage under a Section 218 Agreement must be provided for employees by groups. A Section 218 Agreement may be modified to increase the extent of coverage but generally not to reduce the amount of coverage. (An exception applies to election worker services and solely fee–based positions.)

4.23.5.8.2.1
(11-03-2009)
Mandatory Social Security Coverage

(1) Effective July 2, 1991, social security and Medicare coverage is mandatory for state and local government employees who are not qualified participants in a public retirement system and who are not covered under a Section 218 Agreement. See IRC 3121(b)(7)(F).

(2) Employees hired or rehired after March 31, 1986, and currently covered under the Medicare portion of FICA remain subject to that tax regardless of their membership in a retirement system. Employees covered by social security under a Section 218 Agreement are automatically covered.

4.23.5.8.2.2
(11-03-2009)
Mandatory Medicare Coverage

(1) State and local government employees hired (or rehired) after March 31, 1986, are subject to mandatory Medicare coverage. Public employees covered under a Section 218 Agreement are already covered under Medicare. Employees whose services are not covered for social security but who are required to pay the Medicare-only portion of FICA are referred to as Medicare Qualified Government Employees (MQGE).

(2) Employees who have been in continuous employment with the employer since March 31, 1986, who are not covered under a Section 218 Agreement, nor subject to the mandatory social security and Medicare provisions, remain exempt from both social security and Medicare taxes, provided they are members of a public retirement system. (See Pub 963, Federal - State Reference Guide, for additional guidance.)

4.23.5.8.3
(12-10-2013)
Public Retirement Systems

(1) A public retirement system is a pension, annuity, retirement, or similar fund or system established and maintained by a state or political subdivision (or an agency or instrumentality thereof) that provides retirement benefits to its employees that are comparable to the benefits provided under the Old-Age portion of the Old-Age Survivors and Disability Insurance (Social Security) part of FICA. See Treas. Reg. 31.3121(b)(7)-2 for further information on the requirements for a public retirement system.

(2) Social security is **NOT** a public retirement system for purpose of the definition in (1).

4.23.5.8.3.1
(08-31-2012)
Types of Retirement Systems

(1) In general, there are two types of retirement systems – the defined contribution plan and the defined benefit plan. The retirement system:

a. Provides retirement benefits to governmental employees who are participants, and
b. May be a qualified plan described in IRC 401(a), an annuity plan or contract under IRC 403(a) or (b), or a nonqualified deferred compensation plan described in IRC 457(b), 457(f) or 409A.

Note: The minimum benefit requirements are contained in Treas. Reg. 31.3121(b)(7)-2(e)(2) and Rev. Proc. 91-40, 1991-2 C.B. 694.

4.23.5.8.3.2
(11-03-2009)
Defined Contribution Plan

(1) A defined contribution plan is a plan that provides an individual account for each participant and provides benefits based solely on the amount contributed to the participant's account, and any income, expenses, gains or losses that may be allocated to that participant's account. See IRC 414(i).

(2) A defined contribution plan that satisfies the definition of a IRC 3121(b)(7)(F) retirement system must provide for an allocation to the employee's account of at least 7.5 percent of the employee's compensation for service performed during the period under consideration.

(3) Contributions from both the employer and employee may be used to make up the 7.5 percent. Matching contributions by the employer may be taken into account for this purpose. However, the 7.5 percent cannot include any earnings on the account. See Treas. Reg. 31.3121(b)(7)-2(e)(2)(iii)(A).

(4) The defined contribution plan must credit the employees' accounts with a reasonable interest rate, or the accounts must be held in a separate trust subject to general fiduciary standards and credited with actual earnings on the trust fund. See Treas. Reg. 31.3121(b)(7)-2(e)(2)(iii)(C).

(5) An employee is a qualified participant in a defined contribution retirement system with respect to services performed on a given day if, on that day, the employee has satisfied all conditions (other than vesting) for receiving an allocation to their account (exclusive of earnings) that meets the minimum retirement benefit requirement. The benefit must be calculated with respect to compensation during a period ending on that day and beginning on or after the beginning of the plan year of the retirement system. This is the case regardless of whether the allocations were made or accrued before the effective date of IRC 3121(b)(7)(F). See Treas. Reg. 31.3121(b)(7)-2(d)(1)(ii).

(6) A part-time, seasonal, or temporary employee is not a qualified participant on a given day unless any benefit relied upon to meet the minimum benefit requirement is 100 percent non-forfeitable on that day. See Treas. Reg. 31.3121(b)(7)-2(d)(2).

4.23.5.8.3.3
(08-31-2012)
Defined Benefit Plan

(1) A defined benefit plan is any plan other than a defined contribution plan (IRC 414(j)). A defined benefit plan determines benefits on the basis of a formula, generally based on age, years of service, and compensation.

(2) A defined benefit plan must provide a retirement benefit comparable to the benefit provided by the social security part of FICA. A plan generally meets the requirement if the benefit under the system is at least 1.5 percent of average compensation during the employee's last three years of employment, multiplied by the employee's number of years of service.

(3) An employee is a qualified participant in a defined benefit retirement system with respect to services performed on a given day if, on that day, the employee is or has ever been an actual participant in the retirement system and the employee actually has a total accrued benefit that meets the minimum retirement benefit requirement. See Treas. Reg. 31.3121(b)(7)-2(d)(1)(i).

(4) An employee may not be treated as an actual participant or as actually having an accrued benefit for this purpose to the extent that such participation or benefit is subject to any conditions (other than vesting) that have not been satisfied. For example, such conditions include a requirement that the employee attain a minimum age, perform a minimum period of service, make

an election in order to participate, or be present at the end of the plan year in order to be credited with an accrual. See Treas. Reg. 31.3121(b)(7)-2(d)(1)(i).

4.23.5.8.4
(11-22-2017)
Examination of State/Local Government Entities

(1) The FSL/ET Area under EO/GE has the primary responsibility for examination of state and local government entities.

(2) Any unusual issues or trends uncovered by other operating divisions will be referred to the Director of EO/GE.

4.23.5.8.5
(11-22-2017)
Federal Agencies

(1) Federal agencies are generally bound by the same statutory and common law rules as the private sector. The FSL/ET Area under EO/GE has overall responsibility for employment compliance efforts involving federal agencies.

(2) There are unique protocol issues for federal agencies, including the military. If a compliance issue or lead involving a federal agency is received by another IRS office, this lead or issue will be referred to the FSL/ET Area under EO/GE using the Specialist Referral System.

(3) Guidance has been provided to federal employers by the Office of Personnel Management on the employer-employee relationship and the proper classification of workers.

4.23.5.9
(02-01-2003)
Social Security Coverage of Employees of Nonprofit Organizations

(1) The Social Security Amendments of 1983 extended social security coverage on a mandatory basis to all employees of IRC 501(c)(3) organizations with respect to services performed on or after January 1, 1984. Terminations of coverage by organizations which had waived their exemptions under IRC 3121(k)(1)(D) would not be permitted on or after March 31, 1983.

4.23.5.10
(12-10-2013)
Social Security Coverage for Church Employees

(1) IRC 3121(w) provides that any church or qualified church-controlled organization may make an election within the time period described below, that services performed in the employ of such church or organization shall be excluded for purposes of Title II of the Social Security Act. An election may be made under this section only if the church or qualified church-controlled organization (see (4) below) states that such church or organization is opposed for religious reasons to the payment of the tax imposed under IRC 3111. The election is made on Form 8274, Certification By Churches and Qualified Church – Controlled Organizations Electing Exemption from Employer Social Security and Medicare Taxes.

(2) The election under IRC 3121(w) must be made prior to the first date on which a quarterly return is due or would be due had the election not been made. This election does not apply to services as ministers of a church, members of a religious order, or to services performed in an unrelated trade or business of the church or qualified church organizations. An election under this section applies to current and future employees. This election may be permanently revoked by the organization by paying social security and Medicare taxes for wages covered by this section. The IRS will permanently revoke the election if the organization does not file Forms W-2 for two years or more and does not provide the information within 60 days after a written request by the IRS.

(3) Although the employees of an electing church or organization are exempt from payment of FICA tax, these employees generally **must** pay social security tax

under the rules that govern self-employed persons if they are paid $108.28 or more in a year. See IRC 1402(j)(2)(B) and Form 8274. The electing church or organization remains subject to the requirements for withholding and reporting of income tax on wages, tips and other compensation paid to each employee on Form W-2.

(4) For purposes of this section, the term "church" means a church, a convention or association of churches, or an elementary or secondary school that is controlled, operated, or principally supported by a church, convention, or association of churches. The term "qualified church organization" is defined in IRC 3121(w)(3)(B).

(5) Where related entities are separate employers, an election must be made for each employer. In instances where there is doubt as to which church or organization is the employer of a particular worker, it is advisable for each to file a separate Form 8274. In order to elect the exemption, Form 8274 must be signed by an authorized official of the church or organization and filed with the IRS Campus where the church or organization would file its Form 941, Employer's Quarterly Federal Tax Return. The election exempts a church or organization and its employees from employer and employee FICA taxes and applies to all services performed on or after January 1, 1984, by employees of the electing church or organization, whether or not they were employees on January 1, 1984, or on the date the election is made. Employment Code "C" on IDRS indicates the organization has filed Form 8274.

4.23.5.11
(12-10-2013)
FICA Tax on Wages Paid to Residents of the Philippines for Services Performed in the Commonwealth of Northern Mariana Islands (CNMI)

(1) The purpose of this subsection is to provide administrative guidance to IRS employees assigned to conduct enforcement activities on businesses in the Commonwealth of Northern Mariana Islands (CNMI) that employ residents of the Philippines.

(2) IRC 3121(b)(18), in combination with the Covenant to Establish a Commonwealth of the Northern Mariana Islands in Political Union with the United States, provides an exception from employment for purposes of the FICA tax for services performed by residents of the Philippines temporarily admitted to the CNMI on H-2 status under the United States Immigration and Nationality Act (INA).

(3) Prior to November 28, 2009, the CNMI had its own immigration laws with its own visa categories, and the INA did not apply in the CNMI. However, CNMI immigration laws provided a CNMI temporary work visa in the Commonwealth of Northern Mariana Code, which was similar to INAs H-2 status. The IRS determined that the exemption from FICA under IRC 3121(b)(18) applied to residents of the Philippines admitted to the CNMI on this similar CNMI temporary work visa.

(4) On May 8, 2008, Congress enacted the Consolidated Natural Resources Act of 2008 (CNRA), which extended federal immigration laws of the INA to the CNMI. As a result, CNMI immigration laws no longer apply and CNMI visas and work permits no longer exist. Nonresident aliens in the CNMI must apply for a federal immigration status if they wish to remain in the CNMI.

(5) Residents of the Philippines employed in the CNMI are no longer exempt from FICA tax on the basis of holding a work permit under CNMI immigration law. While the CNMI is transitioning to full implementation of U.S. immigration law, a new Commonwealth Only Transitional Worker (CW) visa classification is

available to workers in the CNMI. Workers on the CW visa, including those from the Philippines, are not exempt from FICA tax under IRC 3121(b)(18). Employers are required to withhold and pay FICA tax unless the worker in the CNMI is eligible for an exemption from FICA tax as a resident of the Philippines holding a valid U.S. H-2 visa or based on some other circumstance.

Note: The FICA exemption applies to both the H-2A and H-2B visas held by nonimmigrant Philippine residents whether they are resident aliens or nonresident aliens.

(6) Many residents of the Philippines currently employed in the CNMI have been seeking to determine their proper immigration status. As a result, these workers and their employers have been or are uncertain about their immigration statuses. For this reason, and to ease the CNMIs transition to federal immigration law, Announcement 2012-43, FICA Taxes on Wages Paid to Residents of the Philippines for Services Performed in the Commonwealth of the Northern Mariana Islands, provides that the IRS will not assert that any taxpayer has understated liability for FICA taxes by reason of a failure to treat services performed before January 1, 2015, in the CNMI by a resident of the Philippines as employment under IRC 3121(b). Accordingly, IRS employees will cease enforcement activity regarding the imposition of FICA tax owed by businesses in the CNMI on wages paid to residents of the Philippines until after December 31, 2014. IRS employees will resume normal enforcement activity to ensure that employers in the CNMI withhold and pay FICA taxes on wages paid to residents of the Philippines who do not hold an H-2 status for services performed in the CNMI after December 31, 2014, unless those workers are eligible for FICA exemption based on some circumstances other than the exemption at IRC 3121(b)(18).

4.23.5.12
(11-22-2017)
Related Corporations Providing Concurrent Employment—Common Paymaster

(1) When an employee is concurrently employed by two or more related corporations and compensated through a common paymaster, the aggregate dollar amounts for FICA and FUTA taxes shall be no more than the taxes imposed upon a single employer. See IRC 3121(s) and IRC 3306(p).

(2) Each corporation is considered to have paid only the remuneration it actually pays to the individual(s) and that the total amount of the FICA and FUTA taxes are determined as if the individual(s) had only one employer.

(3) To determine that the common paymaster provisions are met, the examiner can reference the provisions of Treas. Reg. 31.3121(s)-1:

a. The corporations are considered related under one of the four tests provided in the regulations,
b. The common paymaster is a member of the related group and the employees covered under these provisions receive their remuneration through a common paymaster, and
c. There is concurrent employment which contemplates the performance of services by the employee for the benefit of the employing corporations.

(4) The provisions of this section apply only to remuneration disbursed in the form of money, check or other similar instrument. Be alert to other forms of compensation subject to FICA and FUTA taxes.

(5) If the common paymaster fails to remit these taxes, it remains liable for the full amount of the unpaid portion of these taxes. In addition, each of the other

related corporations using the common paymaster is jointly and severally liable for its appropriate share of these taxes. See Treas. Reg. 31.3121(s)-1(c)(1).

(6) The common paymaster is responsible for filing information and tax returns and issuing Form W–2 with respect to wages it paid under this section.

(7) Neither IRC 3121(s) nor IRC 3306(p) have any effect on the deductibility for federal income tax purposes of employment taxes or of wages payable by a corporation through a common paymaster. Each corporation is entitled to its own deduction.

(8) The related entities can be held jointly and severally liable per Treas. Reg. 31.3121(s)-1(c)(1) if the payment of the adjustment remains in default. Where a potential whipsaw situation exists, follow the procedures in IRM 4.10.7.4.9, Whipsaw (a/k/a correlative adjustments). Separate reports are to be issued to both the common paymaster for the full amount of the proposed adjustment and to each related corporation for their respective share.

(9) Where the Government's interest is being protected by making the same assessment against two or more taxpayers, Item 401 on Form 5344, Whipsaw Indicator, is set by entering a "K" (Key Whipsaw Return) or an "R" (Related Whipsaw Return).

4.23.5.12.1
(05-22-2015)
Wages Paid by Predecessor Attributed to Successor

(1) The successor may count the taxable wages paid by the predecessor to a continuing employee for purposes of the total FICA and FUTA wage limitations if:

a. An employer during any calendar year acquires all or substantially all of the property used in the trade or business of a predecessor employer or a unit of the business of such employer,
b. The employee was employed in the trade or business of the predecessor employer immediately prior to the acquisition and is employed by the successor employer in its trade or business immediately after the acquisition, and
c. Such wages were paid during the calendar year in which the acquisition occurred and prior to such acquisition.

(2) The acquisition may also occur as a result of the incorporation of a business by a sole proprietor or a partnership. In addition, a previously existing partnership that is continued by a new partnership or by a sole proprietorship may allow the successor to count the taxable wages paid by the predecessor employer of a continuing employee.

(3) For additional information, see Treas. Reg. 3121(a)(1)-1(b)(2) and Rev. Proc. 2004-53, which provide rules concerning predecessor/successor wage issues.

4.23.5.13
(11-22-2017)
Third-Party Payers

(1) Many employers out-source their payroll and related tax duties to a third-party payer who may report, collect, deposit, or pay employment taxes with federal, state, and local authorities on behalf of the employer clients. Even though this outsourcing occurs, the common law employer remains ultimately responsible for the deposit, payment, and reporting of federal employment tax liabilities. Thus, even though the employer may forward the tax amounts to the third-party payer to make the tax deposits, if the third-party payer fails to make the federal employment tax payments, the employer remains liable for the taxes and the IRS may assess penalties and interest on the employer's account.

(2) During the audit of a business that uses the services of a third-party payer, the examiner must:

a. Inform the employer that it is not relieved of the responsibility to ensure that its tax returns are filed timely, and that taxes are deposited and paid correctly and timely, and
b. Instruct the employer to take actions to determine that its filing and payment responsibilities have been met.

Note: The filing and payment responsibilities are dependent on the type of third-party payer the employer uses.

(3) For additional information on third-party payers, see IRM 5.1.24, Field Collecting - Third-Party Payer Arrangements for Employment Taxes.

4.23.5.13.1
(08-14-2020)
Payroll Service Providers and Reporting Agents

(1) Payroll Service Providers (PSP) and Reporting Agents prepare and file employment tax returns under each employer's Employer Identification Number (EIN). For employers who use either a PSP or Reporting Agent, the examiner will instruct the employer to take the following actions to ensure timely filing of its tax returns, deposits, and/or payments:

- Verify its employer address is the address of record with the IRS, not the address of the PSP or Reporting Agents. This will ensure the employer remains informed of tax matters involving its business because the IRS will correspond to the employer's address of record if there are any issues with an account. Examiners must check IDRS and inform the employer of the address on file. Further, the examiner will instruct the employer that it could verify the address of record by calling the phone number listed at "Business and Specialty Tax Line and EIN Assignment" listed on the "Telephone Assistance Contacts for Business Customers" page at *https://www.irs.gov/businesses/telephone-assistance-contacts-for-business-customers*.
- Verify the PSP or Reporting Agent uses the Electronic Federal Tax Payment System (EFTPS) when making employment tax deposits and payments,
- Enroll in EFTPS so the employer can view EFTPS deposits and payments made on its behalf under its Employer Identification Number. Information about enrolling on EFTPS can be found at *https://www.eftps.gov/eftps/*.

  Note: EFTPS will issue Inquiry PINs to all employers who are registered on EFTPS by their TPPs. Inquiry PINs allow employers to view their deposit history without a separate EFTPS enrollment.

(2) An examiner conducting an audit of an employer using a PSP or Reporting Agent must document in the case file that the examiner provided the above information to the taxpayer.

(3) Rev. Proc. 2012-32 requires a Reporting Agent to provide clients with a quarterly, written statement. The written statement must advise the client that it remains responsible for the timely filing of tax returns and timely payment of employment taxes, even if the client authorizes a Reporting Agent to file returns and make payments on its behalf. This statement also includes a recommendation for the client to enroll in EFTPS to monitor its account.

