Federal Tax Controversy Hot Topics

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by

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Ms. Mondrik and her associates represent the firm's state tax clients in administrative and legal proceedings before the Comptroller's office, the State Office of Administrative Hearings and the Texas state courts. They also represent federal tax clients in audits, at the administrative appeals level and in proceedings before the United States Tax Court and the United States District Courts. Ms. Mondrik is licensed to practice in the United States Tax Court, the United States District Court, Western District of Texas, and all of the Texas state courts.

Ms. Mondrik and members of her firm are frequent authors and lecturers on federal tax controversies and state taxation.

Ms. Mondrik has served on the State Bar of Texas Tax Section's governing council and has served as chair and vice-chair of its Tax Controversy, CLE and Solo and Small Firms Committee Committees. After completing her 2010-13 SBOT Tax Section council member term, Ms. Mondrik served as annual meeting committee chair for 2013-14. She is also State Bar Tax Section Leadership Academy chair for 2016-17.

The TSCPA awarded Ms. Mondrik the Young CPA of the Year Award for 2009-10. She also received the 2012 TSCPA Rising Star Award. The Austin Chapter of CPAs awarded Ms. Mondrik the Distinguished Service Award in 2015.

Ms. Mondrik currently serves on the State Bar of Texas and TSCPA State Taxation Committees, and is vice chair and commenting subcommittee chair of the Texas Society of Certified Public Accountants (TSCPA) Federal Tax Policy Committee. She also recently served a three-year term on the TSCPA Executive Board. Ms. Mondrik was the 2009-10 President, and has served as manager of education and leadership and chair and on the Oversight Council of the Austin Chapter of CPAs Ms. Mondrik has also served as chair of the TSCPA Texas State Tax Conference Committee and its State Taxation Committee. As chair of the state taxation committee, she was a principal drafter of comments submitted by the TSCPA in response to legislation implementing the Texas margin tax and various administrative rules.

Ms. Mondrik earned her B.B.A. in Accounting and her J.D., with honors, both from the University of Texas at Austin. She has been licensed as an attorney by the State of Texas since 2001.

Introduction

This outline covers "hot topics" in federal tax controversies. This paper is not intended to provide a comprehensive analysis of these issues, but is meant to identify issues.

1. US Tax Court Rules of Practice and Procedure

US Tax Court issued a press release March 28, 2016, adopting interim amendments to the Rules of Practice and Procedure related to the Bipartisan Budget Act of 2016 (BBA),[1] the Fixing America's Surface Transportation (FAST) Act,[2] and the Protecting Americans from Tax Hikes (PATH) Act of 2015.[3] These changes are generally effective December 18, 2015.

Federal Rules of Evidence

The Federal Rules of Evidence now apply to US Tax Court cases. Previously, US Tax Court matters followed the rules of evidence "applicable in trials without a jury in the United States District Court of the District of Columbia." Except for cases commenced under Title XXVI relating to actions for administrative costs, evidence relevant only to the issue of a party's entitlement to reasonable litigation or administrative costs shall not be introduced during the trial of a case.[4]

Bankruptcy and Receivership

The period for Tax Court review of spousal relief or lien or levy action under Internal Revenue Code (IRC) §§ 6015(e) and 6330(d) is suspended during a federal bankruptcy proceeding. This means affected taxpayers are restricted from filing a Tax Court petition seeking relief under these provisions until 60 days after the bankruptcy proceeding has concluded.

Jurisdiction to Review Interest Abatement

A taxpayer may now petition the US Tax Court for interest abatement if the taxpayer files a claim with the IRS under IRC § 6404(h) and the Commissioner fails to issue a final determination within 180 days after the claim was filed. *See* revised Rule 281(b) for the content of a petition to abate interest.

As a practical matter, interest abatement is rarely granted, and is generally only allowable in the context of unreasonable errors or delays caused by an IRS employee performing a ministerial or managerial act.[5] A ministerial act is one that is merely mechanical and doesn't involve exercising judgment or discretion. For a ministerial delay to occur, all prerequisites, such as conferences and supervisory review, must have already taken place.[6] A managerial delay

[1] Pub. L. 114-74, ___ Stat. ____ (enacted on Nov. 2, 2015).
[2] Pub. L. 114-94, ___ Stat. ____ (enacted on Dec. 4, 2015).
[3] Pub. L. 114-113, ___ Stat. ____ (enacted on Dec. 18, 2015).
[4] *See* Rules 231 and 232. Evidence in those matters is addressed in Rule 274 and Rule 174(b).
[5] IRC § 6404(e)(1).
[6] Regs. § 301.6404-2(b)(2).

occurs as a result of a temporary or permanent loss of records or the exercise of judgment or discretion regarding the management of personnel (e.g. an IRS employee is sent to training, the case is not reassigned, and the delay occurs as a result of the manager's decision to send the employee to training, without assigning a replacement).[7].

