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MEMORANDUM FOR Director, Office of Employment Tax Administration and Compliance
Attn: Charles M. Harvel

FROM: Acting Chief, Employment Tax Branch 1, Office of Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities)

SUBJECT: Corporate Officer Compensation and Classification Issues

As a follow-up to the advice we issued in January 2000 (IRS CCA 200009043; 2000 IRS CCA Lexis 1), you have asked for additional technical advice involving several areas related to corporate officer compensation and classification. [redacted] We welcome the opportunity to provide additional written guidance and clarification in these areas. For clarity, these issues have been separately numbered and discussed below.

QUESTIONS PRESENTED

1. Are corporate officers entitled to treatment under section 530 of the Revenue Act of 1978 and, if so, is submission of a Form 1099 sufficient to establish the corporation's treatment of that worker as an independent contractor?

2. When is it appropriate to issue a Notice of Determination Concerning Worker Classification (notice of determination) under I.R.C. § 7436 when the worker involved is a corporate officer?

3. Is the Classification Settlement Program (CSP) available when compensation to a corporate officer is mischaracterized, rather than when the officer's worker classification is incorrect?

4. Are the I.R.C. § 3509 rates appropriate for application in the context of corporate officer misclassification?

BRIEF ANSWERS

1. Corporate officers are entitled to treatment under section 530. Further, submission of a Form 1099 may be sufficient to establish a corporation's treatment of the officer as an independent contractor.

2. Where an audit of a corporation has resulted in an actual controversy as to the classification of a corporate officer as an employee for employment tax purposes, or where the Service has determined that the corporation is not entitled to section 530 relief, a notice of determination must be issued.

3. Where a corporate officer's compensation has been mischaracterized, as opposed to a corporate officer's status being misclassified, CSP relief is not available.

4. Section 3509 rates are appropriate for application where the status of a corporate officer has been misclassified.

DISCUSSION

1. Section 530 relief for corporate officers and submission of a Form 1099 as sufficient treatment for independent contractor status

Under section 530(a)(1) of the Revenue Act of 1978, termination of certain employment tax liability is appropriate where: **1**) the taxpayer did not treat the individual as an employee for any period; **2**) all required Federal tax returns reflect the taxpayer's consistent treatment of the individual as a non-employee; and **3**) the taxpayer had a reasonable basis for not treating the individual as an employee. Additionally, section 530(a)(3) requires that the taxpayer not have treated any individual in a substantially similar position as an employee for any period. However, section 530(d) contains specific exceptions from employment tax liability relief under section 530(a). Specifically, in the context of a three-party service arrangement where a business provides workers to a client, section 530 relief is unavailable if a worker provides services "as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work." Revenue Act of 1978 § 530(d).

The language of section 530 contains no specific exclusion which would prevent a taxpayer from obtaining section 530 relief if the Service determined that its corporate officers were employees. Indeed, when Congress was considering exceptions to section 530 relief, its intent was to except workers, under the common law rules, retained by businesses which provide technical services. *See* "Independent Contractor or Employee?: Training Materials" [Training 3320-102 (Rev. 10-96) TPDS 84238I] at 1-38. Accordingly, section 1706 of the Tax Reform Act of 1986 (1986-3 C.B. (Vol. 1) 698), amended section 530 by adding the specific exclusions under section 530(d). Corporate officers are not included in this exclusion. Furthermore, section 3.09 of Revenue Procedure 85-18 specifically states that "[f]or purposes of section 530(a) of the Act, the term employee means employees under sections 3121(d), 3306(i), and 3401(c) of the Code." Rev. Proc. 85-18, 1985-1 C.B. 518. Corporate officers are defined as employees under I.R.C. §§ 3121(d)(1), 3306(i), and 3401(c).

Although Revenue Procedure 85-18 explains that, for section 530 relief, the term employee means those individuals defined as employees under I.R.C. §§ 3121(d), 3306(i), and 3401(c), it has been suggested that the intent of Congress was to limit this

relief to common law employees. Indeed, H.R. Rep. No. 95-1748, 95th Cong., 2nd Sess. 4 (1978), 1978-3 C.B. (Vol. 1) at 632, notes that, *in general*, the bill was intended to provide an interim solution involving controversies regarding whether certain individuals were employees under interpretations of the common law. However, the corresponding Senate Report (S. Rep. No. 95-1263, 95th Cong., 2nd Sess. at 209 (1978)) noted that "[*w*]ith *certain limited statutory exceptions*, the classification of particular workers or classes of workers as employees or independent contractors (self-employed persons), for purposes of Federal employment taxes, must be made under common law rules." 1978-3 C.B. (Vol. 1) at 507 (emphasis added). The report also noted that, "[*g*]*enerally,* the basis for determining whether a particular worker is an employee or independent contractor is the common law test of control." Id. (emphasis added). Further, the report noted, when explaining the reason for the change, that it was appropriate to provide interim relief for taxpayers who are involved in employment tax status controversies with the Service. Id. at 210; 508. The Senate's explanation did not indicate that section 530 relief was limited to controversies surrounding determinations of employee status made under common law rules, but, rather, to taxpayers involved with employment status controversies, common law or otherwise.