4.23.5.13.2
(05-22-2015)
IRC 3504 Agent with an Approved Form 2678

(1) An employer may request authorization from the IRS on Form 2678, Employer/Payer Appointment of Agent, to appoint an IRC 3504 agent to act on behalf of the employer with regard to its employment tax obligations. Once the IRS has approved Form 2678, the IRC 3504 agent assumes liability along with the employer for the employer's Social Security tax, Medicare tax, and FITW, reporting, and payment responsibilities with regard to wages the agent pays. An IRC 3504 agent with an approved Form 2678 must file aggregate Forms 941 (*e-file* or paper) using the IRC 3504 agent's EIN. The IRC 3504 agent generally cannot file aggregate Form 940, Employer's Annual Federal Unemployment (FUTA) Tax Return, returns using the IRC 3504 agent's EIN. An IRC 3504 agent with an approved Form 2678 must attach a Schedule R (Form 941), Allocation Schedule for Aggregate Form 941 Filers, to the aggregate Form 941 to provide an allocation of the aggregate amounts reported on the employment tax return filed by the IRC 3504 agent.

Note: An exception applies for an employer that is a home care service recipient disabled individual or other welfare recipient receiving in-home care through a state or local program. See Rev. Proc. 2013-39.

(2) Examiners may review Schedule R (Form 941) information that has been filed electronically in the EUP, Employee User Portal.

(3) Examiners will advise the employer that it remains liable along with the IRC 3504 agent. In addition, the examiner will advise the employer to use due diligence in requesting authorization from the IRS to appoint an IRC 3504 agent on Form 2678, and to continue to use the IRC 3504 agent after the authorization is approved.

4.23.5.13.3
(05-22-2015)
Professional Employer Organization (PEO)

(1) A Professional Employer Organization (PEO) might file an aggregate Form 941 using the PEO's EIN. Examiners will advise an employer using a PEO that, generally, the employer is not relieved of its employment tax obligation with regard to wages paid to its employees by using a PEO. In addition, the examiner will advise the employer to use due diligence in selecting and continuing to use the services of any PEO. Examiners auditing an employer who is using a PEO/CPEO must also contact the analyst in Specialty Exam Policy and Quality, Employment Tax, for current procedures addressing PEO issues relating to certain third parties (including PEOs) that are subject to Treas. Reg. 31.3504-2, "Designation of Payor to Perform Acts of an Employer." Examiners must provide the following information:

- Name and EIN of client,
- Tax periods under examination, and
- Name and EIN of PEO.

Note: The list of Employment Tax Policy Analysts, their contact information, and program assignments are found at *Employment Tax Policy Contacts* (https://irsgov.sharepoint.com/sites/ETD-KMT-KB014/SitePages/Employment%20Tax%20Resources/Contacts%20Tools%20and%20Trainings/EmploymentTaxPolicyContacts.aspx).

(2) Additional information and links to guidance on employee leasing companies can be found at: *Employee Leasing Preferred Employee Organization CHP* (Cafeteria and Health Plans) (https://irsgov.sharepoint.com/sites/ETD-KMT-

KB014/SitePages/Exam%20Case%20Issues/Cafeteria%20and%20Health%20Plans/Employee-Leasing-Preferred-Employee-Organization-CHP.aspx).

4.23.5.13.4
(11-22-2017)
Certified Professional Employer Organizations

(1) The Stephen Beck, Jr., Achieving a Better Life Experience (ABLE Act) Act of 2014, was enacted on December 19, 2014, as part of The Tax Increase Prevention Act of 2014 (P.L. 113-295). Provision 206 of the ABLE Act established a voluntary for Professional Employer Organizations (PEOs) certification program. Two new IRC sections were enacted, IRC 3511 and IRC 7705, which provide requirements and definitions for certified PEOs.

(2) A certified professional employer organization (CPEO) is an entity certified by the IRS to perform federal employment tax withholding, reporting, and payment functions related to the wages it pays to workers performing services for its customers. Under a CPEO contract between a customer and a CPEO, the CPEO pays wages to the customer's workers and is responsible for the withholding, reporting and paying of federal employment taxes with regard to these wages.

(3) Once certifications are effective, the IRS will publish on irs.gov a list of all organizations that are certified as CPEOs, and the effective date of their certification at the CPEO page on a quarterly basis, by the 15th day of the first month of every calendar quarter. The IRS will also publish lists of CPEOs whose certification has been revoked or suspended. See *https://www.irs.gov/tax-professionals/cpeo-public-listings*.

(4) CPEOs use Form 8973, Certified Professional Employer Organization/Customer Reporting Agreement, to notify the IRS that a CPEO contract between a CPEO and a customer has started or ended. A CPEO files aggregate returns using the CPEOs EIN. The CPEO is required to attach a Schedule R (Form 941) to its aggregate return. Examiners may review Schedule R (Form 941) information that has been filed electronically in the EUP.

(5) CPEOs are required to electronically file Form 941 and Form 940. Under certain circumstances, the IRS may waive the electronic filing requirement.

4.23.5.14
(11-22-2017)
IRC 3512 Motion Picture Project Employers

(1) Beginning January 1, 2016, all wages paid by a motion picture project employer to a motion picture project worker during a calendar year are subject to a single social security tax wage base and a single FUTA tax wage base regardless of the worker's status as a common law employee of multiple clients of the motion picture project employer. For more information, including the definitions of a motion picture project employer and motion picture project worker, see IRC 3512(b).

(2) For background on the development of this IRC section, see *Cencast Services, L.P. v. U.S.*, 729 F.3d 1352, (9th Cir., 2013).

4.23.5.15
(11-22-2017)
Fringe Benefits

(1) A fringe benefit is any cash, property, or service that an employee receives in addition to regular taxable wages. IRC 61 states that, except as otherwise provided, gross income means all income from whatever source derived, including but not limited to, compensation for services including fees, commissions, fringe benefits, and similar items. Consequently, a fringe benefit

provided by an employer to an employee is presumed to be income to the employee unless it is specifically excluded from gross income by another section of the IRC. See Treas. Reg.1.61-21(a).

(2) Publication 15-B, Employer's Tax Guide to Fringe Benefits, may be used for quick research on the treatment of certain fringe benefits. However, the IRC, regulations, revenue rulings, and court decisions are the authority for any proposed issues.

(3) The following non-exhaustive list provides examples of fringe benefits:

Examples of Fringe Benefits
Automobile allowances
Awards and prizes
Back pay awards
Bonuses
Cafeteria plans
Chauffeur services
Communications equipment (such as cell phones)
Company owned or leased aircraft
Company owned or leased vehicles
Country club memberships
Dependent care assistance programs
Disability payments
Discounts on property or services
Educational reimbursements
Executive dining rooms
Estate planning
Financial counseling
Free or subsidized lodging
Golden parachute payments
Group term life insurance
Home security systems
Income tax return preparation
Legal services
Loans (low interest or interest-free)
Local transportation for commuting
Meals or meal money/allowances

Examples of Fringe Benefits
Moving expense reimbursements
Outplacement services
Parking
Personal computers allowed to be used at home
Personal liability insurance
Physical examinations
Reimbursement of expenses on the sale of a personal residence
Safety awards
Severance pay
Scholarships and fellowships
Sick pay
Spousal travel
Stock options
Travel reimbursement
Use of vacation homes
Vacations (all expense paid or discounted)

4.23.5.15.1
(08-14-2020)
Statutory Exclusions from Gross Income

(1) After a fringe benefit is identified, it is necessary to determine whether there is a statutory provision that specifically excludes it from gross income. The IRC excludes the following fringe benefits from income:

Fringe Benefit	IRC section
Employee achievement awards ***Note:*** The Tax Cuts and Jobs Act (TCJA) section 13310 added a definition of "tangible personal property" that excludes certain items for purposes of the deduction for employee achievement awards, including but not limited to cash, cash equivalents, gift cards, certain types of gift certificates, vacations, and meals. See IRC 274(j)(3)(a).	IRC 74(c)
Group-term life insurance	IRC 79
Amounts received under accident or health plans	IRC 105
Contributions by an employer to an accident or health plan	IRC 106
Rental value of parsonages	IRC 107

Fringe Benefit	IRC section
Certain combat pay of members of the armed forces ***Note:*** The TCJA section 11026 temporarily (through January 1, 2026) identifies the Sinai Peninsula of Egypt as a "qualified hazardous duty area" that is to be treated in the same manner as a combat zone for purposes of determining eligibility for benefits available to members of the Armed Forces."	IRC 112
Qualified tuition reduction	IRC 117(d)
Meals or lodging furnished for the convenience of the employer	IRC 119
Cafeteria plans	IRC 125
Educational assistance program	IRC 127
Dependent care assistance	IRC 129
Certain fringe benefits	IRC 132
Certain qualified military benefits	IRC 134
Adoptions assistance program	IRC 137

(2) For a statutory exclusion to apply to an identified fringe benefit, the requirements of the IRC section must be met. Even if an exclusion applies, the result may be that the value of the fringe benefit is only partially excludable from the employee's wages.

4.23.5.15.2
(08-14-2020)
Fringe Benefits under IRC 132 and Definitions

(1) IRC 132(a) provides that gross income shall not include any fringe benefit that qualifies as one of the following:

- No-additional-cost service,
- Qualified employee discount,
- Working condition fringe,
- De minimis fringe,
- Qualified transportation fringe,
- Qualified moving expense reimbursement,
- Qualified retirement planning services, or
- Qualified military base realignment and closure fringe.

(2) **No–Additional–Cost Services:** IRC 132(b) applies when an employee receives a free service at no substantial additional cost (including foregone revenue) to the employer. Generally, no–additional–cost services are only available to employees with respect to services that are offered for sale to customers in the ordinary course of the same line of business in which the employee performs substantial services for the employer. Generally, no–additional–cost services are excess capacity services, such as airline tickets or hotel rooms.

(3) **Qualified Employee Discount:** IRC 132(c) applies to a price reduction an employer gives an employee on qualified property or services that are offered to customers in the ordinary course of the same line of business in which the employee performs substantial services for the employer. The discount on services is limited to 20 percent of the price charged to customers. The

discount on merchandise cannot exceed the gross profit percentage times the price charged to customers for the item.

(4) **Working Condition Fringe:** IRC 132(d) applies to any property or service provided to an employee to the extent that, if the employee paid for it, the amount paid would be allowable as a deduction as an ordinary and necessary business expense under IRC 162 or IRC 167. This exclusion applies to property and services provided by an employer to an employee, necessary for an employee to perform their job. Examples of working condition fringe benefits include an employee's use of a company car for business or the provision of job-related education.

(5) **De minimis Fringe:** IRC 132(e) applies to any property or service provided to employees that is provided infrequently and has so little value that accounting for it would be unreasonable or administratively impracticable. A cash fringe benefit (or cash equivalent) is never excludable as de minimis, regardless of amount, except for occasional meal money or transportation fare meeting certain conditions. Examples of de minimis fringe benefits include:

a. Occasional personal use of a company copying machine,
b. Occasional parties or picnics for employees and their guests,
c. Occasional tickets for entertainment or sporting events,
d. Flowers or fruit for special occasions, and
e. Holiday gifts, **other than cash**, with a low fair market value (FMV).

(6) **Qualified Transportation Fringes:** IRC 132(f) and applies to the following benefits:

a. A ride in a commuter highway vehicle, under IRC 132(f)(5)(A), meaning any highway vehicle that transports the employee between the employee's home and workplace. The vehicle must seat at least 6 adults (excluding the driver) and the expectation must exist that at least 80 percent of the vehicle's mileage will be for transporting employees between home and work. Employees must occupy at least one-half of the seats, not including the driver.
b. A transit pass, under IRC 132(f)(5)(B), meaning any mass transit pass, token, farecard, or voucher entitling a person to ride free or at a reduced rate on a mass transit system or in a commuter highway vehicle as defined previously.
c. Qualified parking, under IRC 132(f)(5)(C), meaning parking that the employer provides to employees on or near the employer's business premises. It also includes parking on or near the location from which employees commute to work using mass transit, commuter highway vehicles, carpools or any other means.

Note: The TCJA section 11047 suspends the exclusion from gross income and wages for qualified bicycle commuting reimbursements for taxable years beginning after December 31, 2017, and before January 1, 2026.

(7) **Qualified Moving Expense Reimbursement:** IRC 132(g) applies to any amount given to an employee, directly or indirectly, as payment for, or a reimbursement of, moving expenses. Only those expenses that the employee could deduct under IRC 217, if the employee had paid or incurred them, are excludable. Any other expenses paid by the employer on behalf of the employee are includible as compensation subject to employment taxes. Examples of non-excludable expenses include house-hunting trips, storage of goods, closing

costs, and interest free or low interest loans when an employee's former home has not sold. Expenses that qualify under this exclusion are limited to reasonable expenses for:

a. Moving household goods and personal effects from the former home to the new home, and
b. Traveling expenses, including lodging, from the former home to the new home.

Note: The TCJA section 11048 repealed the exclusion from gross income and wages for qualified moving expense reimbursements, **except** in the case of a member of the Armed Forces of the United States on active duty who moves pursuant to a military order. Applies to taxable years beginning after December 31, 2017, and before January 1, 2026.

(8) **Qualified Retirement Planning Services:** IRC 132(m) applies to any retirement planning advice or information provided to an employee and the employee's spouse by an employer maintaining a qualified employer plan. A qualified plan includes an employer's pension, profit-sharing, or stock bonus plan. It also includes an annuity plan described in IRC 403(a) or IRC 403(b), a simplified employee pension within the meaning of IRC 408(k) and any simple retirement account described in IRC 408(p).

(9) **Qualified Military Base Realignment and Closures:** IRC 132(n) applies to certain payments to offset the adverse effects on housing values as a result of a military base realignment or closure.

(10) **On-Premises Athletic Facilities:** IRC 132(j)(4)(B) applies to an on–premises athletic facility operated by the employer in which substantially all of the use is by employees, their spouses, and their dependent children. The athletic facility must be located on premises that the employer owns or leases. A public facility or a facility for residential use does not qualify for this exclusion.

4.23.5.15.3 (11-22-2017) Valuation of Fringe Benefits

(1) A non–cash fringe benefit is typically valued at its fair market value. This is the amount an employee would have to pay a third party in an arm's–length transaction to buy or lease the benefit. Refer to Treas. Reg. 1.61-21(b).

(2) Treas. Reg. 1.61-21 provide special valuation rules for some commonly provided fringe benefits such as automobile and airplane travel.

4.23.5.15.3.1 (11-22-2017) Employer Provided Cell Phones

(1) For taxable years after December 31, 2009, cell phones were removed from the definition of listed property by Section 2043 of the Small Business Jobs Act of 2010. The Act did not otherwise alter the requirement that an employer-provided cell phone was a fringe benefit, the value of which must be included in the employee's gross income unless an exclusion applies.

(2) Notice 2011-72, "Tax Treatment of Employer-Provided Cell Phones", issued September 14, 2011 in Internal Revenue Bulletin 2011-38, provides guidance on the treatment of employer-provided cell phones or other similar telecommunications equipment (collectively "cell phones").

(3) Notice 2011-72 provides that, when an employer provides an employee with a cell phone primarily for non-compensatory business reasons, the IRS will treat the employee's use of the cell phone for reasons related to the employer's trade or business as a working condition fringe benefit. The value of this use

will be considered excludable from the employee's income and, solely for purposes of determining whether the working condition fringe benefit provision in IRC 132(d) applies, the substantiation requirements that the employee would normally have to meet in order for a deduction to be allowable under IRC 162 are deemed to be satisfied.

(4) In addition, the IRS will treat the value of any personal use of a cell phone provided by the employer primarily for non-compensatory business purposes as excludable from the employee's income as a de minimis fringe benefit.

(5) The application of the working condition and de minimis fringe benefit exclusions under the notice apply solely to employer-provided cell phones and should not be interpreted as applying to any other fringe benefits.

(6) Tablet devices, such as iPads, are considered "similar telecommunications equipment."

(7) The rules of the Notice 2011-72 apply to any use of an employer-provided cell phone occurring after December 31, 2009.

4.23.5.15.3.2
(11-22-2017)
Employer Payments for Employee Cell Phones

(1) In cases where employers, for substantial non-compensatory business reasons, require employees to maintain and use their personal cell phones for business purposes and reimburse the employees for the business use of their personal cell phones, examiners will analyze reimbursements of employees' cell phone expenses in a manner that is similar to the approach described in Notice 2011-72.

(2) Specifically, in cases where employers have substantial business reasons, other than providing compensation to the employees, for requiring the employees' use of personal cell phones in connection with the employer's trade or business and reimbursing them for their use, examiners will not necessarily assert that the employer's reimbursement of expenses incurred by employees after December 31, 2009, results in additional income or wages to the employee. Conditions include that:

a. The employee must maintain the type of cell phone coverage that is reasonably related to the needs of the employer's business,
b. The reimbursement must be reasonably calculated so as not to exceed expenses the employee actually incurred in maintaining the cell phone, and
c. The reimbursement for business use of the employee's personal cell phone must not be a substitute for a portion of the employee's regular wages.

(3) Arrangements that replace a portion of an employee's previous wages with a reimbursement for business use of the employee's personal cell phone and arrangements that allow for the reimbursement of unusual or excessive expenses should be examined closely.

(4) Examples of substantial non-compensatory business reasons for requiring employees to maintain personal cell phones and reimbursing them for their use include:

a. The employer's need to contact the employee at all times for work-related emergencies, and

b. The employer's requirement that the employee be available to speak with clients at times when the employee is away from the office or at times outside the employee's normal work schedule (i.e., clients are in different time zones).

(5) The following is an example of a reimbursement arrangement that does **not** result in additional income or wages. An employer has a substantial non-compensatory business reason for requiring the employee to maintain a personal cell phone to facilitate communication with the employer's clients during hours outside the employee's normal tour of duty in the office and reimburses the employee for the use of the phone. The employee uses the cell phone for both business purposes and personal purposes and the employee's basic coverage plan charges a flat rate per month for a certain number of minutes for domestic calls. The employer reimburses the employee for the monthly basic plan expense to enable the employee to maintain contact with business clients throughout the United States after hours.

(6) Examples of reimbursement arrangements that **may** be in excess of the expenses reasonably related to the needs of the employer's business and will be examined more closely include:

a. Reimbursement for international or satellite cell phone coverage to a service technician whose business clients and other business contacts are all in the local geographic area where the technician works, or
b. A pattern of reimbursements that deviates significantly from a normal course of cell phone use in the employer's business (for example an employee received reimbursements for cell phone use of $100 per quarter in quarters 1 through 3, but receives a reimbursement of $500 in quarter 4).