2. Revised Partnership Audit Procedures

The BBA and the PATH Act collectively repealed the Tax Equity and Fiscal Responsibility Act of 1992 (TEFRA) rules governing partnership audits and replaces them with a new centralized partnership audit regime. Proposed Treasury Regulations are pending comment.

The new regime is generally effective for partnership returns beginning after December 31, 2017, and generally authorizes the IRS to assesses and collect tax at the partnership level, limiting the ability of individual partners to challenge the liabilities. While the new laws were intended to curb perceived abuses by large publicly traded partnership, they affect partnerships of all sizes.

The BBA removed the electing large partnership regimes. While there are some potential opt out procedures for certain small partnerships, it's uncertain how they will work and how many businesses will even know about the election. The imputed underpayment under IRC § 6625(b) will be computed by netting all adjustments of income, gain, loss, or deduction; multiplying them by the highest tax rate in effect for the reviewed year; treating any net decrease increase in income; and taking into account any adjustments to items of credit as an increase or decrease. The law allows for statutory adjustments for amended returns of partners, tax-exempt partners, modification of the highest applicable tax rates, and potential other items established by regulations. The partnership may file a request for an administrative adjustment to the amount of one or more items of income, gain, loss, deduction or credit.

Judicial review will be available under the revised partnership audit procedures within 90 days of notice of the final partnership adjustment. Taxpayers may petition the Tax Court, US District Court or Court of Federal Claims.

References to tax matters partners have been replaced by a partnership representative. This likely necessitates the rewriting of all existing partnership agreements to govern how partners will address the partnership level adjustment under the revised partnership audit regime.

Early Opt In Procedures and Tax Court Jurisdiction

The Tax Court has jurisdiction over a partnership action only if the partnership elects under BBA § 1101(g)(4) to apply the revised partnership provisions; the Commissioner has mailed a notice of final partnership adjustment with respect to the taxable year, and the partnership representative files a petition for readjustment within 90 days after the date on which the notice of final partnership adjustment was mailed. The caption of the case must state the

[7] Regs. §301.6404-2(c).

name of the partnership and the partnership representative. Rule Key 255.2 specifies the necessary content of a Tax Court Petition challenging notice of final partnership adjustment under the revised partnership audit rules. A decision issued under these procedures is binding on the partnership and all of its partners under IRC § 6223(b).

3. Certification and Failure to Reverse Certification with Respect to Passports

The new IRC § 7345 enacted in the FAST Act, provides for the denial of new passport or passport renewal applications and the revocation of current passports for taxpayers who owe more than $50,000 in "delinquent" taxes. The statute requires the IRS to share information with the US Department of State and places restrictions on taxpayers' freedom to travel, potentially affecting their ability to participate in international business activities.

Under IRC § 7345(e), if a taxpayer believes the IRS has improperly certified that a passport should be denied or revoked or that the certification has not been properly reversed, the taxpayer can bring action in federal district court or the U.S. Tax Court. The U.S. Tax Court has jurisdiction to review a certification or failure to reverse certification under these provisions. In general, the Rules of Practice and Procedure apply to these actions. Rule 351 provides the details governing the commencement of the action, the content of the petition, and the filing fee.

4. Appeals Face-to-Face Conferences

IRS Appeals has limited availability to face-to-face conferences. This has occurred as part of the IRS "Future State" initiative. Effective October 1, 2016, the IRS revised the Internal Revenue Manual (IRM) on conference practice to promote telephonic and virtual conferences over face-to-face conferences.

The Appeals mission is "to resolve tax controversies, without litigation, on a basis which is fair and impartial to both the Government and the taxpayer and in a manner that will enhance voluntary compliance and public confidence in the integrity and efficiency of the Service."