The language of section 530(a) makes no statement that indicates that this treatment is applicable to common law employees only. Indeed, although section 530(d) specifically lists the exceptions to section 530, no "corporate officer exception" is included. Additionally, section 104.6.5.4(1)a of the Employment Tax Handbook explains that, for purposes of section 530 relief, the workers involved must be defined as employees under I.R.C. § 3121(d). Also, section 104.6.5.7(1) explains that corporate officers are employees under I.R.C. § 3121(d) for section 530 relief purposes. *See also* Employment Tax Handbook §104.6.5.8.3. Further, Revenue Procedure 85-18 specifically indicates that corporate officers are employees for the purposes of section 530 relief.

Therefore, if a taxpayer did not treat a corporate officer as an employee, and meets the other section 530 requirements for relief from employment taxes, the taxpayer would be entitled to section 530 relief consideration.

Regarding whether submission of a Form 1099 is sufficient to establish the taxpayer's treatment of corporate officers as independent contractors rather than employees, for purposes of section 530 relief, section 3.03 of Revenue Procedure 85-18 interprets the word "treat" within the context of a section 530(a)(1) relief determination. That revenue procedure includes guidelines for use when determining whether a taxpayer did not "treat" an individual as an employee for any period for section 530 relief purposes. These guidelines note that treatment as an employee includes such actions as withholding income tax or Federal Insurance Contributions Act (FICA) tax from the individual's wages or filing employment tax returns for a period with respect to the individual.

Where the taxpayer treats the individual as a non-employee by filing a Form 1099, this would support a determination that the taxpayer did not treat the individual as an employee, as required under section 530(a)(1)(A). However, it must be noted that

this determination is highly fact specific and that section 530 requires review of several additional related factors to determine if employment tax relief is appropriate. The taxpayer's filing of a Form 1099 for the individual must be consistent with its treatment of the individual as a non-employee. Revenue Act of 1978 § 530(a)(1)(B). Further, the taxpayer must also not have treated any individuals with substantially similar positions as employees for employment tax purposes for any period after 1977. Revenue Act of 1978 § 530(a)(3). Finally, the taxpayer must have had some reasonable basis for treating the individual as a non-employee. Revenue Act of 1978 § 530(a)(1).

When asking if section 530 applied to all corporate officers, you also asked how Revenue Ruling 82-83 affected treatment of corporate officers under section 530. Revenue Ruling 82-83 involved a corporation that treated its officers as independent contractors, without reliance on any "safe haven" basis under section 530(2)(A), (B) or (C), and characterized their compensation as "draws" rather than as "salaries." Rev. Rul. 82-83, 1982-1 C.B. at 151. Additionally, the officers were compensated, as independent contractors, for services that are typical and customary for officers to perform (i.e., fundamental decisions regarding corporate operations) and that are rarely delegated to independent contractors. Id. at 152. The ruling explained that "[i]t is a question of fact in all cases whether officers of a corporation are performing services within the scope of their duties as officers or whether they are performing service as independent contractors." Id. Based on those facts, it was held that the corporation was not entitled to section 530 relief because there was no reasonable basis for it to treat its officers as non-employees, even with a liberal interpretation of the reasonable basis requirement in section 530.

Revenue Ruling 82-83 provides useful guidance when evaluating whether a corporation had some reasonable basis for treating corporate officers as non-employees, as required by section 530(a)(1). It also can serve as an example to illustrate that section 530 has two separate threshold requirements that must be met prior to application - "treatment" and "reasonableness." The initial requirement is that a taxpayer must properly "treat" the individual as a non-employee (including the reporting requirements and consistency requirements). Then, if properly "treated" as a non-employee, that treatment must have been "reasonable." Reasonableness can be established by the use of statutory standards (reasonable reliance on one of the three standards provided in section 530(a)(2)) or by some other means. Both requirements are highly fact specific and Revenue Ruling 82-83 illustrates that, although the officers might have been properly "treated" as non-employees, that treatment was not "reasonable" under the facts of that case.

Therefore, filing a Form 1099 may establish that a taxpayer did not "treat" a corporate officer as an employee (where that filing was consistent with its treatment of the officer as a non-employee in other non-filing contexts, and where other individuals with substantially similar positions were not treated as employees). Then, prior to application of section 530 relief, it must be separately determined whether the taxpayer also had a "reasonable basis" for treating the officer as a non-employee (based on the statutory standards or by some other means).