4.23.5.15.4
(11-22-2017)
Audit Techniques for Identifying Fringe Benefits

(1) Fringe benefits can be a significant form of compensation, and examiners should consider fringe benefit issues during an examination. Fringe benefits can be identified from a number of sources. Examiners should inspect the following documents and records, if available:

Documents and Records
Employee benefits handbook
Union agreements
Employment contracts (particulary those for executives)
Annual financial reports
SEC reports such as Form 10-K and proxy statements
Taxpayer's web site
Corporate minutes
Chart of accounts
Written policies and procedures regarding fringe benefits
Accounts payable journal

Documents and Records
Schedule M-1 (Form 1120), Reconciliation of Income (Loss) per Books With Income per Return or Schedule M-3 (Form 1120), Net Income (Loss) Reconciliation for Corporations With Total Assets of $10 Million or More, workpapers
General ledger accounts that include employee benefits
Payroll journals

(2) Examiners should also look at expense categories that are less obvious but may include fringe benefits such as miscellaneous expenses, meetings, automobile expense, insurance, tax preparation, and travel expense reimbursements.

(3) When discussing fringe benefits with the taxpayer, it is important that examiners communicate with the appropriate parties. For example, personnel in the payroll department may not have the same awareness of benefits as those in the human resources department. Discussions with other IRS personnel who may be involved in the examination are also important because they may encounter potential employment tax issues in the course of their assigned examinations to be addressed in the employment tax exam.

4.23.5.15.5
(11-22-2017)
Reporting Fringe Benefits

(1) Non-cash fringe benefits are includible in the employee's wages in either the pay period, the quarter or any other period the employer chooses, as long as the fringe benefits are treated as paid at least once per calendar year. Employers do not have to make the same election for all employees and may change their election as frequently as they desire. Employers may treat the value of non-cash fringe benefits provided during the last two months of the calendar year or any shorter period as paid during the subsequent calendar year. Refer to Announcement 85-113, which provides the rules for the timing of inclusion in wages.

(2) Fringe benefits are subject to all employment taxes including social security, Medicare, FUTA, and FITW unless special rules apply.

4.23.5.16
(11-22-2017)
Executive Compensation

(1) LB&I employment tax cases may include issues generally associated with executives and other highly compensated employees. Because of restrictions on qualified retirement plans, particularly discrimination restrictions, more top-paid employees are relying on nonqualified plans, as well as stock–based compensation and golden parachute arrangements, to ensure job security and provide additional retirement benefits.

(2) LB&I implemented the Corporate Executive Compliance (CEC) Strategy to support the Service-wide goal of improving compliance of high-income taxpayers. The CEC focuses on executive compensation issues, tax shelter issues, and non-filing by executives. The key officer and executive returns compliance check requirements have been updated to allow agents to use their professional judgment, knowledge of the taxpayer's operations, and other available information to determine whether inspection of executive returns is warranted. See IRM 4.46.3-6 , Inspection of Key Officer and Executive Returns.

(3) Additional guidance for compensation and benefits can be found at the Corporate and Business Issues (Non-Credits) Knowledge Base Homepage at *https://irsgov.sharepoint.com/sites/ETD-KMT-KB020*.

4.23.5.16.1
(11-22-2017)
Non-qualified Deferred Compensation

(1) A non-qualified deferred compensation (NQDC) plan is an elective or non-elective arrangement between an employer and an employee to pay the employee compensation some-time in the future. NQDC plans differ from qualified plans in that they do not meet all of the requirements of IRC 401(a). The terms of these arrangements differ widely, but their common objective is to provide tax deferral for a specified period. NQDC plans may provide for payment upon retirement, death, disability, or termination of employment. Others may permit payment after a specified number of years.

(2) In contrast to the general timing rule under which remuneration is subject to FICA tax when "actually or constructively paid" (Treas. Reg. 31.3121(a)-2(a)), amounts deferred under a NQDC plan are subject to FICA tax under a **special timing rule.** NQDC is taxed (taken into account) only once. When amounts are paid from the plan in a later period, they are not subject to additional FICA and FUTA taxes provided the amounts were properly taken into account at the time of deferral. In addition, any earnings attributed to the amounts deferred are likewise not subject to FICA or FUTA. This rule is commonly called the **non-duplication rule.** Amounts deferred under a NQDC plan are subject to FICA tax at the later of:

1. When the services are completed, or
2. When there is no substantial risk of forfeiture.

Note: Refer to Treas. Reg. 31.3121(v)(2)-1(a)(2)(iii).

(3) Participants in NQDC plans may include:

- Key executives and/or directors
- A select group of management or highly compensated employees
- Employees whose benefits are limited by qualified plan rules
- Any other employee whom the employer wishes to reward

(4) The most commonly used types of NQDC plans are salary reduction arrangements, bonus deferral plans, top-hat plans, and excess benefit plans.

- **Salary reduction arrangements:** This type of plan simply defers the receipt of otherwise currently taxable compensation by allowing the executive to select a percentage or dollar amount to be taken out of current salary and have the employer pay the deferred amount at a future date.
- **Bonus deferral plans:** This is similar to a salary reduction arrangement, except that it defers receipt of an employee's bonus.
- **Top-hat plans:** Also known as Supplemental Executive Retirement Plan (SERP). These are NQDC plans primarily for a select group of management or highly compensated employees to supplement qualified retirement plans.
- **Excess benefit plans:** Also known as benefit equalization plans or benefit replacement plans. These are NQDC plans that provide benefits to employees whose benefits under the employer's qualified plan are limited by IRC 415.

(5) All NQDC plans are either unfunded or funded. Most NQDC plans are intended to be unfunded arrangements because of the tax advantages. With an unfunded arrangement, the employee has only the employer's "mere promise to pay" the deferred compensation in the future and the promise is not secured in any way. The employer may simply keep track of the benefit in a bookkeeping account or may invest the funds in annuities, securities, or insurance arrangements. In order to help fulfill its mere promise to pay the employee, the employer may transfer funds to a trust that remains a part of the employer's general assets, subject to the claims of the employer's creditors upon insolvency.

(6) Generally, a funded arrangement exists if assets are set aside from the claims of the employer's creditors, for example, in a trust, escrow, or annuity.

(7) For more information on NQDC refer to Pub 5528, Nonqualifed Deferred Compensation Audit Technique Guide.

4.23.5.16.1.1
(11-09-2023)
IRC 409A

(1) If a deferred compensation plan does not comply with IRC 409A, all amounts deferred under the plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income. Such amounts are also subject to two additional taxes, as discussed below.

(2) In general terms, IRC 409A imposes four principal requirements:

a. If a taxpayer is given an election to defer compensation, the election must be made not later than the time specified in the statute and regulations,
b. A taxpayer can elect to delay the payment date of deferred compensation (a subsequent or second election), but only if the election is made not later than a specified time,
c. NQDC can be paid only upon the occurrence of a specified trigger (death, disability, change of control, separation from service, unforeseeable emergency, or at a specified time or on a fixed payment schedule), and
d. Payment of NQDC cannot be accelerated except as permitted in the regulations.

(3) In addition, IRC 409A requires income inclusion in circumstances where:

- Assets are set aside in a foreign trust for the purpose of paying NQDC,
- Assets are restricted to paying nonqualified deferred compensation in the case of a change in the employer's financial health, or
- Assets are set aside in a trust during certain periods, such as when the employer's defined benefit qualified plan is underfunded or the employer has filed for bankruptcy.

(4) NQDC plans subject to IRC 409A must comply with IRC 409A in both operation and in form. Generally, if an employee has deferred compensation under a plan that fails to comply with the IRC 409A operation requirements after December 31, 2008, the employee will have to pay regular income tax on the amounts deferred plus an additional 20 percent income tax on the amount, and a premium interest tax based on the underpayment interest (computed at the underpayment interest rate plus 1 percent) that would have been due if the amounts deferred had been includible in the employee's income in the year when the amounts were first deferred or, if later, vested.

Note: If there is an adjustment to IRC 409A and it includes interest, make sure to annotate Form 3198 with the interest start and ending date, and include instructions to add an additional one percent on the amount of tax.

Note: See IRM 20.2.11.17, IRC 409A, Inclusion in Gross Income of Deferred Compensation under Nonqualified Deferred Compensation Plans, and IRM 20.2.5, Interest - Interest on Underpayments, for information regarding the computation of interest.

(5) IRC 409A applies to amounts deferred after December 31, 2004 (including amounts deferred before that date which were not earned and vested before January 1, 2005). IRC 409A also applies to deferred amounts that were earned and vested before January 1, 2005 (grandfathered amounts) if the arrangement is materially modified after October 3, 2004.

(6) Beginning with Notice 2005-1, the Treasury Department and IRS published extensive guidance on IRC 409A including both transition relief and substantive requirements. The transition relief provided to taxpayers expired on December 31, 2008. In reverse chronological order, the guidance is as follows:

Guidance Issued	Description
Notice 2010-80	Modification to the relief and guidance on corrections of certain failures of a NQDC plan to comply with IRC 409A
Rev. Rul. 2010-27	Guidance on what constitutes an unforeseeable emergency under IRC 457(b) and IRC 409A,
Notice 2010-6	Relief and guidance on corrections of certain failures of a NQDC plan to comply with IRC 409A
Notice 2009-92	Guidance on the application of IRC 409A(a) to changes to NQDC plans to comply with an Advisory Opinion of the Office of the Special Master for TARP Executive Compensation
Notice 2009-49	Guidance under IRC 409A(a)(2)(A)(v) on certain transactions pursuant to the Emergency Economic Stabilization Act of 2008
Notice 2008-113	Relief and guidance on corrections of certain failures of a NQDC plan to comply with IRC 409A(a) in operation
Proposed Treas. Reg. 1.409A-4	Blank
Notice 2007-100	Transition relief and guidance on corrections of certain failures of a NQDC plan to comply with IRC 409A(a) in operation
Notice 2007-86	Notice of additional 2008 transition relief under IRC 409A
Notice 2007-78	Transition relief and additional guidance on the application of IRC 409A to NQDC plans
Final Treas. Regs. 1.409A	Blank
Notice 2007-34	Guidance regarding the application of IRC 409A to splitdollarlife insurance arrangements

Guidance Issued	Description
Announcement 2007-18	Announcement establishing a compliance resolution program
Notice 2006-79	Interim guidance
Notice 2006-4	Interim guidance on the application of IRC 409A to stockrights issued by non-public companies
Proposed Regulations	Blank
Notice 2005-1	Initial transactional guidance, relief, and reasonable good faith interpretation of the statute standard pending further guidance

(7) The TCJA section 13603, "Treatment of qualified equity grants", added IRC 409A(d)(7) discussing the treatment of qualified stock.

(8) For further information refer to deferred compensation page on the *Corporate and Business Issues (Non-Credits) Knowledge Base Homepage* (https://irsgov.sharepoint.com/sites/ETD-KMT-KB020).

4.23.5.16.2
(08-14-2020)
Stock-Based Compensation

(1) Stock in the employer's company is a commonly used form of compensation for employees and may also be provided as compensation for service providers who are not employees, such as outside directors. Stock–based compensation includes any compensation paid to an employee or independent contractor, either in cash or property, that is based on the value of the stock. This includes stock options, restricted stock awards, stock appreciation rights and phantom stock.

(2) A stock option is the right to purchase a given number of shares of stock at a given price within a specified period of time. Stock options granted in connection with the performance of services are either statutory or non-statutory stock options. Statutory options include incentive stock options under IRC 422 and options issued under an employee stock purchase plan under IRC 423. All other options are non-statutory options governed by IRC 83 and Treas. Reg. 1.83-7.

(3) **Non-statutory Stock Options:** Any option that does not qualify for treatment as a statutory option is a non-statutory option. Most non-statutory stock options are taxed on the date of exercise or other disposition. The amount includible in income is the difference between the fair market value of the stock on the exercise date over the amount paid (spread amount). If an option is sold or otherwise disposed of prior to exercise, the money or property received is includible in income. The income is characterized as compensation income to the recipient for the year in which the option is exercised or the option is sold or otherwise disposed of prior to exercise.

a. In the case of an employee, the amount includible in income under IRC 83 with respect to non-statutory stock options is also subject to FICA, FUTA, and FITW and must be reported on Form W-2. Non-employees, such as directors or outside contractors, are issued a Form 1099-MISC or Form 1099-NEC.
b. A corresponding compensation expense deduction is generally allowed to the employer for the taxable year in which the optionee's taxable year of

inclusion ends. See IRC 83(h) and Income Treas. Reg. 1.83–6(a)(1) and the exception provided to this general rule in Treas. Reg. 1.83–6(a)(3). This expense generally is identified on the corporate income tax return as a Schedule M-1 (Form 1120) adjustment under "Deductions on this return not charged against book income" or on Schedule M-3 (Form 1120), Part III, Line 9, as a stock option expense.

(4) **Statutory Stock Options:** While non-statutory stock options may be provided to any service provider, statutory options may be granted only to employees. IRC 421 to IRC 424 contain a set of requirements, all of which must be followed, for an option to be considered statutory. Violating any of these rules results in the option being disqualified. The result of disqualification is that the option is considered to be a non-statutory option that is taxable under the rules of IRC 83. Statutory options include incentive stock options and options granted under an employee stock purchase plan.

(5) **Incentive Stock Options:** Incentive stock options (ISOs) are governed by IRC 422 and are not subject to the anti-discrimination rules. Although there are no anti-discrimination rules, there are still some rules addressing ISOs given to stockholders with a certain ownership percentage. The options can never be granted with an exercise price that is less than the FMV of the underlying stock on the date of grant. Gain from the sale of the stock purchased under the ISO is includible in gross income of the employee only upon sale or other disposition of the stock.

Note: TCJA section 13603 amended IRC 422(b) by providing that ISOs do not include any option if an election is made under IRC 83(i) with respect to the stock received in connection with the exercise of the option.

(6) **Employee Stock Purchase Plans:** Employee stock purchase plans (ESPPs) are governed by IRC 423 and are intended for all employees, with certain exceptions. See IRC 423(b)(4) for employees that may be excluded. All employees must be given an opportunity to participate in the plan without discrimination, with exceptions for new, part-time, seasonal, or highly compensated employees. The option to purchase stock can be price discounted but cannot be less than the lesser of 85 percent of the FMV of the stock on the date of grant or 85 percent of the value of stock on the date of exercise.

Note: Unlike non-statutory stock options, compensation income is not recognized on the exercise of a statutory stock option unless there is a "disqualifying disposition."

Note: TCJA section 13603 added IRC 423(d), "Coordination with qualified equity grants", stating that an option for which an election is made under IRC 83(i) with respect to the stock received in connection with its exercise shall not be considered as granted pursuant to an ESPP.

(7) Disqualifying dispositions, under IRC 421(b), occur when stock acquired under a statutory stock option plan is sold or otherwise disposed of prior to the expiration of the applicable holding period. This is generally the later of two years after the date the option is granted or one year after the date the option is exercised. The income realized on the disqualifying disposition is treated as

compensation to the extent of the spread amount (or gain if less for ISOs). This compensation is included in the employee's Form W-2, but is not subject to FICA, FUTA, or FITW.

(8) The exercise and qualifying disposition of stock acquired pursuant to a statutory stock option plan provide no tax deduction for the employer. See IRC 421(a)(2). However, the employer is entitled to a deduction for the amount the employee recognizes as compensation on a disqualifying disposition. See IRC 421(b).

(9) IRC 3121(a), IRC 3306(b), IRC 421(b) and IRC 423(c) were amended by the American Jobs Creation Act (AJCA) of 2004 to address the application of FICA and FUTA taxes and FITW to statutory stock options. See IRC 3121(a)(22) and IRC 3306(b)(19). These sections provide that any exercise of a statutory stock option or disposition of stock acquired pursuant to such exercise will not result in wages for purposes of FICA and FUTA. Furthermore, income tax withholding will not apply to a disqualifying disposition or with respect to the ordinary income recognized upon a qualifying disposition of stock acquired pursuant to an employee stock purchase plan. These amendments are effective for exercises of statutory stock options exercised after October 22, 2004.

(10) Prior to the AJCA amendments, the position of the IRS was set forth in Notice 2001-14 and Notice 2002-47. Notice 2001-14 placed a retroactive moratorium on any assessments until January 1, 2003. The notice provides that the IRS will not enforce application of FICA and FUTA taxes upon the exercise of statutory stock options and will not enforce the application of FITW upon the sale or disposition of stock acquired pursuant to such options. Notice 2002-47 effectively extended the moratorium.

(11) TCJA section 13603 "Treatment of qualified equity grants" added IRC 83(i) . Under IRC 83(i), qualified employees who are granted stock options or restricted stock units (RSUs) and who later receive stock upon exercise of the option or upon settlement of the RSU (qualified stock) may elect to defer the recognition of income for up to 5 years if the corporation's stock was not readily tradable on an established securities market during any prior calendar year, if the corporation has a written plan under which not less than 80 percent of all U.S. employees are granted options or RSUs with the same rights and privileges to receive qualified stock, and if certain other requirements are met. An election under IRC 83(i) applies only for federal income tax purposes. The election has no effect on the application of FICA and FUTA. These rules apply to stock attributable to options exercised, or RSUs settled, after December 31, 2017.

(12) Stock option plans are identified in a corporation's annual reports and also in reports filed with the SEC, such as Form 10-K and proxy statements. Examiners will inspect the Schedule M-1 or M-3 adjustments on the employer's income tax returns. Any income tax expense deductions taken in regard to stock-based compensation may appear as a deduction on the return that was not taken for book purposes.

4.23.5.16.3
(11-09-2023)
Golden Parachute Payments

(1) A corporation may have contracts with key personnel that provide for payments to be made if an executive loses their job as a result of a change in ownership or control of the company. These payments are referred to as "golden parachute payments."

(2) IRC 280G applies to the payor and disallows the deduction of an “excess parachute payment.” IRC 4999 applies to the recipient and imposes a 20 percent nondeductible excise tax on any such payment. The excise tax must be withheld by the payor (refer to IRC 4999(c)(1)). This excise tax is administered as an income tax under IRC 4999(c)(2). In addition, wages constituting parachute payments are subject to FICA, FUTA, and FITW, the same as other termination payments.

(3) A payment is generally considered an excess parachute payment if its present value, along with the present values of all such payments, equals or exceeds three times the average annual compensation of the recipient over the previous five-year period. The amount of the payment in excess of the average annual compensation is the excess parachute payment.

Example: An officer of a corporation receives a golden parachute payment of $400,000. The officer's average compensation over the previous five–year period was $100,000. The excess parachute payment is $300,000 ($400,000 minus $100,000). The corporation cannot deduct the $300,000 and must withhold excise tax of $60,000 (20 percent of $300,000) from the payment.

Note: Due to the fact that the 20% excise tax is treated as income tax withholding under IRC 3402, this amount would be subject to the abatement provisions of IRC 3402(d).