IRM 8.6.1.4.1 (10-01-2016)
Conference Practice

1. Make multiple attempts to initiate a personal contact with the taxpayer or representative by telephone or by correspondence. During personal contact, discuss whether an alternative conferencing method (other than telephone) is necessary based on the unique facts and circumstances of the case.
2. Except as set forth below, hold conferences by telephone. Hold conferences on dates that are reasonably convenient for taxpayers and representatives and the ATE.
3. Offer a taxpayer requesting an in-person conference a virtual conference as an alternative when the technology for a virtual conference is available (see Virtual Service Delivery (VSD), discussed below). If the taxpayer declines the opportunity for a VSD conference:

   A. Document the taxpayer's decision in the Case Activity Record (CAR)
   B. Input code "VSDX" in the LOC7 field.
4. There may be situations in which an in-person conference, including circuit riding should be held to help reach resolution. The decision to hold an in-person conference can be made upon the request of the taxpayer or at the suggestion of the ATE. The ATM must concur with the decision. Appeals will consider the following facts and circumstances in making the decision to hold an in-person conference:
   - There are substantial books and records to review that cannot be easily referenced with page numbers or indices
   - The ATE cannot judge the credibility of the taxpayer's oral testimony without an in-person conference
   - The taxpayer has special needs (e.g. disability, hearing impairment) that can only be accommodated with an in-person conference
   - There are numerous conference participants (e.g., witnesses) that create a risk of an unauthorized disclosure or breach of confidentiality
   - An alternative conference procedure (e.g., Post Appeals Mediation (PAM) or Rapid Appeals Process (RAP)) involving separate caucuses will be used
   - Another IRM section specific to the workstream calls for an in-person conference
5. The ATE will communicate the decision regarding the in-person conference to the taxpayer and/or representative.

While this may assist the IRS in serving taxpayers in remote areas, these procedures are not optimal for complex cases, circumstances in which taxpayers have limited English proficiency or otherwise have difficulty communicating, and situations that could be resolved by an in-person conversation, rather than alternative communication methods. The American College of Tax Counsel issued a comment letter on the IRM revisions, warning that the shift to telephonic appeals conferences "will have a serious negative effect on the prompt and fair resolution of tax disputes and on the public's perception of the fairness of Appeals and the federal tax system in general."[8] Similar comment letters are in progress from the Texas Society of CPAs Federal Tax Policy committee, the Texas State Bar Tax Section, and the American Bar Association Section of Taxation Administrative Practice Committee.

5. Appeals Judicial Approach and Culture (AJAC)

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The IRS initiated the Appeals Judicial Approach and Culture ("AJAC") project in 2012 to ensure the policies and practices of Appeals are consistent with its mission.[9] AJAC is based on the premise that Appeals should not perform compliance actions.[10] Rather, Appeals' role is to attempt to settle a case after IRS compliance functions (which include Accounts Management, Collection, and Examination) have made a determination to which the taxpayer does not agree.[11]

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[8] http://procedurallytaxing.com/wp-content/uploads/2016/10/ACTC-Letter.pdf/
[9] IRS Fact Sheet, available online at: https://www.irs.gov/PUP/individuals/factsheet.pdf?_ga=1.124212874.1092037745.1407982312
[10] Id.
[11] Id.

The IRS's objective in establishing the policies of AJAC was to ensure the IRS compliance functions are the fact finders and Appeals does not take investigative actions. The changes aimed to ensure taxpayers have a true appeal right – where Appeals reviews a final determination made by a compliance function. AJAC implemented changes to appeals of both collection and examination matters:

Key Collection Changes:[12]

- Appeals will not take investigative actions with respect to financial information provided by taxpayers. Financial information needing investigation or verification will be sent to Collection.
- Appeals will only consider assets that were documented by Collection or introduced by the taxpayer.
- Appeals will accept as "verified" those financial statements reviewed by Collection within the previous 12 months.
- Appeals will not make recommendations to file Notices of Federal Tax Lien.
- All Offers in Compromise ("OIC") submitted in Collection Due Process ("CDP") or Equivalent Hearings will be reviewed by Collection for a preliminary recommendation or acceptance.
- In non-CDP OIC cases, Appeals will only determine the acceptability of the OIC and will not offer other collection alternatives.[13]

Key Examination Changes:[14]