2. Notice of determination issuance where the worker is a corporate officer

Section 7436 of the Internal Revenue Code provides the Tax Court's jurisdictional requirements in order for it to review determinations made by the Service that workers are employees for purposes of subtitle C of the Code or that the person for whom services is performed is not entitled to treatment under section 530 of the Revenue Act of 1978. Specifically, I.R.C. § 7436(a) describes the Tax Court's authority to review such determinations upon the filing of a petition if:

> . . . in connection with an audit of any person, there is an actual controversy involving a determination by the Secretary as part of an examination that -
> (1) one or more individuals performing services for such person are employees of such person for purposes of subtitle C, or
> (2) such person is not entitled to the treatment under subsection (a) of section 530 of the Revenue Act of 1978 with respect to such individual.

This language describes the three requirements that must be met before the Tax Court can review a Service determination. *See* T.C. Rule 290(b). Because a prerequisite to Tax Court review is that the taxpayer received a notice of determination, the requirements of I.R.C. § 7436 must also be met prior to the issuance of a notice of determination. *See* Notice 98-43, 1998-33 I.R.B. 13; *see also* Rev. Proc. 99-28 at § 4.01(5). Indeed, Revenue Procedure 99-28 states, in section 4.01(5), that employment taxes dependent upon the determination of an individual's status as an employee or upon a determination of the application of section 530 cannot be assessed unless the taxpayer has been given an opportunity to file a petition for review by the Tax Court regarding those issues.

Therefore, the requirements for issuing a notice of determination are: (**1**) that an audit was conducted (i.e., the Service did not determine that employment taxes were due as the result of non-audit procedures such as the discovery of mathematical errors, or that workers should be classified as employees based on a private letter ruling or an evaluation of a Form SS-8); (**2**) that there is an "actual controversy" (e.g., not purely an academic exercise - taxes will be assessed as a result of the determination, and the taxpayer must have been determined to be the employer); and (**3**) *either* (**a**) one or more of the individuals that provided service for the taxpayer were employees for the purposes of subtitle C (i.e., Federal Insurance Contributions Act (FICA), Federal Unemployment Tax Act (FUTA), and Railroad Retirement Tax Act (RRTA)), *or* (**b**) that the taxpayer is not entitled to relief under section 530. However, Notice 98-33, 1998-33 I.R.B. at 13 notes that, in order to provide taxpayers with the opportunity to resolve both issues in one judicial determination, the Service will issue a notice of determination only after it has determined both that a person providing service is an employee and that the taxpayer is not entitled to relief under section 530 (i.e., requirements (3)(a) and (3)(b) above).

Thus, in the context of corporate officer misclassification, a notice of determination must be issued where an audit of a corporation has resulted in an actual controversy as to the classification of corporate officers as employees for employment

tax purposes or where the Service determined that the corporation is not entitled to section 530 relief.

Examples of cases where issuance of a notice of determination would be inappropriate include: (**1**) where a corporation concedes both the classification issue and the section 530 relief issue, indicated by a signed closing agreement which explicitly indicates a waiver of restrictions on assessment in I.R.C. §§ 7436(d)(1) and 6213, creating a lack of "actual controversy" (*See* Notice 98-33, 1998-33 I.R.B. at 14); (**2**) where the audit involves employment-related issues not arising under subtitle C (e.g., the classification of corporate officers for pension plan coverage or treatment of individual income tax deductions) (Id. at 13); (**3**) where the Service determination was not made as part of an audit of the corporation (Id.); and (**4**) where the corporation already treats its officers as employees (by withholding income taxes and the employee portion of the FICA taxes, by paying the employer's portion of the FICA taxes, and by issuing Forms W-2 to the officers) and the issue is whether certain payments were wages subject to employment tax.

Conversely, examples of cases where issuance of a notice of determination would be appropriate include: (**1**) where a corporation conceded neither the classification issue nor the section 530 relief issue; (**2**) where a corporation concedes either the classification issue or the section 530 relief issue; (**3**) where the Service determination was made as part of an audit and involved employment taxes; and (**4**) where the corporation had not already treated its officers as employees.

Perhaps one of the scenarios most frequently encountered by examiners is where a corporation treats corporate officers as independent contractors and all payments as payments to independent contractors by filing Forms 1099 and not filing Forms W-2. Where the Service proposes an assessment of employment taxes for payments as remuneration for services performed as corporate officers and the corporation did not treat the officers as employees (i.e., filed Forms 1099), a controversy would exist as to whether the officers were employees. Therefore, a notice of determination should be issued. A related controversy would exist regarding the nature of the services compensated. Although regulations indicate that, generally, corporate officers are employees of the corporation, regulations also indicate that an officer is not considered an employee of the corporation where the officer performs only minor services and does not receive (and is not entitled to receive) any remuneration. Treas. Reg. § 31.3401(c)-1(f). Further, directors of a corporation, serving in that capacity, are not employees of the corporation. Id.