(4) Payments under IRC 280G(b)(6), (payments pursuant to a qualified retirement plan), or IRC 280G(b)(4), (payments that the taxpayer establishes are reasonable compensation for services rendered on or after the date of change in control), are not considered parachute payments. In addition, parachute payments do not include payments made by a small business corporation or a corporation with no readily tradable stock if certain shareholder approval requirements are satisfied. See IRC 280G(b)(5).

(5) Golden parachute payments made to employees are reported on Form W–2 along with any taxes withheld. The total payment is included in Boxes 1, 3, and 5 and is subject to the usual income tax withholding, social security and Medicare taxes. The 20 percent excise tax on excess parachute payments is included in Box 2 as income tax withheld and is also reported in Box 12 with Code “K”. The employee must include the 20 percent excise tax as other taxes on Form 1040 Schedule 2, Additional Taxes.

(6) Total golden parachute payments made to nonemployees are reported on Form 1099–NEC in Box 1, “Nonemployee Compensation.” Any excess parachute payments are reported in Box 14, “Excess Golden Parachute Payments” of Form 1099-MISC. The payor of a parachute payment to an independent contractor would not have a withholding requirement. The recipient of the payment would determine the 20 percent excise tax on the amount shown in Box 14 and report it as other taxes on Form 1040 Schedule 2, Additional Taxes.

(7) To identify parachute payments, determine if a change in ownership or control has occurred. Changes in ownership or control may be determined by analyzing merger agreements, employment contracts, stock option plans, and

deferred compensation plans. If a payment under certain benefit plans is accelerated, it may possibly be considered to be contingent on a change in ownership.

(8) Audit adjustments are made using the standard employment tax examination report forms. For employee adjustments, the 20 percent excise tax is computed on Form 4668 - Schedule of Adjustments, line 17, “Other income tax withholding wage adjustment” of Form 4668, Employment Tax Examination Changes Report.

4.23.5.17 (11-09-2023) Excess Per Diem Payments under Revenue Ruling 2006-56

(1) Rev. Rul. 2006-56 provides guidance as to the proper employment tax treatment of expense allowance payments where an employer fails to treat amounts exceeding the federal per diem rate as wages.

(2) The Rev. Rul. 2006-56 holds as evidence of a pattern of abuse of the accountable plan rules when an expense allowance arrangement:

a. Has no mechanism or process to determine when an allowance exceeds the amount that may be deemed substantiated,
b. Routinely pays allowances in excess of the amount that may be deemed substantiated without requiring actual substantiation of all expenses,
c. Requires no repayment of the excess of amount, and
d. Fails to treat the excess allowances as wages for employment tax purposes. .

(3) This abuse causes **all** payments made under the arrangement to be treated as paid under a nonaccountable plan.

(4) The revenue ruling was effective upon issuance on November 9, 2006.

4.23.5.17.1 (11-22-2017) Considerations for Periods After December 31, 2006

(1) For periods after December 31, 2006, the examiner will determine whether the plan is abusive based on the extent of the excess payments that are not treated as wages and on whether a system for tracing excess payments is being utilized.

(2) There are four conditions to be addressed:

1. **When does an employer routinely make payments in excess of the**

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Note: If the condition is not met, excess payments will not constitute a pattern of abuse, absent other significant plan defects.

2. **When does an employer fail to track excess allowances?** If the condition above is satisfied, the agent must determine whether the employer has implemented and utilizes a system to track allowances that permits it to determine when the allowances paid, computed on a per diem basis, exceed the deemed substantiated amount and to treat such amounts as wages. If the agent determines the employer utilizes such a system, then the fact that the employer, due to errors in its system, routinely pays excess allowances that it does not treat as wages generally does not, on its own, evidence a pattern of abuse. Each case stands on its own, and a determination must be made based on the "facts and circumstances" of that particular case.
3. **What happens if a plan evidences a pattern of abuse?** If a plan evidences a pattern of abuse, all of the per diem payments made under the plan will be treated as taxable wages.
4. **What happens if a plan does not evidence a pattern of abuse?** If a plan does not evidence a pattern of abuse, but an employer has paid excess allowances without treating such amounts as wages, only the excess per diem payments will be considered taxable wages in the audit.

4.23.5.18
(11-22-2017)
Accountable Plans – "Tool Reimbursement" and "Rental" Payments

(1) Examiners may encounter employers who treat part of an employee's compensation as "tool rental" or "tool reimbursement." They usually exclude these payments from wages. They may also report the payments on Form 1099-MISC or Form 1099-NEC as rental payments. These types of payments are no different from any other expense reimbursements and must meet the requirements of an accountable plan to be excluded from wages.

(2) Payments to employees for equipment they are required to provide as a condition of employment are wages for employment tax purposes unless paid under an accountable plan. See Rev. Rul. 2002-35.

(3) An employer who designates part of an employee's compensation as a "tool allowance" must meet accountable plan requirements. To be excluded from wages, amounts paid to employees to cover expenses incurred to acquire or maintain tools must be paid under a reimbursement or other expense allowance arrangement that meets the requirements of IRC 62(c). **An arrangement that provides for a tool allowance based upon hours worked or any other estimate fails to meet both the substantiation and the return of excess requirements, and thus does not qualify as an accountable plan.** See Rev. Rul. 2005-52.

(4) A related issue is the payment of "rent" to employees for the use of tools and equipment provided by the employees as a requirement of the job. These payments are usually reported to the employees on Forms 1099. This may be an attempt by the employer to circumvent the accountable plan rules. Generally, payments to employees for the use of employee-provided equipment are wages and not rent since the payments are related to the services provided as an employee and are not paid under an accountable plan. Thus, the payments will be considered wages subject to employment taxes and reportable on Form W-2 and Form 1040 unless the payments were made under an accountable plan.

(5) Typically, the employer will characterize a portion of each employee's compensation as a reimbursement for equipment rather than as wages, thus avoiding both employment and income taxes on the equipment payment amount.

(6) Although the payment may be intended to reimburse the employee for the expenses incurred in purchasing and maintaining equipment, the amount is generally determined without reference to the expense that might be incurred. It is more likely that the payments are used to provide employee compensation that is treated as not subject to employment taxes. Employers do not include the rental payments in the employee's wages. Consequently, the employers reduce their liability for employment taxes.

(7) The issue to be determined with respect to equipment rents is whether employees who furnish and maintain their own equipment are reimbursed for such expenses under an accountable plan. A reimbursement or other expense allowance arrangement will be treated as a nonaccountable plan if it fails to meet any one or more of the requirements of business connection, substantiation, or return of excess.

4.23.5.18.1
(11-22-2017)
Accountable Plan – Per Diem Payments and Wage Recharacterization

(1) If an expense reimbursement plan serves to recharacterize amounts previously paid as wages, amounts paid under it will not be treated as paid under an accountable plan. Such recharacterization violates the business connection requirement of Treas. Reg. 1.62-2(d) because the employees receive the same amount regardless of whether expenses are incurred, the only difference being the ratio of the amount treated as taxable wages to the amount treated as nontaxable reimbursement. Consequently, all reimbursement allowances paid under the plan must be treated as paid under a nonaccountable plan, must be included in the employee's gross income, and must be reported as wages for FICA tax, FUTA tax, and FITW purposes. The recharacterization as a reimbursement allowance of amounts previously paid as wages violates the business connection requirement of Treas. Reg. 1.62-2(c) regardless of whether the employee actually incurs (or is reasonably expected to incur) deductible business expenses related to the employer's business. See Rev. Rul. 2012-25.

(2) Examiners should be alert to the split of wages between taxable wages and per diem payments, most often paid to employees who provide services through a temporary staffing service or other temporary employment arrangement and have to travel for the job. The payment arrangement typically pays the employee an hourly rate, but the rate is divided between taxable wages and "per diem" payments. The combined rate is comparable to the taxable wage rate paid to employees who work in the same location but do not travel for the job.

(3) Examiners who encounter this issue are to contact the Employment Tax Policy Analyst responsible for accountable plans for more guidance on this issue.

4.23.5.19
(11-09-2023)
Digital Asset - Application of Tax Principles in Examination

(1) Infrastructure Investment and Jobs Act (IIJA) provides a definition of the term **digital asset** as any digital representation of value which is recorded on a cryptographically secured distributed ledger or any similar technology as specified by the Secretary. Virtual currency, convertible virtual currency, cryptocurrency, stablecoins, and non-fungible tokens (NFTs) all fall under the definition of a digital asset.

(2) The IRS has issued guidance in the form of frequently asked questions (FAQ) on the application of existing general tax principles to transactions using a digital asset, previously referred to as "virtual currency," in Notice 2014-21, Tax

Treatment of Virtual Currency. Digital asset that has an equivalent value in real currency, or that acts as a substitute for real currency, is referred to as "convertible" digital asset.

(3) According to the FAQ, "a digital asset" is treated as property for federal tax purposes and is not treated as currency that could generate foreign currency gain or loss for U.S. federal tax purposes. Also, a taxpayer who receives digital assets as payment for goods or services must, in computing gross income, include the fair market value of the digital asset, measured in U.S. dollars, as of the date that the digital asset was received. The character of a gain or loss generally depends on whether the digital asset is a capital asset in the hands of the taxpayer. For example, stocks, bonds, and other investment property are generally capital assets. Bitcoins held as an investment would be a capital asset. In addition:

- Wages paid to employees using digital asset are taxable to the employee, must be reported by an employer on a Form W-2, and are subject to FICA, FUTA and FITW.
- Payments using digital asset made to independent contractors and other service providers are taxable and self-employment tax rules generally apply. Normally, payers must issue Form 1099-NEC for non-employee compensation when the value of the digital asset exceeds $600.
- A payment made using ditigal asset is subject to information reporting to the same extent as any other payment made in property.

(4) No inference should be drawn regarding digital assets (virtual currencies) not described in the notice. For additional information regarding convertible ditigal assets, see the Financial Crimes Enforcement Network (FinCEN) report "FIN-2013-G001".

4.23.5.20
(11-22-2017)
Whistleblower Claims for Award - General

(1) IRC 7623 provides for the payment of awards, not otherwise provided for by law, for information that leads to the detection of underpayments of tax; or detection and bringing to trial and punishment of persons guilty of violating internal revenue laws or conniving at the same.

(2) Treas. Reg. 301.7623-1 provides that whistleblowers may file a claim for an award on Form 211, Application for Award for Original Information.

(3) The Whistleblower Office (WO), under Services and Enforcement (SE:WO), has the responsibility for the administration of the award program for both 7623(a) and 7623(b) claims. All claims for award must be coordinated with the IRS WO upon receipt.

(4) The majority of all employment tax cases involving a claim for award will originate with the WO. The initial designation (7623(a) or 7623(b) claim) will have already been determined and special instructions will be included in the assigned case. However, if an examiner receives a Form 211 directly from a taxpayer, they must immediately coordinate the claim with the WO and the Lead Subject Matter Expert (SME).

(5) Additional information can be found at the "Whistleblower Office Home Page" at: *https://irsgov.sharepoint.com/sites/WO*.

(6) IRM 25.2.1, General Operating Division Guidance for Working Whistleblower Claims, and IRM 25.2.2, Whistleblower Awards, provide procedures and

guidance for **all** IRS personnel to ensure consistent and proper handling of these cases and that proper safeguards are used to protect the whistleblower's identity.

Note: Maintaining the security and confidentiality of the whistleblower and whistleblower information is of critical importance and proper procedures must be followed at all times.

4.23.5.20.1
(11-09-2023)
Taint Review

(1) Some whistleblower information, such as information that may be subject to a valid claim of privilege, may create risks if used by the IRS; this information is "tainted". If potentially tainted information is identified at any time during the review of the whistleblower's information (for example Employment Tax - Workload Selection and Delivery (ET-WSD) or in the field), the reviewer/examiner will contact the Lead SME and request a taint review. The Lead SME will assign a SME to conduct the taint review of the potentially tainted information and the SME will coordinate with the Operating Division Counsel to determine whether information is subject to a recognized privilege. The IRS will not use information subject to attorney client privilege or the federally authorized tax practitioner privilege. If it is determined that the information will not be used, it will immediately be returned to the Whistleblower Office's ICE Team in Ogden in a double-sealed envelope along with any analysis received from Counsel regarding the use of the information. The SME will provide a memorandum for the case as to the final result of the taint review to be posted on e-trak and included in the case file.

(2) **Taint Review**: In general, the goal of the taint review is to determine whether any information provided by the whistleblower may be barred from introduction into evidence in later court cases. The most common cause of evidence preclusion is that the evidence is subject to a legal privilege, such as attorney-client privilege or the federally authorized tax practitioner privilege. Other instances of tainted information (whether potentially inadmissible or not) might include evidence obtained illegally (for example document stolen from the taxpayer by the whistleblower), documents obtained in violation of employment agreements between the whistleblower and the taxpayer, or documents containing trade secrets (for example if the whistleblower is a current employee and the whistleblower obtained the documents without authorization).

(3) The examiner/team will not contact the whistleblower for additional information. If the examiner/team determines that debriefing the whistleblower would result in information that would be material to the evaluation of the submission, the examiner/team should contact the Lead SME. The Lead SME will assign the debriefing to a SME. A debriefing may yield additional information that the whistleblower did not recognize as relevant to the taxpayer's matters, information about the credibility of the whistleblower, information relevant to legal issues that can affect the use of documents, and leads to other sources of information. A debriefing may also clarify the whistleblower's submission.

4.23.5.20.2
(08-14-2020)
IRC 7623(a)
Whistleblower Claims

(1) If it is determined that a whistleblower's claim with regard to employment taxes is equal to or less than the $2 million threshold (tax, penalties, interest, additions to tax, and additional amounts in dispute), the WO will designate it as an "a" claim (Tracking Code 7882 "Referrals – Form 211 7623(a)"). All "a" claims are sent from the WO to the Employment Tax - Workload Selection and Delivery unit (ET-WSD) for review and classification. Generally, the WO will not perform any screening or case building on "a" claims.

(2) Referrals selected upon classification by ET-WSD are sent to the field with the controls established, the appropriate project code based on the key issue identified during classification, the appropriate Whistleblower tracking code, and the appropriate freeze code. Included in the selected case will be an "instructional insert" along with specific instructions from the WO on required closing procedures.

(3) If the referral is related to an open employment tax examination, the information will be forwarded to the group for association. The appropriate freeze code will be added to the established controls.

(4) See IRM 25.2.1.5, Working a Whistleblower Claim, for detailed procedures.

4.23.5.20.3
(11-22-2017)
IRC 7623(b) Whistleblower Claims

(1) If a whistleblower's claim with regard to employment taxes is greater than the $2 million threshold (tax, penalties, interest, additions to tax, and additional amounts in dispute), the WO will designate it as a "b" claim.

(2) On all "b" claims, the WO will conduct preliminary screening and case building. If the initial claim is accepted, the claim will be forwarded to ET-WSD.

(3) A whistleblower must meet several conditions to qualify for an award under IRC 7623(b). The whistleblower's information must be:

a. Signed and submitted under penalty of perjury,
b. Relate to an action in which the tax, penalties, interest, additions to tax, and additional amounts in dispute exceed $2,000,000, and
c. Relate to a taxpayer, and for individual taxpayers only, whose gross income exceeds $200,000 for at least one of the tax years in question.

(4) If the information meets the conditions in (3) above and substantially contributes to an administrative or judicial action that results in the collection of tax, penalties, interest, additions to tax, or additional amounts, the IRS will pay an award under IRC 7623(b). If the whistleblower does not meet these requirements, then IRC 7623(a) may apply, and the referral will be processed as outlined in IRM 4.23.5.20.2, IRC 7623(a) Whistleblower Claims.

(5) For additional information, see IRM 25.2.1, General Operating Division Guidance for Working Whistleblower Claims.

4.23.5.20.3.1
(08-14-2020)
Unique Procedures for IRC 7623(b) Referrals

(1) The following is a brief summary of the infrastructure for the processing and/or examination of "b" claims for SB/SE Employment Tax:

- WSD Whistleblower Coordinator (WB Coordinator): ET-WSD agent who oversees the initial SB/SE ET Whistleblower process.
- Lead SME: Employment Tax Examination personnel assigned to conduct initial analysis and SME assignment.
- SME: Responsible for individual claims and conducts additional analysis, performs taint reviews, and debriefs the whistleblower, as necessary. The SME will also be responsible for arranging assignment of a Counsel Attorney assistance on the taint review.
- Taint Team: SME teamed with assigned Counsel Attorney.
- SB/SE ET Exam Groups: Assigned cases are subject to normal case examination procedures, with special attention and procedures due to the confidentiality aspects of the case.

Note: For Exempt Organization procedures, refer to IRM 4.70.6, TE/GE Examinations, Classification and Case Assignment (C&CA) Procedures

(2) If an examiner is assigned a "b" claim, a case insert is to be included in the file describing actions taken by WSD and instructions.

Note: If a case insert is not included, the examiner will contact ET-WSD.

(3) For all "b" claims, the Lead SME will:

a. Perform analysis and forward the case to SMEs if further development is recommended, or returns the case to the WO with the Form 11369, Confidential Evaluation Report on Claim for Award, and closing attachments if surveyed,
b. Assign claims to SMEs,
c. Monitor claims assigned to the SMEs,
d. Coordinates claims for technical issues and/or by whistleblower,
e. Acts as liaison for Employment Tax Examination, including "a" claims,
f. Coordinate with Employment Tax Policy if assistance is needed.

(4) For all "b" claims, the SME will:

a. Review case file information and perform research,
b. Review materials for taint concerns and contact Counsel attorney, as necessary, to develop relevant legal issues,
c. Debrief the whistleblower to clarify the submission and obtain any additional supporting evidence,
d. Forward the case to WSD for case building if selected for examination, or
e. Return the case to the Lead SME if a survey is recommended, for final signature of the Form 11369 and closing.

(5) All IRC 7623(b) case package mailings will include the green cover sheet, Sensitive But Unclassified (SBU) Cover Sheet, Catalog Number 56033J, to ensure the proper safeguarding of the claim information. All whistleblower packages will notate on the Form 3210, Document Transmittal, "Form 211 Whistleblower IRC 7623(b) Claim."

4.23.5.21
(11-09-2023)
SB/SE Employment Tax Group Procedures for Whistleblower Claims

(1) The examiner will review all information regarding the allegations and conduct a pre-contact analysis and review of the case prior to making contact with the taxpayer. If an examination is warranted, the examiner will follow normal employment tax procedures for working the issues.

Note: For Exempt Organization procedures, refer to IRM 4.70.6, TE/GE Examinations, Classification and Case Assignment (C&CA) Procedures.

(2) The whistleblower file and all references to a whistleblower must, at all times, be kept separate from the examination file. Whistleblower communications are confidential and the existence of the whistleblower and all whistleblower communications are not to be revealed to the taxpayer.