- Appeals will attempt to settle a case on factual hazards when not fully developed by Examination (i.e., cases will not be sent back to Examination for further development).
- Appeals will not raise new issues or reopen issues on which the taxpayer and Examination have reached an agreement, with limited exceptions.
- Most new case receipts in Appeals must have at least one year remaining on the statute of limitations.
- Appeals will return non-docketed cases to Examination when a taxpayer submits new information or evidence or raises a new issue that merits investigation or additional analysis.
- For most work streams, Appeals will engage Examination for review and comment when a taxpayer raises a relevant new theory or alternative legal argument.[15]

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[12] IRS Fact Sheet, available online at: https://www.irs.gov/PUP/individuals/factsheet.pdf?_ga=1.124212874.1092037745.1407982312

[13] The changes are effective for all Collection cases, Collection Information Statements and significant information received by Appeals on or after Aug. 11, 2014.

[14] IRS Fact Sheet, available online at: https://www.irs.gov/PUP/individuals/factsheet.pdf?_ga=1.124212874.1092037745.1407982312

[15] These changes are effective for new Appeals' case receipts on or after Sept. 2, 2014

In July 2014, the Department of Treasury, Internal Revenue Service, issued Appeals Memoranda AP-08-0714-0004 and AP-08-0714-0005, setting forth these changes in further detail. These memoranda set expiration dates of September 2, 2016, and August 11, 2016, for the applicable provisions to be incorporated into the IRM.

IRS Guidance to Taxpayers:[16]

- Taxpayers and their representatives are encouraged to fully cooperate with IRS compliance functions during the development of the case so a file is complete when coming to Appeals.
- When appealing a compliance function's decision, taxpayers should be specific in their tax appeal on the item(s) in dispute.
- The introduction of new information in Appeals may result in Appeals releasing jurisdiction and returning the file to compliance.

The National Taxpayer Advocate's 2015 Annual Report to Congress expressed concerns regarding the IRS's implementation of AJAC:

Although AJAC's aspirations are commendable, its practical implementation is eroding the very perceptions of fairness and objectivity that it claims to bolster. One commentator stated, "[t]here seems to be something problematic in the procedure for just about everyone involved." Further, non-docketed Examination-based Appeals receipts have steadily fallen and TAS has observed that AJAC cases, at least in some circumstances, may be generating less thorough review than pre-AJAC cases. The National Taxpayer Advocate has long been a proponent of an independent and effective Appeals process within the IRS. Nevertheless, she is concerned that, in application, AJAC is:

- Being used to intimidate taxpayers and deny their right to an administrative appeal;
- Causing cases to bounce back and forth between Appeals and Compliance; and
- Resulting in curtailed review by Appeals Hearing Officers (Hearing Officers) of IRS Examination and Collection actions.[17]

6. Appeals Process in Docketed Cases

Rev. Proc. 2016-22 updates the Appeals processes in cases docketed before the U.S. Tax Court.[18] Counsel generally refers docketed cases to Appeals for settlement consideration unless Appeals issued the Notice of Deficiency or the taxpayer waives appeal rights. Procedures between Appeals and Counsel determine the timing of the return of an unagreed case file to Counsel for trial preparation.

- With certain exceptions, Counsel will refer docketed cases to Appeals for settlement consideration unless 1) Appeals issued the notice of deficiency or made the determination

[16] These changes are effective for new Appeals' case receipts on or after Sept. 2, 2014
[17] Citations omitted. Full report available online at: http://taxpayeradvocate.irs.gov/reports/2015-annual-report-to-congress
[18] Available online at: https://www.irs.gov/irb/2016-15_IRB/ar11.html?_ga=1.219334809.1245584263.1394038694

that is the basis of the Tax Court's jurisdiction or 2) the taxpayer notifies Counsel that the taxpayer wants to forego settlement consideration by Appeals.

- If Appeals issues a notice of deficiency, or makes a determination, without having fully considered one or more issues because of an impending expiration of the statute of limitations on assessment, Appeals may include a request in the administrative case file for Counsel to return the case to Appeals for full consideration of the issue or issues once the case is docketed in the Tax Court. If Appeals includes such a request in the administrative case file, the case will be treated as if Appeals did not issue the notice of deficiency or make the determination.