3. CSP relief where compensation to a corporate officer has been mischaracterized

The Classification Settlement Program (CSP) establishes standard settlement agreements in worker classification cases, and allows businesses and tax examiners to resolve worker classification cases as early as possible in the administrative process. *See* IR 96-7, 1996 I.R.B. LEXIS 76; FS-96-5, 1996 I.R.B. LEXIS 75; Employment Tax Handbook, § 104.6.6. Cases within the CSP involve determinations by the Service that a worker is an employee and that the taxpayer is not entitled to section 530 relief.

Where a business issued timely Forms 1099 for payments it made to a corporate officer and treated that officer as an independent contractor, the business is eligible for the CSP. Employment Tax Handbook, § 104.6.6.7(5).

However, section 104.6.6.8(1) of the Employment Tax Handbook explains that the CSP is available exclusively for worker classification issues. Because CSP is available exclusively for worker classification issues, the CSP is appropriate for use where the business clearly meets the section 530 relief requirements but would rather treat workers as employees. Employment Tax Handbook § 104.6.6.6(2). A CSP offer for prospective treatment allows the taxpayer to begin treating the workers as employees without negating their claim for section 530 relief as to prior years. Id.

Section 104.6.6.8(7) specifically excludes for CSP consideration cases which involve reclassifying distributions to officers/shareholders as wages. Therefore, for example, where a taxpayer already treated an officer/shareholder as an employee and the Service determined that some profit distributions should be characterized as wages, the case would not be eligible for the CSP, per section 104.6.6.8(7) of the Employment Tax Handbook. Additionally, section 104.6.6.8(1) states that the CSP is not available for issues other than worker classification, which "includes cases in which a threshold issue, such as the nature of a payment as dividends or wages, has not been resolved at the examination level." The CSP is available exclusively for worker classification issues. Employment Tax Handbook § 104.6.6.8(1). Accordingly, CSP is not available to resolve issues involving the nature of compensation paid to corporate officers.

4. Corporate officer status misclassification and application of section 3509 rates

Section 3509 of the Internal Revenue Code reduces an employer's liability for income tax withholding and the employee portion of the FICA taxes where the employer failed to deduct and withhold those taxes because it treated the employee as a non-employee. That liability is reduced to 1.5% of the employee's wages for income tax withholding and 20% of the employees' portion of the FICA tax. I.R.C. § 3509(a). However, if the employer failed, without reasonable cause, to comply with applicable information reporting requirements consistent with the treatment of the employee as a non-employee, those percentages are doubled. I.R.C. § 3509(b). The employer is liable for the full tax where it intentionally disregarded the deduction and withholding requirements. I.R.C. § 3509(c).

However, § 3509 reductions do not apply to the reduction of the employer's liability for the employee's portion of the FICA taxes for those statutory employees described in § 3121(d)(3) (i.e., certain agent- or commission-drivers, those who sell life insurance full-time, home workers, and traveling or city salespersons). I.R.C. § 3509(d)(3). This exception is without regard to whether the individual is otherwise described in § 3121(d)(1) or (2) (i.e., a corporate officer or common law employee). Id. In other words, if the individual could be classified as either a corporate officer under § 3121(d)(1) or a statutory employee as described in § 3121(d)(3), then § 3509 reductions of the employer's liability for the employee's portion of the FICA taxes would be inapplicable. Similarly, if the individual could be classified as either a common law

employee under § 3121(d)(2) or a statutory employee as described in § 3121(d)(3), then § 3509 reductions of the employer's liability for the employee's portion of the FICA taxes would be inapplicable.

This is further explained in proposed regulation § 31.3509-1(d)(3) which notes that § 3509 does not apply to social security taxes of individuals described in § 3121(d)(3). "[I]f an individual would be an employee under section 3121(d)(3) but for the fact that such individual is an employee under section 3121(d)(1) or (2), such individual shall be treated as an individual described in section 3121(d)(3)."

Therefore, in the context of corporate officers, § 3509 reductions are applicable, unless the corporate officer could also be classified as an agent- or commission-driver, a full-time life insurance salesperson, a home worker, or a traveling or city salesperson. In a case where a corporate officer could also be classified as an employee under § 3121(d)(3), then the § 3509 rates apply only as to the employer's liability for income tax withholding and not as to the employer's liability for the employees' portion of the FICA taxes.

We hope this discussion will be helpful to you. If you have any questions, please contact me at (202) 622-6040.

Lynne Camillo