(3) If the examiner determines the return does not warrant examination, they will complete Items 1 through 9 and Items 12 through 14 on Form 11369 and attach a brief explanation as to why the case will not be worked. The Form 11369 will be signed by the examiner and the manager and be processed as follows:

a. If an “a” claim, return directly to the Whistleblower Office. Request the freeze code be removed from the controls so the case can be surveyed.
b. If a “b” claim, contact the Lead SME. The Lead SME, upon review and concurrence with the examiner, will forward the information to ET-WSD for a determination as to the disposition of the case and removal of the freeze code. When the freeze code is removed, the examiner can close the case to the manager.

(4) If the examiner determines the case needs to be re-assigned to another group, they will complete Items 1 through 9 and Items 12 through 14 on Form 11369 and:

a. If an “a” claim, the examiner will discuss the reassignment with the group manager and can transfer or re-assign case at the group level.
b. If a “b” claim, the examiner will discuss the reassignment with the group manager and can transfer or re-assign case at the group level.

(5) If the case will be examined, the examiner will develop the issues according to general employment tax procedures. When developing the issues related to information received from the whistleblower, examiners will attempt to independently corroborate and/or refute the information provided. The independently developed information will form the basis for any proposed assessment as well as the recommendation whether an award is appropriate.

(6) The examiner is not to contact the whistleblower for either “a” or “b” cases. The SME is responsible for all contacts with the whistleblower, including debriefings:

a. If a debriefing has not been performed by a SME and the agent determines that additional information is required from the whistleblower to clarify the submission, the agent will contact the Lead SME with a list of questions to be asked. The Lead SME will assign a SME to conduct the debriefing on behalf of the examiner and provide a narrative of the responses.
b. If additional contact with the whistleblower is warranted after a debriefing, the examiner will discuss the necessity with the Lead SME and provide the description of the additional material needed.

(7) Upon completion of the examination, the examiner must complete all relevant portions of the Form 11369, including detailed narrative in response to the following:

a. Summary of the facts of the case.
b. Description of the timing of the receipt of the Form 211 submission to chronicle whether or not the taxpayer was already under audit when the claim was received.
c. Short description of the issue reported by the whistleblower.
d. Detail how the examiner used whistleblower’s information.
e. Provide a detailed description of how the information assisted the examination.

Note: Do not state any value determinations regarding the usefulness of the information. For example, avoid merely stating that the information was “great,” “excellent,” “useful,” or “useless.”

f. Description of the audit steps performed, including if a Technical Advisor or Counsel was involved.

g. Description of the issue(s) audited from the Form 211 claim.
h. Description of whether or not there were other issues examined and adjusted, for example the addition of another issue or additional years or related taxpayers specifically attributable to the whistleblower.
i. Description of the final results, including whether adjustments were proposed, if the case was agreed or not, if a 30-day letter was issued, if Appeals was requested, if the taxpayer has elected not to respond, and final disposition - the case was stat-noticed, and so on.
j. Brief statement specifically addressing the field's assessment of whether or not the whistleblower's information contributed to the adjustment or part of the adjustment (and what portion/percentage).
k. Specific reasons if the referral is surveyed.

(8) The examiner must ensure the whistleblower file and all relevant documents are maintained separately from the administrative case file throughout the examination. The examiner shall not make any references indicating the existence of a whistleblower claim in any document that will be included in the administrative case file, including Activity Record and any workpapers. When the case is ready to close, the examiner must take steps to separate information pertaining to, or referencing the existence of, a whistleblower in the examination case file. There will be two case files:

1. The whistleblower case file, containing all relevant information in the examination including a copy of the examination report, relevant workpapers, and all documents submitted with the initial whistleblower referral.

   Note: The Whistleblower Office requests that examiners submit copies of all leadsheets and workpapers that support every adjustment on the Form 2504. The Whistleblower Office needs to support every item on the report, whether the examiner thinks it relates back to the WB claim or not, as the Whistleblower Office has to justify why an adjustment is or isn't related to the claim if the whistleblower or the POA questions it. Also, if a report is generated using adjustments reflected on a secured return, provide a copy of that return.

2. The examination case file, the normal closed-case administrative file.

   Note: Any document that remains with the examination case file, such as the classification sheet, Form 5345-D, Examination Request - ERCS Users, or Form 5346, Examination Information Report, must have any reference to the presence of a whistleblower or the identification of a whistleblower case redacted. This includes deleting the tracking code from any of these documents.

(9) **No whistleblower information, whistleblower files, or any references to a whistleblower will be included or associated with the examination files when sent for closing or to Appeals.** The whistleblower files for case closures are sent directly to the Whistleblower Office. See Instructions for Form 11369 for detail.

4.23.5.22
(11-09-2023)
Financial Crimes Enforcement Network Query (FCQ) System, Currency Transaction Reports (CTRs), and Suspicious Activity Reports (SARs)

(1) This guidance is specific to SB/SE Employment Tax employees authorized to access the FinCEN Query (FCQ) System. All FCQ users have access to at least ten years of historical financial transaction data as well as recently filed data captured in the FinCEN System of Record. The FCQ System does not block the user from accessing Suspicious Activity Reports (SARS).

(2) Authorized employees include selected Employment Tax specialists, policy analysts, managers, and classifiers.

(3) All examiners who request FinCEN data must complete the following Integrated Talent Management (ITM) courses prior to requesting SAR data:

- 36427, Safeguarding, Requesting and Using Suspicious Activity Reports (SAR) Security Briefing
- 41166, Safeguarding Online Access and Using Suspicious Activity Report (SAR) Info Briefing

(4) All managers that manage employees that request SAR Data must complete the following ITM courses:

- 36428, Manager SAR Audit Trail Reviews
- 41167, Manager Online Suspicious Activity Report (SAR) Audit Trail Reviews Briefing

(5) To obtain access to FCQ System, an examiner will submit a request to add access through BEARS for **SYS USER FINCEN QUERY SYSTEM –IRS EMPLOYMENT TAX FUNCTIONS (FINCEN QUERY –CURRENCY AND BANKING RETRIEVAL SYSTEM)**.

(6) The SAR information must be treated with the same security as information received from a confidential whistleblower and is subject to restrictions of both Title 31 and Title 26.

Note: The rules governing access to and disclosure of returns and return information under the IRC (Title 26) are different from the rules governing access and disclosure of information collected under the Bank Secrecy Act (BSA) (Title 31).

(7) No SAR information, including the existence of a SAR, can be disclosed in the course of any compliance activity to the filer of the SAR, the subject of the SAR, or to any party outside the IRS without prior consultation with the Bank Secrecy Act (BSA) Liaison to the Financial Crimes Enforcement Network (FinCEN). FinCEN may allow sharing of SAR information, but only in special circumstances.

(8) For those examiners without access to the FCQ System they must follow the procedures provided in IRM 4.26.4.5.4 (3), Gatekeeper or Super User Procedures, when requesting SAR information.

4.23.5.23
(11-09-2023)
Qualified Small Business Payroll Tax Credit for Increasing Research Activities

(1) IRC 41, Credit for Increasing Research Activities, (commonly known as Research Credit), was enacted in 1981 as a temporary measure to stimulate research and development in the United States by helping businesses offset some of the costs associated with increasing their qualified research activities through the use of income tax credits.

(2) The Research Credit allows taxpayers a credit against income tax for increasing research activities. Generally, the credit is an incremental credit equal to the sum of 20 percent of the excess (if any) of the taxpayer's qualified research expenses ("QREs") for the taxable year over the base amount. For tax years ending after December 31, 2006, taxpayers may elect to determine their credit under the alternative simplified credit (ASC) rules of IRC 41(c)(5). Under the ASC, the credit is equal to 14 percent of the QREs for the taxable year over 50 percent of the average QREs for the 3 years preceding the credit year.

(3) The Protecting Americans from Tax Hikes (PATH) Act of 2015 made IRC 41 permanent after December 31, 2014 and added IRC 41(h) and IRC 3111(f), which allow a Qualified Small Business (QSB) to elect to apply a portion of the IRC 41(a) research credit for the taxable year against the employer portion of FICA. The option to elect the new payroll tax credit is designed to benefit any eligible startup that has little or no income tax liability.

   a. The maximum credit that could be elected in a tax year to be applied to payroll taxes was $250,000.
   b. The credit could only be applied against the employer's share of social security tax

(4) Provision 13902 of the Inflation Reduction Act of 2022 (IRA):

   a. Increases the maximum amount of research tax credit that a QSB can elect to apply against payroll tax liability from $250,000 to $500,000, and
   b. Allows the credit to be claimed against the employer's share of both social security and Medicare taxes.

(5) The changes enacted in IRA Provision 13902 affect both new credit elections and prior year credits carried over for tax years beginning after December 31, 2022.

   a. For new elections, the changes apply for tax years beginning after December 31, 2022. This generally means that new elections made on income tax returns beginning with the 2023 tax year will be applied to payroll taxes starting in the first quarter of 2024.
   b. A short tax year filer may be able to make an election on an income tax return filed in 2023. The short year filer would then claim the credit on the first payroll tax return in the period after the short year income tax period. This may result in the credit being applied to a 2023 payroll tax return.
   c. For older elections that are carried over into 2023, the carryover amount can now be applied against the employer's share of social security tax (up to $250,000) and then to the employer's share of Medicare for employment tax returns.
   d. For both new elections and carryovers, a credit in excess of the employer's share of social security tax and Medicare tax shown on a payroll tax return may be carried over to the next period's payroll tax return.

(6) IRC 41(h) QSB payroll tax credit for increasing research activities ("payroll tax research credit") is elected on the taxpayer's income tax return. See IRM 4.23.5.23.2, Electing the Payroll Tax Research Credit. The credit is applied against the employer's share of tax on the first payroll tax return in the period after the income tax period in which it is elected. See IRM 4.23.5.23.3, Applying the Payroll Tax Research Credit.

(7) Notice 2017-23 provides interim guidance for determining eligibility for and making the payroll tax credit election under IRC 41(h) to claim the payroll tax credit under IRC 3111(f). In addition, the Notice provides interim guidance for claiming the payroll tax credit. In addition, Notice 2017-23 provides interim guidance for claiming the payroll tax credit.

(8) General information about the IRC 41 can be found at:

- IRM 4.1.1, Planning and Special Programs – Planning, Monitoring, and Coordination (SB/SE only)
- IRM 4.10.11, Examination of Returns – Claims for Refund, Requests for Abatement, and Audit Reconsiderations
- IRM 4.46.3, LB&I Examination Process – Planning the Examination
- IRM 4.51.8.3.10, Research Credit Claims

4.23.5.23.1
(11-09-2023)
Qualified Small Business

(1) A QSB is a corporation (including an S corporation), partnership, or any other taxpayer (excluding not-for-profit organizations), with gross receipts of less than $5 million for the current tax year, and no gross receipts for any tax year before the 5 taxable year period ending with the current tax year.

(2) Gross receipts are determined under IRC 448(c)(3) without regard to IRC 448(c)(3)(A). Gross receipts must be annualized for short tax years, reduced by returns and allowances, and adjusted for predecessor entities.

(3) A single taxpayer under IRC 41(f)(1) includes a controlled group or corporation, or businesses or trades under common control. Entities or persons treated as a single taxpayer under IRC 41(f)(1) are treated as a single taxpayer under IRC 41(h).

a. Each of the persons treated as a single taxpayer may separately make the QSB election under IRC 41(h)(1) for any taxable year, and
b. The election amount shall be allocated among all persons or members treated as a single taxpayer, as provided in IRC 41(f)(1), meaning on a proportionate basis based on its share of the aggregate of the qualified research expenses, basic research payments, and amounts paid or incurred to energy research consortiums, taken into account by such controlled group or all such persons under common control.

(4) For purposes of the gross receipts test, a single taxpayer must determine gross receipts as follows:

a. Gross receipts must be aggregated for all entities or persons treated as a single taxpayer.
b. Gross receipts includes but are not limited to investment income such as annuities, dividends, interest, rents, and royalties, but does not include items such as loan repayments or sales tax. See Treas. Reg. 1.448-1T(f)(2)(iii) and (iv).
c. The gross receipts exception under IRC 41(c)(7) and Treas. Reg. 1.41-3(c) does not apply to qualification as a QSB.

4.23.5.23.2
(11-09-2023)
Electing the Payroll Tax Research Credit

(1) Form 3800, General Business Credit, is used by taxpayers to claim any of the general business credits. Form 6765, Credit for Increasing Research Activities, may be used by individuals, estates, trusts, organizations, or corporations to figure and claim the payroll tax credit for increasing research activities. Forms 3800 and 6765 must be attached to the taxpayer's income tax on which the credit is elected.

(2) A QSB must complete Form 3800 before completing Section D of Form 6765 if the payroll tax credit is being claimed.

(3) A partnership or S corporation must file Form 6765 to claim the payroll tax credit. Any other taxpayer must file Form 6765 unless their only source for this credit is a partnership, S corporation, estate, or trust, in which case the taxpayer can report the payroll tax credit directly on Form 3800.

(4) The payroll tax research credit that may be elected is the smallest of:

a. The current year research credit,
b. An elected amount not to exceed $250,000 (for tax years beginning on or prior to December 31, 2022,) or $500,000 (for tax years beginning after December 31, 2022), or
c. The general business credit carryforward for the tax year, before the application of the payroll tax credit election for the tax year.

(5) The election amount for entities or persons treated as a single taxpayer is limited to the smallest of their allocable share of the items of paragraph (4)(a) to (c) of this subsection.

(6) For partnerships or S corporations, the payroll tax research credit election is made at the entity level, and the general business credit carryforward limitation does not apply.

(7) The payroll tax research credit election:

a. Is an annual election that must be made on or before the due date of the originally filed income tax return (including extensions).
b. Can be made for a tax year if the election was not made for five or more preceding tax years.
c. May be revoked only with the consent of the IRS.

Note: If the Research Credit claim on the income tax return appears unusual or potentially suspicious, discuss the claim with an IRC 41 subject matter expert (SME). You may contact the SME at "sbse.abusive.transactions.re.credit@irs.gov."

4.23.5.23.2.1
(11-09-2023)
Election through a Valid Claim

(1) The election may be made on a valid claim for refund that includes the section IRC 41 research credit.

(2) Treas. Reg. 301.6402-2(b)(1) require that for a refund claim to be valid, it must set forth sufficient facts to apprise the IRS of the basis of the claim. Field Advice 20214101F (*https://www.irs.gov/pub/irs-lafa/20214101f.pdf*) was issued to clarify requirements for eligible taxpayers to claim the credit. The legal opinion provides that for a IRC 41 research credit claim for refund to be considered valid, taxpayers must provide the following information at the time the refund claim is filed with the IRS:

a. Identify all the business components to which the IRC 41 research credit claim relates for that year.
b. For each business component, identify all research activities performed and name the individuals who performed each research activity, as well as the information each individual sought to discover.
c. Provide the total qualified employee wage expenses, total qualified supply expenses, and total qualified contract research expenses for the claim year. This may be done using Form 6765.

(3) This information must be submitted when the refund claim is filed and be provided with a declaration signed under the penalties of perjury verifying that the facts provided are accurate. Otherwise, the refund claim will be rejected as deficient without audit. A taxpayer who fails to provide the required information with a timely filed IRC 41 research credit claim for refund will have 45 days to perfect the claim prior to the IRS' final determination on the claim.

Note: For field guidance on claims for refund that include a claim for credit for increasing research activities, refer to IRM 4.46.3.7, LB&I Claims Process.

4.23.5.23.3
(11-09-2023)
Applying the Payroll Tax Research Credit

(1) The payroll tax research credit claimed by an employer on an income tax return and then applied on an employment tax return cannot exceed the employer's share of applicable FICA tax for any calendar quarter on wages paid with respect to the employment of all individuals in the employ of the employer. These limits are:

a. For tax years beginning in 2022 and prior, the maximum credit that can be elected on Form 6765 is $250,000. For tax years beginning after December 31, 2022, the maximum credit that can be elected on Form 6765 is $500,000.
b. For payroll tax returns filed for 2022 and prior, the credit can only be applied against the employer's share of social security tax.
c. For payroll tax returns filed for or after the first quarter of 2023, the credit can be applied first to the employer's share of social security tax up to a limit of $250,000, and then to the employer's share of Medicare tax.

(2) A QSB uses Form 8974, Qualified Small Business Payroll Tax Credit for Increasing Research Activities, to apply these limits to the amount of the payroll tax credit it elected on Form 6765, and to allocate the research credit from Form 6765 to the specific employer that will claim the credit on their employment tax return to the extent of the available employer's share of employment taxes.

(3) The amount of payroll tax research credit claimed on Form 6765 in excess of the employer's share of applicable FICA tax for the calendar quarter, as determined on Form 8974, is carried over to the succeeding calendar quarter(s) and allowed as a payroll tax credit for the succeeding quarter(s), subject to the social security tax limitation applicable to the quarter(s).

(4) A QSB that files quarterly payroll tax returns may apply the credit on its payroll tax return for the first quarter beginning after it files the federal return appropriately reflecting the election. A QSB that files annual payroll tax returns may apply the credit on its payroll tax return that includes the first quarter beginning after the date on which the business files the federal return appropriately reflecting the election.

4.23.5.23.4
(11-09-2023)
Schedule B (Form 941): Report of Tax Liability

(1) With respect to the timing of the payroll tax credit for purposes of calculating deposit liabilities, the employer will apply the credit against deposit liabilities as the employer incurs liability for the employer's share of applicable FICA tax on wages paid in the quarter to which it applies, beginning with the first payment of wages in the quarter. Therefore, the payroll tax research credit is not a refund of tax paid, but rather is a genuine credit.

   a. For tax years beginning after December 31, 2022, the credit would be applied against the employer's share of social security tax (up to $250,000) and then to the employer's share of Medicare for employment tax returns, up to the total employer's share of Medicare shown on the return.
   b. For tax years beginning on or before December 31, 2022, the credit would be applied against the employer's share of social security tax.
   c. An employer cannot take the payroll tax credit against employee social security tax or income tax withholding.
   d. There should be no negative entries on the Schedule B (Form 941).

(2) The payroll tax credit is applied to succeeding liabilities on the Schedule B within the quarter until it is used. Any excess credit not used in the quarter can be carried forward as a payroll tax credit to the following quarter, .

(3) Refer to legal advice issued by IRS Associate Chief Counsel number AM 2017-003, Timing Issues Related to Payroll Tax Credit for Increasing Research Activities (PRENO-120484-17), July 31, 2017 (*https://www.irs.gov/pub/lanoa/am-2017-003.pdf*.

4.23.5.23.5
(11-09-2023)
Aggregate Form 941 or Form 943

(1) A third-party payer may apply the credit to an aggregate return filed on behalf of clients that qualify for and claim the IRC 41(h) QSB payroll tax credit for increasing research activities.