- Counsel will not refer to Appeals any docketed case or issue that has been designated for litigation by Counsel. In limited circumstances, a docketed case or issue that has not been designated for litigation will not be referred to Appeals if Division Counsel or a higher level Counsel official determines that referral is not in the interest of sound tax administration. For example, Counsel may decide not to refer a docketed case to Appeals in cases involving a significant issue common to other cases in litigation for which it is important that the IRS maintain a consistent position or in cases related to a case over which the Department of Justice has jurisdiction. If Counsel determines that a docketed case or issue will not be referred to Appeals, Counsel will notify the taxpayer that the case will not be referred to Appeals.

- For cases not covered by these exceptions, Counsel will refer a docketed case to Appeals within 30 calendar days of the case becoming "at issue in the Tax Court" (as defined by Tax Ct. R. 38). Counsel may, with manager approval, delay forwarding a docketed case to Appeals if Counsel identifies a need for additional time. A delay of more than 90 calendar days (120 calendar days from when the case is at issue) requires approval of a Counsel executive. If a delay of more than 90 calendar days is approved, Counsel will discuss with Appeals the need for the delay and when Counsel expects to forward the case to Appeals for settlement consideration. Examples of when Counsel may delay forwarding a docketed case to Appeals include, but are not limited to, cases in which Counsel determines a need to retain the administrative file for early trial preparation or when new facts, issues, or items are raised in the pleadings. Counsel may also delay forwarding a docketed case to Appeals when Counsel anticipates filing a dispositive motion, in which case Counsel will retain the case until the Tax Court rules on the motion. If a delay of more than 90 calendar days is approved by a Counsel executive, Counsel will promptly notify the taxpayer that referral of the case to Appeals will be delayed.

- When a docketed case is forwarded to Appeals for consideration, Appeals has the sole authority to resolve a docketed case through settlement until the case is returned to Counsel.

- To the extent feasible, Counsel will alert Appeals about limits on the amount of time that Appeals may have the case for settlement consideration. In such cases, Counsel and Appeals shall then agree upon the time when the case will be returned to Counsel.

- A docketed case proceeding as a small tax case under the provisions of section 7463, or as a regular case in which the amount at issue for each year is $50,000 or less, that has been forwarded to Appeals for consideration may be recalled by Counsel after six months. If not recalled, Appeals will return the case so that it is received by Counsel no later than 30 calendar days prior to the date of the calendar call. In all other docketed cases, Appeals will return the case to Counsel when Appeals concludes that the case is not susceptible to settlement or within 10 calendar days after the case appears on a trial calendar, whichever is sooner. In all cases, Counsel and Appeals may agree to extend the time for Appeals to consider a case if settlement appears reasonably likely.

- If Counsel determines that the case is needed for trial preparation, Counsel may request that Appeals return the case (including settlement authority) to Counsel before Appeals has completed its consideration of the case.

- Notwithstanding any other provision in this revenue procedure, any docketed case may be transferred from Counsel to Appeals or from Appeals to Counsel by agreement between Appeals and Counsel. This authority will be used when such transfer may promote a more efficient disposition of the case.

- Upon request, Appeals will make the administrative case file, or a copy, readily available to Counsel when needed for trial preparation. A request for the administrative case file by Counsel will not transfer settlement authority back to Counsel. Counsel will promptly return the administrative file to Appeals on request, or when it is no longer needed by Counsel for trial preparation.

- When transferring a docketed case to Appeals, Counsel may request to be included in a settlement conference with the taxpayer. Appeals may, with manager approval, decline to include Counsel in the settlement conference if, after considering the views of both Counsel and the taxpayer, Appeals determines that Counsel's participation in the settlement conference will not further settlement of the case. Whether or not Counsel participates in the settlement conference, Counsel will continue with trial preparation, which may include, but is not limited to, asking the taxpayer to participate in informal discovery conferences with Counsel only.
- .12 Appeals will provide Counsel with access to any documents received by Appeals in a settlement conference with respect to the docketed case.

- If a taxpayer or the taxpayer's representative raises an issue for the first time while the docketed case is with Appeals for settlement consideration, Appeals will advise Counsel as soon as the new issue is identified. Appeals or Counsel will coordinate with the examination function as appropriate to obtain the IRS's views on the new issue, and in docketed cases containing an issue that was not previously examined, Appeals or Counsel will coordinate with the examination function of the relevant operating division, as needed, to develop the material facts relating to the new issue prior to Appeals' consideration of the issue.