(2) An approved IRC 3504 agent or a certified professional employer organization (CPEO) must complete Schedule R (Form 941), Allocation Schedule for Aggregate Form 941 Filers, or Schedule R (Form 943), Allocation Schedule for Aggregate Form 943 Filers, when filing an aggregate Form 941 or Form 943, respectively. Other third-party payers such as non-certified PEOs must complete and file Schedule R (Form 941) only in certain circumstances, including when they have clients that are claiming the research payroll tax credit.

(3) For a third-party payer to claim the credit, the client must be a QSB (or an entity included in a QSB). The QSB must elect to apply the research credit against payroll tax liability by attaching Form 6765 to its timely filed income tax return. The amount of the payroll tax credit is determined on Form 6765 and then reported on each entities' Form 8974.

(4) The third party payer must attach to its aggregate payroll tax return a Form 8974 for each client that is taking the payroll tax credit. See the IRS webpage, Qualified Small Business Payroll Tax Credit for Increasing Research Activities.

(5) If a QSB includes more than one entity and a third-party payer paid wages on behalf of only some of the entities claiming the research payroll tax credit on Form 6765, both the QSB entity and the third-party payer would attach Form 8974 to their payroll tax return, and each entity would claim only its respective share of the credit.

4.23.5.23.6
(11-09-2023)
Examination Procedures

(1) An examination of the payroll tax research credit consists of an income tax examination to determine whether the credit is properly computed and claimed on a QSB's income tax return, and a simultaneous employment tax examination or compliance check to determine whether the credit is properly allocated and applied to the employment tax return of the QSB or an entity included in a QSB.

(2) Income Tax Exam is responsible for determining whether the research credit is properly claimed and computed on Forms 3800 and 6765 of the QSB's income tax return. Workload for Income Tax Exam is classified and selected by SB/SE Planning and Special Programs (PSP). For the payroll tax research credit, workload sources include returns identified and selected by PSP, and employment tax returns referred by Employment Tax Exam which are then filtered and accepted or rejected by PSP.

(3) The employment tax determination of whether the credit is properly allocated and applied on the related payroll tax return may be made by Income Tax Exam or Employment Tax Exam. The Exam group that makes the employment tax determination **must**:

a. Establish examination controls for the employment tax return (Form 941/ MFT 01 or Form 943/MFT 11) for the period(s) in which the credit is applied to the employment tax return. For information on establishing examination controls on the Audit Information Management System (AIMS) and Examination Returns Control System (ERCS) refer to IRM 4.23.3.6.3.3, Controlling Employment Tax Returns,
b. Protect the employment tax return's assessment statute. For more information refer to IRM 4.23.5.23.8, Statute of Limitations, and
c. Perform mandatory employment tax case procedures and prepare mandatory employment tax workpapers to support the employment tax determination. For more information refer to IRM 4.23.5.23.6.1.

4.23.5.23.6.1
(11-09-2023)
Mandatory Employment Tax Procedures and Workpapers

(1) Workpapers must clearly and concisely state the issue, facts, audit steps, law, taxpayer's position, and conclusion for each issue examined. In addition, workpapers must document actions and/or audit steps taken. For further information refer to IRM 4.23.4.2, Workpapers.

(2) Employment Tax Lead Sheets (ETLS) will be prepared for all SB/SE employment tax cases, unless similar RGS lead sheet are prepared as part of the primary return examination and included in the employment tax case file. For further information refer to IRM 4.23.4.3, Guide for Examiners Using ETLS - Employment Tax Lead Sheets.

(3) Large Case Employment Tax Specialists are encouraged to use ETLS but may use the equivalent mandatory workpapers discussed in IRM 4.23.4.5, Procedures for Employment Tax Examiners Working on Large Case Audits: General.

(4) Income Tax Exam is not required to follow the Employment Tax Exam manager's recommendations on the Risk Analysis Workpaper. However, if Income Tax Exam declines to expand the scope of the examination as recommended by the Employment Tax Exam manager, the workpapers must state the reason why (for example, due to short statute).

4.23.5.23.6.2
(11-09-2023)
Examination Initiated in Income Tax Exam

(1) For cases identified and selected by SB/SE PSP (meaning, not referred by Employment Tax Exam to SB/SE PSP), the Income Tax Revenue Agent may submit an SRS consultation request for assistance with preparing or reviewing the Employment Tax Examination Case.

(2) Income Tax Exam is not required to follow the Employment Tax Exam manager's recommendations on the Risk Analysis Workpaper. However, if Income Tax Exam declines to expand the scope of the examination as recommended by the Employment Tax Exam manager, the workpapers must state the reason why (for example, due to short statute).

4.23.5.23.6.3
(11-09-2023)
Examination Initiated in Employment Tax Exam

(1) Income Tax Exam will examine the IRC 41 research tax credit. In general, where a payroll tax research credit is claimed by a taxpayer, Income Tax Exam will open and control the employment tax return. However, Income Tax Exam may submit an SRS request for assignment of an Employment Tax Examiner, as discussed in IRM 4.23.5.23.6.2.

4.23.5.23.6.4
(11-09-2023)
Employment Tax Examination Source and Project Codes

(1) For examinations of payroll research tax credits on an original employment tax return (for example, Form 941) use:

- Project Code 1528 - Payroll Research Tax Credits
- Tracking Code 7504 - Payroll Research Tax Credits

(2) For examinations of payroll research tax credits on a corrected employment tax return (for example Form 941-X) use:

- Project Code 1528 - Payroll Research Tax Credits
- Tracking Code 7891 - Claims-Employment Tax

4.23.5.23.6.5
(11-09-2023)
Preliminary Compliance Checks

(1) **All** examiners will perform the following preliminary compliance checks on all employment tax returns containing the payroll tax research credit.

a. Determine whether the payroll tax election appears correctly made on the income tax return.
b. Determine whether the payroll tax credit is correctly claimed on the employment tax return.

4.23.5.23.6.5.1
(11-09-2023)
Third-Party Payers

(1) If the taxpayer is an unrelated third-party payer (for example, PEO or CPEO), request that the third-party payer substantiate that the preliminary compliance checks are met for each of the third-party payer's clients for which the payroll research tax credit is applied on the employment tax return.

(2) Test the third-party payer's substantiation by comparing it to related schedules and forms, including:

a. A copy of the Schedule R (Form 941) showing the amount of the credit applied for each client.

Note: Schedule R (Form 941) is available via the Employee User Portal (EUP) if the Form 941 was electronically filed. If unavailable on EUP, it is available through Service Wide Employment Tax Research System (SWETRS). Contact the assigned SB/SE Employment Tax Policy Analyst. It may also be requested from the third-party payer.

b. Forms 3800, 6765, and 8974 for each client.
c. Income tax returns evidencing the taxpayer meets the gross receipts test for a QSB and did not make a payroll tax election for more than five preceding tax years including the current tax year.

4.23.5.23.6.6
(11-09-2023)
Subsequent Procedures for Cases Initiated in Employment Tax Exam

(1) If the examination is initiated in Employment Tax Exam, and

If	And	Then
Preliminary audit tests **are met**,	The case meets the criteria for referral to SB/SE PSP,	The Employment Tax Examiner will prepare Form 5346 and submit it to SB/SE PSP. The preliminary compliance checks will be performed prior to preparing the referral.
Preliminary audit tests **are met**,	The case does not meet the criteria for referral to SB/SE PSP or the case meets the criteria for referral to SB/SE PSP but the referral was rejected,	The Employment Tax Examiner will allow the payroll research tax credit on the employment tax return. If no books and records were requested from the taxpayer, the return may be closed as a survey after assignment
Preliminary audit tests **are not met**	The case meets the criteria for referral to SB/SE PSP,	The credit may be disallowed without making a referral. However, the taxpayer will be allowed 45 days to correct computational or other errors on Form 8974 in order to meet the preliminary compliance checks.
Preliminary audit tests **are not met**	The case does not meet the criteria for referral to SB/SE PSP or the case meets the criteria for referral to SB/SE PSP but the referral was rejected,	The Employment Tax Examiner will disallow the payroll research tax credit using normal employment tax procedures specific to the type of return.

Note: For an aggregate return filed by a third party payer, the payroll research tax credit may be partially disallowed.

4.23.5.23.7
(11-09-2023)
Referral to SB/SE PSP

(1) This subsection provides general guidelines and factors to consider when preparing a referral to SB/SE PSP.

4.23.5.23.7.1
(11-09-2023)
SB/SE PSP Referral Criteria

(1) Employment Tax Examiners will consider a referral to SB/SE PSP for any case meeting the following criteria:

a. IRC 41 payroll research tax credit issue classified by Employment Tax Workload Case Selection, identified by the Employment Tax Examiner, or arising during an employment tax examination (for example, when a taxpayer under examination provides a Form 941-X to claim to payroll research tax credit),

#
#
#

c. For payroll tax research credits claimed by taxpayers filing returns under their own EIN or under the EIN of a related party (such as a common paymaster).

(2) If the employer is a third-party payer (for example, a PEO or CPEO), contact SB/SE Employment Tax Policy for referral procedures.

4.23.5.23.7.2
(11-09-2023)
SB/SE PSP Referral Procedures

(1) Form 5346 must be submitted with required enclosures via email to *SBSE R&E Credit ETax Referral.

(2) Spreadsheet ET Research Referral Information must be attached to Form 5346. The spreadsheet must contain:

a. Taxpayer Identification Number (TIN). Generally, this will be an entity's Employer Identification Number (EIN).
b. Year the entity was established.
c. Income tax return type (for example, Form 1120 or 1065)
d. Whether contact has been made with the taxpayer.
e. The industry of the taxpayer claiming/generating the credit.
f. The year the income tax return was filed that included Form 6765 and date filed.
g. Next available employment tax period after date Form 6765 was filed.
h. The payroll tax credit quarter on which the credit is applied.
i. The dollar amount of the credit in aggregate (meaning all periods and years combined).
j. Gross receipts for the Form 6765 year.
k. Gross receipts for taxable years before the 5 previous taxable year periods starting with Form 6765 year. These four periods must be zero.
l. Brief description of any other issues, including year/period and amount of adjustment.

Note: The spreadsheet "ET Research Referral Information" can be found in "Working Payroll Tax Research Credit Tools" under the other related resources area on the Employment Tax Small Business Knowledge Base site titled *Working the Payroll Tax Research Credit* (https://irsgov.sharepoint.com/sites/ETD-KMT-KB014/SitePages/Exam%20Case%20Issues/Other%20Issues/WorkingPayrollTaxResearchCredit.aspx).

Note: The referral and transfer procedures can be found in the "Working the IRC 41(h) Payroll Tax Research Credit" document under "Working Payroll Tax Research Credit Tools" in the other related resources area on the Employment Tax Small Business Knowledge Base site titled *Working the Payroll Tax Research Credit* (https://irsgov.sharepoint.com/sites/ETD-KMT-KB014/

SitePages/Exam%20Case%20Issues/Other%20Issues/WorkingPayrollTaxResearchCredit.aspx).

(3) Each referral must contain:

a. Copies of all relevant tax return pages (for example, Forms 3800, 8974, 6765), and
b. Employment Tax risk analysis and pre-planning analysis.

(4) The Employment Tax Exam group manager will monitor the case for acceptance by SB/SE PSP.

a. If accepted, the case controls will be transferred to SB/SE PSP or an income tax examination group designated by SB/SE PSP.
b. If rejected, the case will be closed as described in IRM 4.23.5.23.6.6(1),Subsequent Procedures for Cases Initiated in Employment Tax Exam.

4.23.5.23.7.3
(11-09-2023)
SB/SE PSP Case Transfer Procedures

(1) Upon receipt of the referral request, the R&E Credit Coordinator will determine if the case is to be transferred. If accepted for transfer, the research R&E Credit Coordinator will email an acceptance to the employment tax examiner.

Note: Do not transfer any case to Income Tax unless the R&E Credit Coordinator has notified Employment Tax Exam that the case has been accepted and is to be transferred.

(2) Any developed issues other than the payroll tax research credit must be processed using a partial agreement prior to transfer.

(3) All case materials will be transmitted electronically, if possible. If there are original returns or paper documents that need to be kept in the case file, the case file will need to be mailed to an address specified by the R&E Credit Coordinator.

(4) Update the project code to 1010 in ERCS prior to transferring the case. See referral and transfer procedures at [URL for ET Knowledge Management site].

Note: The referral and transfer procedures can be found in the "Working the IRC 41(h) Payroll Tax Research Credit" document under "Working Payroll Tax Research Credit Tools" in the other related resources area on the Employment Tax Small Business Knowledge Base site titled *Working the Payroll Tax Research Credit* (https://irsgov.sharepoint.com/sites/ETD-KMT-KB014/SitePages/Exam%20Case%20Issues/Other%20Issues/WorkingPayrollTaxResearchCredit.aspx).

(5) Sources of Payroll Research Credit:

- Form 941 filed by entity
- Form 941-X by entity
- Form 941 filed by PEO
- Form 941-X by PEO
- Form 941 filed by CPEO
- Form 941-X by CPEO

(6) Sources of information:

a. Form 941 assigned to group for a different issue and research credit issue identified by examiner.
b. Form 941 assigned to group for Research Credit issue by Workload Selection & Delivery (WSD).
c. Form 941-X assigned to group for Research Credit issue by WSD to associate with case open in group.
d. Taxpayer provided information on Research Credit during ongoing ET Examination as new issue,
e. Income Tax request for assistance, including employment tax report writing.

4.23.5.23.8
(11-09-2023)
Statute of Limitations

(1) IRC 41(h) payroll tax election presents unique circumstances because it involves both an election made with an income tax return and a credit taken on an employment tax return. The recapture of the payroll tax credit involves an assessment against employment tax and therefore requires that the period of limitations on assessment of employment tax be open.

(2) The period of limitations relevant to the recapture of an invalid payroll tax research credit begins to run from the filing of the employment tax return (for example, Form 941, Form 943, or Form 944) on which the credit is taken, and not from the filing of the income tax return on which the payroll tax credit election is made.

(3) The amount of the payroll tax election taken on Form 6765, filed with the income tax return before the employment tax return is filed, is not necessarily the same as the amount of the payroll tax credit allocated to the employer on Form 8974 filed with the employment tax return. The elected amount is often divided among multiple employers or an aggregate return and/or carried forward to future employment tax return periods. It is not possible for the IRS to discern how much of the payroll tax credit may have been improper until the employment tax return is filed.

(4) Under IRC 6501(c)(4), a taxpayer can execute a consent to extend the period of limitations on assessment that is limited in scope to the payroll research tax credit. However, *Form SS-10*, Consent to Extend the Time to Assess Employment Taxes, is not readily modifiable, and the examiner will contact their local counsel for assistance in the preparation of the consent.

(5) Consent to extend the period of limitations on assessment will be sought in any case where a proposed adjustment may result in an increase of previously assessed tax. If the taxpayer claims the payroll research on an amended return (a claim), the consent will be sought if there are other employment tax issues under examination that may result in an increase in tax.

4.23.5.24
(11-09-2023)
COVID-19 Credits and Deferrals for Employment Taxes - Legislation Overview

(1) In March 2020, Congress enacted the following legislation allowing for Eligible Employers to claim certain tax credits (Paid Sick and Family Leave Credits and Employee Retention Credit) against applicable employment taxes to provide economic relief due to the COVID-19 pandemic:

- Families First Coronavirus Response Act (FFCRA), P.L. 116-127, 134 Stat. 178
- Coronavirus Aid, Relief, and Economic Security (CARES) Act, P.L. 116-136, 134 Stat. 281

(2) In December 2020, Congress enacted the following legislation extending the credits for qualified sick and family leave wages enacted under FFCRA to periods of leave through March 31, 2021, and the Employee Retention Credit enacted under the CARES Act through June 30, 2021:

- COVID-related Tax Relief Act of 2020 (Tax Relief Act), enacted as Subtitle B of Title II of Division N of the Consolidated Appropriations Act, 2021, P.L. 116-260, 134 Stat. 1182
- Taxpayer Certainty and Disaster Tax Relief Act of 2020 (Relief Act), enacted as Division EE of the Consolidated Appropriations Act, 2021, P.L. 116-260, 134 Stat. 1182

(3) In March 2021, Congress enacted the American Rescue Plan Act of 2021 (ARP), P.L. 117-2, 135 Stat. 4, adding new IRC sections for credits for qualified sick and family leave wages for periods of leave beginning April 1, 2021, through September 30, 2021, and an Employee Retention Credit beginning July 1, 2021, through December 31, 2021. The legislation also added a credit for COBRA premium assistance beginning April 1, 2021, through September 30, 2021.

(4) In November 2021, Congress enacted the Infrastructure Investment and Jobs Act (IIJA) (2021), P.L. 117-58, 135 Stat. 429, to amend the law so that the Employee Retention Credit applies only to wages paid before October 1, 2021, unless the employer is a recovery startup business.

(5) Allowable credits under the FFCRA and CARES Act, as amended or modified by the Tax Relief Act or the Relief Act, are claimed against FICA tax imposed by IRC 3111(a) (social security tax) and so much of the taxes imposed on employers under IRC 3221(a) (Railroad Retirement Tax Act (RRTA) tax) as are attributable to the rate in effect under IRC 3111(a). Allowable credits under the ARP Act are claimed against the FICA tax imposed by IRC 3111(b) (Medicare tax) and so much of the taxes imposed by IRC 3221(a) that is attributable to the rate in effect under IRC 3111(b).

(6) The CARES Act also contains provisions that allow employers to defer the deposit and payment of the employer's share of social security tax during the "payroll tax deferral period" on wages paid during the period March 27, 2020, through December 31, 2020.

(7) In addition, on August 8, 2020, the President issued a Presidential Memorandum directing Treasury to use IRC 7508A authority to defer the withholding, deposit, and payment of the employee share of social security tax on compensation paid to an employee beginning on September 1, 2020, and ending on December 31, 2020, but only if the amount of the wages paid for a bi-weekly period were less than $4,000 (or the equivalent amount with respect to other pay periods) per employee.

(8) For additional guidance on the Paid Sick and Family Leave Credits, the Employee Retention Credit, or the Deferral of Social Security Tax, refer to *Training Publication 79909-002, COVID Credits and Deferrals Training for Employment Tax (Student Guide)*.

4.23.5.24.1
(11-09-2023)
Tax Credits for Paid Sick and Family Leave Wages

(1) For the period beginning April 1, 2020, through December 31, 2020, the FFCRA requires employers to provide paid leave through two separate provisions:

- The Emergency Paid Sick Leave Act (EPSLA), which entitles workers up to two weeks (but no more than 80 hours) of paid sick time when they are unable to work for certain reasons related to COVID-19, and
- The Emergency Family and Medical Leave Expansion Act (Expanded FMLA), which entitles workers to certain paid family and medical leave.

(2) The FFCRA provides that Eligible Employers subject to the EPSLA and the Expanded FMLA paid leave requirements are entitled to fully refundable tax credits to cover the cost of the leave required to be paid for these periods of time during which employees are unable to work (which for purposes of these rules, includes telework). For more information refer to sections 7001 and 7003 of the FFCRA.

(3) The Tax Relief Act extended the leave period for which qualified sick and family leave wages can be paid under the FFCRA, with certain modifications, through March 31, 2021. Though the mandate to provide sick and family leave under the EPSLA and Expanded FMLA expired on December 31, 2020, employers may still receive the credits for leave provided for periods beginning January 1, 2021, through March 31, 2021, for paid sick or family leave that would have satisfied the requirements of the EPSLA or Expanded FMLA.

(4) The ARP Act created a new leave period for which qualified sick and family leave wages can be paid beginning April 1, 2021, through September 30, 2021. The credits under the ARP Act were codified as IRC 3131, 3132, and 3133.

(5) For additional guidance on the Paid Sick and Family Leave Credits, refer to IRM 21.7.2.7.1, Credit for Qualified Sick and Family Leave Wages, and *Training Publication 79909-002, COVID Credits and Deferrals Training for Employment Tax (Student Guide)*.

4.23.5.24.2
(11-09-2023)
Tax Credit for Employee Retention

(1) Under section 2301 of the CARES Act, certain employers who pay qualified wages to their employees are eligible for an Employee Retention Credit.

(2) This Employee Retention Credit initially applied to qualified wages paid after March 12, 2020, and before January 1, 2021.

(3) Subsequent legislation extended to include qualified wages paid January 1, 2021, through December 31, 2021.

(4) For 2020, the Employee Retention Credit is a fully refundable tax credit for employers equal to 50 percent of qualified wages (including allocable qualified health plan expenses) that Eligible Employers pay their employees. The maximum amount of qualified wages taken into account with respect to each employee for all calendar quarters through December 31, 2020, is $10,000. Therefore, the maximum credit for an Eligible Employer for qualified wages paid to any employee is $5,000.

(5) For 2021, the legislation increased the credit to 70 percent of qualified wages (including allocable qualified health plan expenses) for $10,000 per employee per calendar quarter in 2021, so the maximum credit for an Eligible Employer for qualified wages paid to any employee is $7,000 per calendar quarter in 2021, for a total of $28,000 for 2021.

(6) For additional guidance on the Employee Retention Credit, refer to IRM 21.7.2.7.2, Employee Retention Credit (ERC), and *Training Publication 79909-002, COVID Credits and Deferrals Training for Employment Tax (Student Guide)*.

4.23.5.24.3
(11-09-2023)
COBRA Premium Assistance Credit

(1) Employer-sponsored health plans generally are required to offer an employee, spouse, or dependent child covered by the plan the opportunity to continue coverage under the plan for a specified period of time after the occurrence of certain events that otherwise would have terminated the coverage (qualifying events). These continuation of coverage requirements, and corresponding coverage (if elected), are often referred to as "COBRA continuation coverage" or "COBRA requirements."

(2) Section 9501 of the ARP Act provides for a temporary 100 percent reduction in the premium otherwise payable by certain individuals and their families who elect COBRA continuation coverage due to a loss of coverage as the result of a reduction in hours or an involuntary termination of employment.

(3) Under section 9501(a)(3) of the ARP, an "Assistance Eligible Individual" is an individual (1) who is a qualified beneficiary with respect to a period of COBRA continuation coverage during the period from April 1, 2021, through September 30, 2021, and eligible for that COBRA continuation coverage by reason of a qualifying event specified in section 603(2) of ERISA, IRC 4980B(f)(3)(B), or section 2203(2) of PHS Act, except for voluntary termination of employment, and (2) who elects COBRA continuation coverage.

(4) The ARP Act added IRC 6432, which provides that the "person to whom premiums are payable for continuation coverage" is allowed a "premium assistance credit" for an amount equal to the premiums not paid by Assistance Eligible Individuals for COBRA continuation coverage.

4.23.5.24.4
(11-09-2023)
Scope of Audit for Examination of COVID-19 Credits

(1) Generally, returns assigned for audits of the credits must be examined, whether they were received from Employment Tax – Workload Selection and Delivery (ET-WSD) through the normal classification process or from a referral from general program income tax exam. Approval from the examiner's manager is required to survey these cases.

(2) Employment tax returns specifically classified for examination of the credits will not be designated as limited scope audits. Examiners will follow normal audit procedures and address any other issues worthy of examination.

(3) For employment tax returns classified for other issues through the normal classification procedures, examiners will determine whether any credits claimed by the employer will be examined based on the audit potential.

Note: If the employer received both the Paid Sick and Family Leave Credits and the Employee Retention Credit, the examiner will examine both credits as part of the audit to ensure that the taxpayer did not include the same wages in the computation of the credits.

(4) When an entity is identified as an Indian Tribal Government or tribal government entity, refer to the service level agreement between SB/SE Exam and TE/GE, *Post-filing Compliance Process for COVID-19 Employer Credits* (https://irsgov.sharepoint.com/sites/ETD-KMT-KB062/RelatedResources/SBSE%20EXAM%20and%20TEGE%20AGREEMENT%20-

%20COVID%20Employee%20Credits%20-%2005012022%20(2).pdf), to find procedures that must be followed prior to contact with the taxpayer.

4.23.5.24.5
(11-09-2023)
Project and Tracking Codes

(1) Project Code 0545 has been assigned to returns selected for audits of the credits.

(2) The following tracking codes will be assigned to the returns based on the specific reason for which the return was selected for audit:

- Tracking Code 2545 – Sick and Family Leave Pay
- Tracking Code 2546 – Retention Credits
- Tracking Code 3067 – SBA Loans

(3) If the audit is expanded to other periods, examiners will use the project and tracking code from the originally assigned return (key case).

(4) If the audit was not classified specifically for the credits but the examiner selects the credits as an audit issue, the examiner must use the original project and tracking codes from the originally assigned return (key case).

4.23.5.24.6
(11-09-2023)
Effect of Credits on Income Tax Returns

(1) Both the Paid Sick and Family Leave Credits and the Employee Retention Credit have an effect on the taxpayer's income tax return.

(2) For the Paid Sick and Family Leave Credits:

a. For periods of leave beginning on April 1, 2020, through March 31, 2021, an Eligible Employer must include the full amount of the credits for qualified leave wages (and any allocable qualified health plan expenses and the Eligible Employer's share of the Medicare tax on the qualified leave wages) in gross income.
b. For periods of leave beginning April 1, 2021, through September 30, 2021, an Eligible Employer must include the full amount of the credits received for qualified leave wages (plus allocable qualified health plan expenses, certain collectively bargained contributions, and the employer's share of social security and Medicare taxes imposed on the qualified leave wages) in gross income.

(3) For the Employee Retention Credit:

a. Section 2301(e) of the CARES Act provides that rules similar to IRC 280C(a)shall apply for purposes of applying the Employee Retention Credit.
b. IRC 280C(a) generally disallows a deduction for the portion of wages paid equal to the sum of certain credits determined for the taxable year.
c. Accordingly, a similar deduction disallowance would apply under the Employee Retention Credit, such that an employer's aggregate deductions would be reduced by the amount of the credit as result of this disallowance rule.

(4) Examiners must verify that an employer who received either the Paid Sick and Family Leave Credits or Employee Retention Credit (or both credits) made the appropriate adjustment on its income tax return.

(5) If the employer made the appropriate adjustment on its income tax return and the credit amount is being adjusted, the employer may be entitled to an income tax refund based on the reduced amount of the credit.

(6) If there is a corresponding income tax audit being conducted, the examiner will notify the income tax examiner of any adjustment to the credit so the income tax examiner can make the appropriate adjustment to income as part of the audit report.

(7) If there is no corresponding income tax audit being conducted, the examiner will notify the employer to do one of the following:

a. File an amended income tax return to correct the amount of the credit adjustment on its income tax return if the examination of the credit is completed and agreed before the period of limitations for filing an amended income tax return has expired, or
b. File a protective claim for the potential income tax refund once the audit of the credit is completed and resolved if the employment tax audit of the credit will not be completed (by the examiner or Appeals in an unagreed case) before the period of limitations for filing an amended income tax return will expire.

(8) If the employer did not make the appropriate adjustment on its income tax return, examiners will need to discuss the case with their group manager about referring the case to General Program Exam to have an income tax examiner open an income tax audit to make the appropriate adjustment.

(9) If the employer has not yet filed an income tax return, the examiner will provide the taxpayer with the proper amount of the credit allowed, if any, and notify the taxpayer to make the appropriate adjustment when the taxpayer files its income tax return.

4.23.5.24.7 (11-09-2023) **Statute of Limitations for COVID-19 Credits**

(1) The statute of limitations for assessment of any amounts of potential tax attributable to the disallowance of a Paid Sick and Family Leave Credits under IRC 3131 and IRC 3132 claimed for qualified leave wages and the Employee Retention Credit under IRC 3134 will not expire until five years from the later of:

a. The date of filing of the original return that includes the calendar quarter in which the credit was claimed, or
b. The date the return is treated as filed under IRC 6501(b)(2).

(2) The extension of limitation on assessment applies to the Employee Retention Credit claimed for the third and fourth calendar quarters of 2021 under IRC 3134 but does not apply to the Employee Retention Credit under section 2301 of the CARES Act.

(3) The extension of limitation on assessment does not apply to other employment tax adjustments such as adjustments to fringe benefits or worker classification. The normal 3-year period of limitations applies to other issues.

4.23.5.24.8 (11-09-2023) **Deferral of Social Security Tax**

(1) The CARES Act also contains a provision allowing employers to defer the deposit and payment of the employer's share of social security taxes from March 27, 2020, through December 31, 2020.

(2) On August 8, 2020, the President issued a Presidential Memorandum directing Treasury to use IRC 7508A authority to defer the withholding, deposit, and payment of certain payroll tax obligations. Notice 2020-65, 2020-38 I.R.B. 567, implements the Presidential Memorandum and provides guidance that allows

employers to defer deposit of the employee share of FICA tax on compensation paid to an employee beginning on September 1, 2020, and ending on December 31, 2020, but only if the amount of the wages paid for a bi-weekly period were less than $4,000.

(3) For additional guidance on the Deferral of Social Security Tax, see IRM 21.7.2.8, Deferred Payment of Social Security Taxes for 2020.

4.23.5.24.8.1
(11-09-2023)
Exam Procedures for Deferral of Social Security Tax

(1) For taxpayers that indicate their intent to defer, a campus examination team will calculate the maximum allowable employer social security tax deferral and input the appropriate adjustments for each 2020 tax period.

Note: This will only be done for examinations where the taxpayer indicates that they intend to defer the employer's portion of social security taxes (discussed below).

(2) For tax year 2020 employment tax closures, prepare the examination report as normal (without any adjustment/consideration of the deferral of the employer's portion of social security tax), document the taxpayer's intent to defer (or not) on Workpaper 940, Closing Conference Agenda, and educate the taxpayer about the deferral. Provide an overview of the employer deferral of social security tax during the closing conference and explain the following:

a. The deferral may result in lower penalties and interest,
b. The deferral may result in additional notices,
c. A portion of the deferral is not due until December 31, 2022. Thus, if the conference and assessment is before December 31, 2022, then the deferral may mean the taxpayer has additional time to pay some of the tax due, and
d. The deferral will not be calculated if the tax due on adjustments is full paid, interest free, and penalty free.

(3) If the taxpayer expresses intent to not defer, does not respond to the examination or examination report, or all of the tax due on the adjustments is full paid, interest free, and penalty free, then document that the taxpayer does not intend to defer and that the deferral will not be calculated and input.

(4) However, if the taxpayer expresses intent to defer, and the tax due on adjustments is not full paid, interest free, and penalty free at case closing, then the examiner must:

a. Send the final ETER (workbook) to **SBSE ET Deferral* (sbse.et.deferral@irs.gov),
b. Indicate the following within the body of the above-mentioned email: social security wages and tips paid March 27-31, 2020, and adjustments to social security wages and tips paid March 27-31, 2020.

Note: If the information above is not specifically included in the email to the Campus team, the deferral will be calculated only on 2nd, 3rd, and 4th quarters 2020 as the Campus team will not have the information needed to calculate any applicable 1st quarter deferral amount.

c. Document on Workpaper 940 and Form 9984 that a copy of the report was sent to the Campus team for deferral computation.

d. Close the case following normal case closing procedures. Deferral will be input and calculated only after the case is closed and adjustments have posted.

(5) These procedures apply to tax year 2020 examination adjustments only.

Exhibit 4.23.5-1 (02-01-2003)
Determining the Right to Direct or Control

Category of Degree of Control and Independence	Description
Behavioral Control	Facts that illustrate whether there is a right to direct or control how the worker performs the specific task for which the worker is hired: • Instructions • Training
Financial Control	Facts that illustrate whether there is a right to direct or control how the business aspects of the worker's activities are conducted: • Significant investment by the worker • Unreimbursed expenses • Services available to the public • Method of payment • Opportunity for profit or loss by the worker
Relationship of the Parties	Facts that illustrate how the parties perceive their relationship: • Employee benefits • Intent of parties/written contracts • Permanency • Discharge/Termination • Regular business activity

Exhibit 4.23.5-2 (12-10-2013)
Employment Tax Treatment for Various Categories of Workers

Type of Worker	Income Tax Withholding	FICA	FUTA
Common Law Employee - IRC 3121(d)(2)	Withhold	Taxable	Taxable
Corporate Officer - IRC 3121(d)(1)	Withhold	Taxable	Taxable
Statutory Employee - IRC 3121(d)(3) Agent or Commission Driver - IRC 3121(d)(3)(A)	No Withholding	Taxable	Taxable
Statutory Employee Full-time Life Insurance Salesperson - IRC 3121(d)(3)(B)	No Withholding	Taxable	Exempt
Statutory Employee Full-time Traveling or City Salesperson - IRC 3121(d)(3)(C)	No Withholding	Taxable	Taxable
Statutory Employee Home Worker - IRC 3121(d)(3)(D)	No Withholding	Taxable if paid $100 or more in cash during the calendar year	Exempt
218 Employee - IRC 3121(d)(4)	Withhold	Taxable	Exempt
Statutory Non-Employee Qualified Real Estate Agent — IRC 3508(b)(1)	No Withholding	Exempt (see note)	Exempt
Statutory Non-Employee Direct Seller — IRC 3508(b)(2)	No Withholding	Exempt (see note)	Exempt
Statutory Non-Employee Companion Sitter — IRC 3506	No Withholding	Exempt (see note)	Exempt

Note: Statutory non-employees are subject to SECA

Exhibit 4.23.5-3 (02-01-2003)
Statutory Employees

FICA Statutory Employee Rules

In addition to common law employees, FICA rules provide for statutory employees, which include: (1) agent drivers and commission drivers, (2) full-time life insurance salesmen, (3) home workers, and (4) traveling or city salesmen.

General Requirements

The four occupational groups are briefly covered in Treas. Regs. 31.3121(d)–1. Workers in these four occupational groups who meet the following requirements are employees, for **FICA purposes**, if they do not meet the common-law test:

1. The contract of service contemplates that the worker will personally perform substantially all the work, and

2. The worker has no substantial investment in facilities other than transportation facilities used in performing the work, and

3. There is a continuing work relationship with the person for whom the services are performed.

NOTE: Agent driver / commission driver and full-time traveling / city salesperson are FUTA taxable.

Contract of Service. Work performed in these occupational groups is done under a contract of service. The term “contract of service”, means the arrangement, oral or written, under which the work is done. This arrangement must contemplate that the worker will do substantially all the work. Thus, if the contract contemplates that the worker will do all the work personally and the alleged employer does not acquiesce in delegating part of this work to another, the fact that the worker does so would not preclude their coverage under this section. The important thing is not whether the worker delegates part of the work to another, but rather whether the arrangement contemplates the worker will do so. The mutual intent of the parties governs.

Sometimes a worker delegates part of their work to another when their contract or work agreement expressly forbids doing so. Conversely, the contract may contemplate a delegation of part of the work and the worker performs all the services himself. The examiner should determine whether the contract of service is being violated or whether it was modified to permit the change.

A contract that contemplates hiring a chauffeur would not affect the personal service requirement because the services of the chauffeur are incidental to the selling activity. Similarly, the right to hire a substitute or assistant occasionally would not preclude qualifying for this provision.

Substantial Investment in Facilities. The term “substantial investment” refers to substantial facilities being furnished by the worker for conducting the business. All the facts of each case must be considered to determine whether the facilities furnished by the worker for the work are substantial. Several factors listed below will be considered in these determinations:

1. What is the value of the worker’s investment compared to total investment?

2. Are the facilities furnished essential to the work or for the personal convenience of the worker?

3. Are the facilities being purchased or leased from the person for whom the services are performed?

4. Are the facilities furnished by the worker considerably more extensive than those usually furnished by other workers performing comparable services?

Exhibit 4.23.5-3 (Cont. 1) (02-01-2003)
Statutory Employees

FICA Statutory Employee Rules

Facilities include such items as office furniture and fixtures, premises, tools, and machinery. An expense may or may not relate to furnishing facilities. Expenses for facilities (for example, expenses for an office, store, showroom, warehouse, stenographic service, utilities, and so on) may be considered in determining whether the facilities furnished represent a substantial investment. Generally, a worker who maintains an office in their own home does not have a substantial investment, but the worker who maintains an office outside their home frequently has a substantial investment in facilities.

Facilities do not include:

1. Education, training or experience, or goodwill,
2. Tools, instruments, or clothing commonly or frequently provided by employees,
3. A vehicle for the worker's transportation, or
4. Transportation facilities for carrying the goods or commodities or for supplying laundry or dry-cleaning services.

Continuing Relationship. Work is considered to be of a continuing nature if it is regular or frequently recurring. Regular part-time work (for example, two days a week), is considered a continuing relationship. Regular seasonal employment is also work of a continuing nature. A single-job transaction, even though it takes a considerable period of time, is not generally a continuing relationship.

Specific Requirements

(1) **Agent-Driver or Commission-Driver**

This group is limited to workers who distribute meat or meat products, vegetables or vegetable products, fruit or fruit products, bakery products, beverages (other than milk), or laundry or dry-cleaning services. These products and services are defined in their commonly accepted sense. The worker may sell at retail or wholesale establishments. They may operate from their own truck or one belonging to the company for which they work. Ordinarily, the worker services customers designated by the company as well as those the worker solicits. The following requirements, in addition to the three general requirements previously listed, must be met if the worker is to qualify as a statutory agent-driver or commission-driver.