- In evaluating the merits of a docketed case that has been referred to Appeals for settlement consideration, Appeals may obtain advice from Counsel and consider it in conjunction with other factors to reach a basis for settlement.

- If Appeals reaches a settlement with the taxpayer in the docketed case, a stipulated decision document reflecting the proposed resolution will be prepared and forwarded to the taxpayer. When Appeals prepares the decision document, Counsel may assist with drafting, as needed. By signing the proposed stipulated decision document and returning the document to the IRS, the taxpayer makes an offer to settle the case. Counsel will review the decision document for accuracy and completeness, sign the decision document on behalf of the Commissioner, and file the document with the Tax Court.

There are exceptions for cases under IRC §§ 6015(e)(1)(A)(i)(II), 6110, 6230, 6330, 6404, 7428, 7476, 7477, 7478, 7479, and 7623.

7. Family Limited Partnership Valuation Issues

The IRS issued proposed regulations, REG-163113-02 published Aug. 4, 2016, under IRC § 2704 concerning restrictions on liquidations of family limited partnership (FLP) interests estate, gift, and generation-skipping transfer taxes. The proposed regulations, which were still undergoing review and comment at the time these materials were prepared, would dramatically restrict, if not eliminate, valuation discounts on intra-family transfers of certain family-owned entity interests.

The proposed regulations conflict with a large body of existing case law. When Congress enacted IRC § 2704 in 1990, it offered restrictions on the regulatory authority granted and provided for exceptions taxpayers have appropriately applied to reduce valuations. These valuation adjustments have been approved by case law, much of which originated in Texas and the Fifth Circuit. IRC § 2704(b)(4) provides that:

> "The Secretary may by regulations provide that other restrictions shall be disregarded in determining the value of the transfer of any interest in a corporation or partnership to a member of the transferor's family if such restriction has the effect of reducing the value of the transferred interest for purposes of this subtitle *but does not ultimately reduce the value of such interest to the transferee.*" (emphasis added)

The IRS has repeatedly championed legislation to overturn this longstanding body of case law, but Congress has declined to enact additional restrictions. The Tax Court's opinion in *Pierre v. Commissioner*, 133 T.C. 24, (2009) stated:

> "In the absence of such explicit congressional action and in the light of the prohibition in section 7701, the Commissioner cannot by regulation overrule the historical Federal gift tax valuation regime contained in the Internal Revenue Code and substantial and well-established precedent in the Supreme Court, the Courts of Appeals, and this Court, and we reject respondent's position in the instant case advocating an interpretation that would do so. Accordingly, we hold that petitioner's transfers to the trusts should be valued for

Federal gift tax purposes as transfers of interests in Pierre LLC and not as transfers of a proportionate share of the underlying assets of Pierre LLC."

IRC § 2704(a) provides that a lapse of liquidation or voting rights, where members of the family hold control both before and after the lapse, will result in a gift or inclusion in gross estate. The existing regulations under § 25.2704-1(c)(2) offer exceptions where the holder, the holder's estate and members of the holder's family cannot immediately liquidate the interest the holder could have liquidated prior to the lapse; where necessary to prevent double taxation; or if the lapse of the liquidation right that results solely from a change in state law. The proposed regulations limit or eliminate these exceptions by requiring the inclusion of the value of the lapsed liquidation right in gross estate where death occurs within three years of the transfer.

IRC § 2035 sets forth a three-year rule where the value of the asset would have been included in the decedent's gross estate under Section 2036, 2037, 2038 or 2042. However, thereIn is no similar provision under IRC § 2704(a). Rather, case law has applied a "facts and circumstances" test[19] and has recognized the impact of ownership by unrelated parties based on facts and circumstances without the imposing a three-year ownership requirement.[20]

The regulations replace the traditional fair market value definition with "minimum value." The proposed regulations do not clearly state how this new standard is to be applied. Applying the proposed regulations appears to substantially reduce or altogether disregard valuation discounts. The proposed regulations also apply a "put right" to every interest holder, which assumes each family member or member of an entity, like an FLP, would have unlimited rights to the entity.