The Worker Must Distribute One or More of the Types of Products or Services Listed Above. The worker may also be engaged in distributing products or services in addition to these if handling the additional products or services is incidental to handling the specified items. If the products are sold for the same principal, all the services are considered within the occupational category. A rule of thumb is that the services are incidental if the time spent handling the additional products or services is 20 percent or less of the time spent handling all products or services. If the time factor does not appear realistic, consider other factors such as ratio of income. If distributing additional products or services for the same principal is not incidental to handling the products or services listed above, the worker is not an employee. If the worker distributes for more than one principal, the services for each principal will be considered separately.

The Worker Must Perform the Services for the Person Engaging Him. The worker, who on their own account, buys merchandise and sells it, or furnishes services to the public as a part of their own independent business, is not included in this occupational category.

(2) **Full-Time Life Insurance Salespersons**

Exhibit 4.23.5-3 (Cont. 2) (02-01-2003)
Statutory Employees

FICA Statutory Employee Rules

Ordinarily, this group includes salespersons whose full-time occupation is soliciting life insurance applications and/or annuity contracts primarily for one life insurance company. They are usually furnished with office space, stenographic help, telephone facilities, forms, rate books and advertising materials by the company or its general agent.

In addition to meeting the three general requirements, an individual must be a full-time life insurance salesperson, that is, one whose entire or principal business activity is devoted to soliciting life insurance and/or annuity contracts primarily for one life insurance company. Generally, the contract of employment will show whether a salesperson meets these requirements.

The intention of a salesperson and the company, shown by the contract of employment and their mutual performance, not the time devoted to the work, will govern in determining whether an individual is a full-time or a part-time salesperson. Thus, the entire or principal business activity of an insurance salesperson will be considered to be soliciting life insurance or annuity contracts if their arrangement with a life insurance company provides for soliciting life insurance or annuity contracts (or for soliciting such contracts and only incidentally soliciting accident and health insurance contracts) for such company as their entire or principal business activity.

Intent Expressed in Contract. When the contract clearly shows that full-time services are intended, a salesperson meets the full-time requirement. On the other hand, if part-time services are contemplated by the contract, a salesperson is not a statutory employee. This applies, regardless of the amount of time devoted to the work, unless a question is raised that the contract does not show what both parties originally or later intended.

Deviation From Original Intent—Parties Agree. If the performance of a salesperson is not consistent with the written contractual terms, determine whether the parties came to a mutual understanding on the deviation. If the parties agreed to the change in their original agreement or the company acquiesces in it, a salesperson's status will be modified, effective with the date the change took place. Their status before that date will be governed by the terms of the original contract.

Deviation From Original Intent—Parties do not Agree. If the performance of a salesperson is not consistent with the contract terms and the company knows of the inconsistency but refuses to change the original agreement or to acquiesce in the deviation, determine whether there is a reasonable basis for the company's position.

Example of Reasonable Position. The company has a set policy restricting the number of full-time salespeople it may employ in a certain territory and notifies all its salespersons under part-time contracts of this policy. It is aware that some of its part-time salespersons are devoting their whole time to selling for the company, but it discourages this custom and treats such salespersons as part-time workers in every respect, that is, pays them at a lower rate of commission than a full-time salesperson and does not include them in its pension and bonus plans, and so on.

Example of Unreasonable Position. The company considers all its salespeople full-time if they work exclusively for their company. The company may know that only one hour a month is devoted to the sale of insurance by the salespersons, and the remainder of their time is spent in other work.

If the company's position is reasonable, a salesperson's status will be determined by the terms of the contract, regardless of their work history. However, if the company's position is unreasonable, a salesperson's status will be determined by a complete evaluation of the situation.

Exhibit 4.23.5-3 (Cont. 3) (02-01-2003)
Statutory Employees

FICA Statutory Employee Rules

Intent Not Expressed in Contract—Parties Agree. If there is no written contract, or the contract does not clearly reveal the mutual intent of the parties on the full-time or part-time aspects of the relationship, a salesperson's status will be determined by the mutual intent of the parties shown by their answers to questions posed by the examiner.

Intent Not Expressed in Contract—Parties Do Not Agree. If the contract does not show whether full-time or part-time services are intended and the parties disagree, the determination of a salesperson's status will be based on a complete factual evaluation. Whether a salesperson's work for the company is their **entire** or **principal business activity** will be decided after considering the factors discussed in the following paragraphs under those headings. The company's classification of a salesperson should be given considerable weight, if there is a reasonable basis for the classification.

Concept of "An Entire Business Activity." An entire business activity may or may not be full-time. A salesperson does not necessarily have to spend 8 hours a day, 5 days a week, in one sole business activity to meet the full-time requirement. A salesperson may work regularly a few hours a day and qualify as a full-time insurance salesperson if other factors in the work relationship indicate a full-time status.

On the other hand, many salespersons work for only one firm but spend only an hour or two a day, or a day or two a week, at their occupations or make sales only occasionally. Generally, even though the services are a salesperson's only work effort, the services are not substantial enough to be considered an "entire business activity." In other words, a salesperson is not an employee if their efforts are so irregular, intermittent, or sporadic that the salesperson would be considered not to be engaged in any business activity.

Concept of "A Principal Business Activity." A principal business activity is one which takes the major part of a salesperson's working time and attention. When a salesperson is engaged in several business activities, it is necessary to determine the principal business activity. In making this determination, consider factors such as:

1. The opinions of the parties involved. A statement by the company that a salesperson is or is not required to devote their work effort principally to the sales of its policies should be given considerable weight. A similar statement by a salesperson should be supported by other evidence.

2. The salesperson's total working time; that is, the amount of time spent in connection with all business activities. What proportion of that time do they spend in soliciting for the firm?

3. The ratio of earnings from the services to total earnings. Does the ratio indicate that the major part of the sales income comes from this firm?

4. Insurance companies usually treat part-time and full-time salespersons differently for commission rates, renewal schedules, pension plans, and so on. In what category has the company placed the salesperson?

Type of Insurance Sold. The salesperson's efforts must be devoted principally to soliciting life insurance or annuity contracts. Occasional or incidental sales of other types of insurance, such as accident and health insurance will not affect this requirement. However, a salesperson who is required to devote substantial effort to selling applications for insurance contracts other than life insurance or annuity contracts (for example accident and health, fire, automobile, and so on), does not meet the requirement.

Exhibit 4.23.5-3 (Cont. 4) (02-01-2003)
Statutory Employees

FICA Statutory Employee Rules

Life Insurance Subagents. It may sometimes be necessary or desirable to determine whether life insurance subagents are employees of the general agent or of the insurance company. Generally, subagents hired by the general agent are employees of the insurance company if the contracts of employment are countersigned or approved by the insurance company. If not, fully explore the contractual arrangements to determine whether the general agent or the insurance company is the employer.

If the subagents are found to be employees of the general agent, this fact will usually preclude the general agent from meeting the personal service requirement since the general agent may delegate a substantial part of the sales services to subagents. In addition, most general agents cannot meet the full-time requirement. The various services required of them in operating and supervising their general agencies indicate that it is not contemplated that they devote their full time to soliciting life insurance or annuity contracts.

(3) **Homeworkers.**

This group generally includes people who make buttons, quilts, gloves, bedspreads, clothing, needlecraft products, and so on. The work is done away from the employer's place of business, usually in the worker's own home, the home of another, or in their own workshop. The work is done on goods or materials furnished by the employer and in accordance with the employer's specifications. The worker returns the processed material to the employer or to a person designated by the employer.

Specific Requirements for Homeworkers Services Performed After 1954. To qualify as an employee, the homeworker must meet, in addition to the three general requirements previously listed, the following requirements:

1. They must do the work in accordance with specifications given by the employer. Generally, these specifications are simple and consist of patterns, samples, and so on,

2. The material or goods on which the work is done must be furnished by the employer, and

3. The finished products must be returned to the employer or a person designated by them. It is immaterial whether the employer calls for the work or the worker delivers it to them.

Special Wage Requirement for Homeworkers. A homeworker who meets the requirements is considered a statutory employee. However, IRC 3121(a)(10) provides that the pay received for such work is not wages unless $100 or more in cash is received by the wage earner in the calendar year from one employer. Thus, a homeworker may be employed by several employers, but if the pay from one employer is to constitute wages, the homeworker must receive at least $100 cash in the year from that employer. If the $100 cash-pay test is met, all the non-cash pay from the same employer can be included as wages.

(4) **Full-Time Traveling or City Salespersons.**

This category includes the salesperson who operates away from the employer's premises. Their full-time business activity is selling merchandise for a principal employer. The test of "full-time" relates to an exclusive or principal business activity for a single firm or person, and not to the time spent on a job. Side-line sales activities for some other person do not exclude a salesperson from coverage.

Salespersons are ordinarily paid on a commission basis. Generally, they are not controlled as to the details of their service or the means by which they cover their territories. However, they are expected to work their territory with some regularity, take orders, and send them to the employer for delivery to the purchaser. This group does not include agent-drivers or commission-drivers.

Exhibit 4.23.5-3 (Cont. 5) (02-01-2003)
Statutory Employees

FICA Statutory Employee Rules

In order for a traveling or city salesperson to fall within the statutory test, they must meet, in addition to the three general requirements, the following requirements:

1. Their entire or principal business activity must be devoted to soliciting, on behalf of and transmitting to their principal, orders for merchandise,

2. The orders must be obtained from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments, and

3. The merchandise they sell must be bought for resale or must be supplied for use in the purchasers' business operations.

The definition of an entire and a principal business activity, given under "Full-time life insurance salesperson" applies here. In addition, you should consider whether the contractual arrangement requires devoting a major portion of the salesperson's time and efforts to sales activity for the firm.

They Must Work for One Principal Employer. A worker who buys merchandise and sells it on their own account is not included in this occupational category. Neither is a manufacturer's representative who holds themselves out as an independent businessperson and serves the public through their connection with a number of firms.

The multiple-line salesperson generally is not an employee because their principal business activity is not soliciting orders for one principal. However, a salesperson who solicits orders primarily for one principal is not excluded because of side-line activities on behalf of other persons or firms. The salesperson may be an employee of the person for whom the orders were principally solicited.

Classes of Purchasers. Salespersons must sell to the classes of purchasers described in IRC 3121(d)(3)(D). They may also sell incidentally to others. In addition to considering the percentage of a salesperson's total working time spent in soliciting orders from the specified classes of purchasers, other factors, for example rates of income, number of sales, and so on, should also be considered. If the sales to excluded purchasers are incidental, all of the salesperson's services for its principal are considered within the occupational category.

1. A wholesaler buys merchandise in large quantities and usually sells in small quantities to jobbers or to retail dealers but not to the ultimate consumer. The wholesaler does not process the merchandise in any way to cause it to lose its identity.

2. A retailer deals in merchandise by selling it in small quantities, usually to persons who consume or use it.

Retail establishments may perform service functions or processing or manufacturing operations with respect to the items they sell without losing their character as retail establishments. For example, a store that sells drapery and slip cover material and also makes draperies and slip covers for the consumer is a retail establishment and not a manufacturer. A neighborhood bakery is essentially a retail store, even though it changes the form of raw or prepared materials.

3. Contractors include such service organizations as window-washing contractors, wall cleaning contractors, other service contractors, and construction contractors.

4. The phrase "other similar establishments" refers solely to establishments similar to hotels and restaurants. It is limited to establishments whose primary function is furnishing food and/or lodging.

Exhibit 4.23.5-3 (Cont. 6) (02-01-2003)
Statutory Employees

FICA Statutory Employee Rules

Status of Purchasers Composed of Several Business Units. An entity not within the included classes of purchasers may, through a unit of its organization, carry on a clearly identifiable and separate business which is in the included category. A salesperson who solicits orders from the entity for merchandise for resale by or for use in business operations in that unit has met the requirement regarding "classes of purchasers." For example, sales made to an unincorporated university bookstore, owned and operated by the university, are sales made to a purchaser included in the statutory definition of "traveling or city salesman."

Merchandise for Resale or Supplies for Use in Purchaser's Business Operations. Merchandise must be for resale or for use in the business operations of the purchaser. The phrase "merchandise for resale" includes only tangibles that do not lose their identity as they pass through the hands of the purchaser. "Supplies for use in the business operations" means supplies principally used in conducting the purchaser's business. Generally, it includes all tangible merchandise not considered "merchandise for resale." Services such as radio time, advertising space, and so on are intangible and outside of this definition. However, advertising novelties, calendars, and so on. constitute supplies within this definition.

The fact that a salesperson performs substantial work in servicing the article sold does not necessarily preclude their meeting the requirements of IRC 3121(d)(3)(D). For example, a salesperson that spends a day selling a machine and a day supervising its installation, and perhaps training the purchaser's personnel in its use, may still have performed services as a full-time salesperson. Furnishing such services by a salesperson may be a necessary part of the inducement for the buyer to purchase. The question, therefore, is whether their total activity is essentially a selling activity. If it is, the services related to such sales, even though substantial, are an integral part of the sale. If it is not, they do not meet the requirements for coverage.

Exhibit 4.23.5-4 (12-10-2013)
Employer-Employee Relationship Cases

The following is a partial list of cases dealing with the issue of worker classification. The cases are not listed in any particular order.

Exhibit 4.23.5-4 (Cont. 1) (12-10-2013)
Employer-Employee Relationship Cases

Case	Discussion
Ewens and Miller v. Comm, 117 T.C. 263 (2001)	In finding that bakery workers and cash payroll workers were common law employees, the Tax Court stated that "whether a worker is a common law employee or an independent contractor, for employment tax purposes, Tax Court considers: (1) degree of control exercised by the principal, (2) which party invests in work facilities used by the worker, (3) opportunity of the worker for profit or loss, (4) whether principal can discharge the worker, (5) whether work is part of principal's regular business, (6) permanency of relationship, and (7) relationship parties believed they were creating. 26 U.S.C.A. 3121(d)." The case also discusses statutory employees.
Avis Rent A Car System. Inc. v. United States, 503 F.2d 423 (2d Cir. 1974)	Car shuttlers were employees, despite the transient nature of their relationship with the employer. The Court found seven relevant non-exclusive factors from *U.S. v. Silk*, 331 U.S. 704 (1947) and *Bartels v. Birmingham*, 332 U.S.126 (1947) including working in the course of the service recipient's business (integration). The importance of avoiding single-fact analysis is stressed in this case. Facts considered relevant include: 1) the right to control the manner in which work is performed, 2) substantial investment, 3) expenses, 4) ability to profit, 5) special skills, 6) permanence, and 7) whether the services performed by the worker were part of the principal's regular business activity.
Ellison v. Commissioner, 55 T.C. 142, 144, 153, 156 (1970) acq. 1971–2 C.B. 2	A worker was an employee of a life insurance company and thus a stock option granted by the company was a restricted stock option. The worker did not bargain with the company with respect to the terms of the working agreement. The fact that an employee has an opportunity to exercise their own faculties in the business of the employer does not negate the employment relationship. The Court found that a provision in the contract indicating there was no employment relationship was not significant.

Exhibit 4.23.5-4 (Cont. 2) (12-10-2013)
Employer-Employee Relationship Cases

Case	Discussion
McGuire v. United States, 349 F.2d 644, 646 (9th Cir. WA 1965)	Truck unloaders ("swampers") required little supervision because the nature of the work was uncomplicated and they were generally familiar with the procedures of the job. "The absence of need to control should not be confused with the absence of right to control. The right to control contemplated by the regulations relevant here and the common law as an incident of employment requires only such supervision as the nature of the work requires."
James v. Commissioner, 25 T.C. 1296, 1301 (1956)	A doctor was an employee of hospitals for which they performed services. "[T]he control of an employer over the manner in which professional employees shall conduct the duties of their positions must necessarily be more tenuous and general than the control over nonprofessional employees." "[T]he general control of the hospitals over petitioner.... coupled with the controls over his method of working furnished by the high standards of his profession...., are sufficient to constitute petitioner an employee rather than an independent contractor."
Professional and Executive Leasing, Inc. v. Commissioner, 862 F.2d 751 (9th Cir. 1988)	A case similar to *James* above - Both cases focus on the right to control the manner in which the work of highly skilled professionals is performed.
Alsco Storm Windows, Inc. v. United States, 311 F. 2d 341, 343 (9th Cir. WA 1962)	Although no one factor is controlling, the test usually considered fundamental is whether the person for whom the work is performed has the right to control the activities of the individual whose status is at issue, not only as to the results, but also as to the means and method to be used for accomplishing the results.
Nationwide Mutual Insurance Co. v. Darden, 503 U.S. 318 (1992)	In this case under Title I of the Employee Retirement Income Security Act of 1974 (ERISA), the Supreme Court held that traditional common law concepts should be used to interpret the term "employee" absent legislative direction to the contrary.
Weber v. Commissioner, 103 T.C. 378 (1994), aff'd per curiam 60 F.3d 1104 (4th Cir. 1995)	The importance of small factual differences is apparent in *Weber*, a Methodist minister was held to be an employee. Compare with *Shelley.*

Exhibit 4.23.5-4 (Cont. 3) (12-10-2013)
Employer-Employee Relationship Cases

Case	Discussion
Shelley v. Commissioner, T.C. Memo 1994-432	The importance of small factual differences is apparent in *Shelley,* a clergyman in another denomination was held to be an independent contractor. Compare with *Weber.*
Grey v. Commissioner, 119 T.C. 121 (2002), aff'd, in unpublished opinion, 93 Fed.Appx. 473 (3rd Cir 2004)	This case analyzes the employment status of an individual who is the president and sole shareholder of a corporation under IRC 3121(d)(1), and concludes that the individual performed services for the corporation in their capacity as president, and therefore, was an employee for employment tax purposes under IRC 3121(d)(1).
Kenney v. Commissioner, T.C. Memo 1995-431	The Tax Court noted that the business' intent was inconsistent with both the substance of the employment relationship and what the parties actually knew the relationship to be. The court found that the business knew that the workers were employees, but it called them independent contractors because the business did not want to pay employment taxes on them or include them in employee benefit plans.
Veterinary Surgical Consultants, P.C. 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)	President of S corporation was an employee and amounts taxpayer paid him were wages for purposes of federal employment taxes. All of taxpayer's income was generated by consulting and surgical services performed by the president. (The taxpayer was the sole shareholder and the only worker.) The Tax Court found that taxpayer had no reasonable basis for treating the president as other than an employee; thus, taxpayer was not entitled to relief under section 530.
Simpson v. Commissioner, 64 T.C. 974 (1975)	The IRS successfully argued in this case that an insurance agent was an independent contractor. Relevant facts were: 1) degree of control over details; 2) investment in facilities; 3) opportunity for profit or loss; 4) right to discharge; 5) whether work is part of principal's regular business; 6) permanency; and 7) the relationship the parties believed they were creating.