8. Worker Classification Cases

Worker classification cases continue to be an active area in tax controversy both at the federal and state levels. The Internal Revenue Service (IRS) and the Texas Workforce Commission (TWC) impose payroll tax, withholding, unemployment tax reporting and payment requirements for employees but not for independent contractors. Payments to independent contractors may still be reportable on Form 1099, but the contractor is responsible for his or her own estimated tax payments and self employment / income tax reporting. Worker classification issues are important for tax purposes but are also very important for a variety of other purposes including labor law, ERISA, employee benefits law, OSHA, etc. This outline primarily covers the tax implications of worker classification and related strategies. Taxpayers and employers should also seek advice from financial advisors and employment law attorneys when planning for worker classification.

[19] See, e.g., *Estate of Murphy v. Commissioner*, T.C. Memo.1990-472.
[20] See *Kerr v. Commissioner*, 292 F.3d 490, 494 (5th Cir.2002).

IRS officials have stated their intention to increase worker classification cases.[21] In addition, the Service intends to increase the number of cases for which information is being sent to 37 participating states (including Texas) through the questionable employment tax program (QETP).[22]

In general, an independent contractor is an individual business owner or contractor who provides services to other businesses, and is generally considered self-employed as a sole proprietor. Self-employed individuals receive Forms 1099 and are required to make their own quarterly estimated tax payments using Form 1040-ES, or suffer the consequences of estimated tax penalties when they report their taxes on Schedule C, file their Forms 1040 “U.S. Individual Income Tax Returns,” and pay their taxes individually. In addition, self-employed individuals are required to pay self-employment tax on their net income, which roughly equates to the employment taxes they would have paid as an employee and an employer. There is a deduction in calculating adjusted gross income on Form 1040 for one-half of the self employment taxes paid by self-employed individuals. Examples include doctors, dentists, veterinarians, lawyers, accountants, contractors, subcontractors, public stenographers, and auctioneers, who offer their services to the general public. However, these types of workers may also be employees, depending upon the circumstances.

Employees, on the other hand, work for the business owners who employ them. They generally receive more direction, more resources from their employers, and have more restrictions (or control) placed upon them than do independent contractors. Employees have payroll taxes and federal income taxes withheld from their paychecks and their employers pay additional social security, Medicare and state and federal unemployment taxes on their behalf. At the end of the year, employees receive Forms W-2, which summarize the income earned and taxes deducted from their paychecks.

The determination of whether an individual is properly classified as an employee or an independent contractor is a highly fact-intensive analysis, which considers all of the facts and circumstances surrounding the relationship between the business and the worker. The factors considered have evolved somewhat over time, but the primary determinative factor continues to revolve around the degree of control a business has over the worker and the work. The more control the business retains, the more likely the worker is to be determined an employee rather than a contractor. As the work environment becomes more flexible, the worker classification issue becomes a more difficult challenge, particularly when a worker performs work for only one or a small number of businesses.

A business receiving an adverse determination of worker classification may file a request for reconsideration of worker classification determination with the IRS SS-8 compliance unit. IRS appeals has jurisdiction over trust fund recovery penalties and appeals of denial of penalty abatement based upon reasonable cause in payroll and unemployment tax cases. A business appealing an assessment of additional payroll and unemployment taxes may pay one quarter’s

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[21] “IRS Intends to Increase Worker Classification Cases, Official Says,” by Lydia Beyoud, Bloomberg BNA Daily Tax Report, May 14, 2013.

[22] *Id.* Referencing a presentation by John Tuzynski, head of IRS employment tax policy, at the American Bar Association Section of Taxation 2013 May meeting in Washington DC.

wages for one employee and proceed into federal district court. The business may also request Section 530 relief. Section 530 relief is available if (1) the taxpayer consistently reported the pay for the worker, (2) had a reasonable basis for its position, and (3) consistently treated the worker and any similar workers as independent contractors. “Section 530” does not reference a section of the Internal Revenue Code, but references the Revenue Act of 1978, as amended.

In some cases, Appeals is willing to reduce or eliminate proposed liabilities in exchange for an agreement by the taxpayer to switch contractors to employees prospectively.[23]

9. Conclusion

The revised partnership audit rules, ongoing controversies involving worker classification, and proposed regulations affecting FLP interest valuations, along with any tax legislation that may arise from upcoming congressional sessions is likely to produce significant fodder for ongoing tax controversies regardless of the outcome of the upcoming presidential election.

[23] See Notice 98-21, 1998-15 I.R.B. 14, describing the classification settlement program for worker classification cases.