

Tax Issues Concerning Independent Contractors and Loan-Out Corporations¹

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Part 1 - Independent Contractor

I. Employee/Independent Contractor Classification

A critical question faced by a business is whether the business is obligated to withhold and pay over employment taxes to the IRS on wages it pays to its workers. This liability hinges upon whether the workers are properly classified as employees or as independent contractors. For this purpose, classification of a worker as an employee or independent contractor is subject to the "common law test" set out in Regs. §31.3401(c)-1 (income tax withholding), Regs. §31.3121(d)-1 (FICA), and Regs. §31.3306(i)-1 (FUTA). This test generally provides that the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. It is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he or she has the right to do so.

A. Consequences of Employee Characterization

If the worker is classified as an employee, the following consequences flow:

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FICA. The worker's wages are subject to tax under the Federal Insurance Contributions Act ("FICA"), which is imposed equally on both the employer and worker under §§3102(a) and 3111. Currently, the FICA tax rate is equal to 7.65% for both employer and employee (for a combined rate of 15.30%). For 1993, the Social Security portion of the FICA tax is 6.2%, and is imposed on a taxable wage base of up to \$57,600. The Medicare portion of the FICA tax is 1.45%, and is imposed on a taxable wage base of up to \$135,000. (The dollar limit on wages subject to the Medicare portion of the FICA tax was repealed by the Revenue Reconciliation Act of 1993, P.L. 103-66, §13207, for wages received after December 31, 1993). The employer may deduct its share of FICA tax.

FUTA. The employer is subject to tax under the Federal Unemployment Tax Act ("FUTA") which is imposed at the rate of 6.2% on the first \$7,000 of wages paid to the worker (partially subject to credit for state withholding). §3301.

Income Tax Withholding. The employer is required to withhold and pay over federal and state income taxes imposed on the worker on the wages paid by the employer. §3401.³

Qualified Plans. The worker is not entitled to maintain his or her own Keogh or corporate qualified pension plan. §401. The worker may be entitled to maintain an Individual Retirement Account ("IRA") and to deduct up to \$2,000 (\$2,250 for a spousal IRA) per year. §§219 and 408. If the worker or the worker's spouse is an active participant in a qualified retirement plan, the deductible IRA amount is phased out to the extent the worker's adjusted gross income exceeds \$10,000. The deduction is totally phased out for single workers whose adjusted gross income equals or exceeds \$35,000, for married taxpayers filing jointly whose adjusted gross income equals or exceeds \$50,000, and for married workers filing separate returns whose adjusted gross income equals or exceeds \$10,000 or more. The employer generally is required to include the worker in its pension plans and other fringe benefit plans available to employees.

State Taxes. The employer may be required to withhold and pay state disability taxes from employee wages, make contributions to a state unemployment fund, and withhold and pay over state income taxes from the worker's wages.

Workers' Compensation. The employer may be required to include the worker in its workers' compensation insurance program. In the case of injury, workers' compensation coverage may produce a lower award than that obtainable under general tort law principles that would apply if the worker was instead classified as an independent contractor.

³See Rev. Rul. 92-106, 1992-49 I.R.B. 7, for tax and withholding obligations imposed on U.S. and foreign employees for U.S. citizens and residents working abroad.

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Itemized Deductions. The worker will not be entitled to deduct "itemized miscellaneous deductions" to the extent they do not exceed 2% of the worker's adjusted gross income. §67. Such expenses include travel, transportation and entertainment expenses, and union or professional dues. Regs. §1.67-1T(a)(1)(i). Miscellaneous itemized deductions are not deductible at all for purposes of computing alternative minimum tax (§56(b)(1)(A)), and substantial alternative minimum tax may result in the case of some employees, e.g., entertainers who pay large agent fees, business management fees, and the like.

An employee is also more adversely affected than an independent contractor by the provisions of §§68 and 151(d). Section 68 reduces the amount of certain itemized deductions that an individual may deduct by the lesser of (i) 3% of the excess of the taxpayer's adjusted gross income over \$100,000 (\$50,000 in the case of a married taxpayer filing separately), or (ii) 80% of itemized deductions. Section 151(d) phases out an individual's personal exemptions once the taxpayer's adjusted gross income reaches a prescribed threshold (\$100,000 for single taxpayers, \$150,000 for married taxpayers filing jointly, \$125,000 for a married taxpayer filing as head of household, and \$75,000 for married taxpayer filing separately). The limitation in §68 and the phase-out in §151(d) are based on a taxpayer's adjusted gross income, which will generally be greater for an employee who cannot deduct certain business expenses above the line like an independent contractor can.

Home Office Expense. The worker can deduct home office expenses only if the use of the home office is for the convenience of the worker's employer and other applicable requirements are met. §280A(c)(1).

B. Consequences of Independent Contractor Characterization

If the worker is deemed to be an independent contractor, the following consequences flow:

SECA. The worker must pay tax under the Self-Employment Contributions Act ("SECA") on self-employment income under §1401. SECA is now equal to the combined FICA rate, which is imposed for 1993 on employers and employees at a rate of 12.4% on a taxable wage base of up to \$57,600 and 2.9% on a taxable wage base of up to \$135,000. (The dollar limit on self-employment income subject to the Medicare portion of the FICA tax was repealed by the Revenue Reconciliation Act of 1993, P.L. 103-66, §13207, for income received after December 31, 1993). The worker may deduct one-half of SECA tax paid. §1401(c).

Estimated Income Tax Payments. The worker is responsible for making quarterly estimated federal and state income tax payments.

Qualified Plan. The worker is entitled to maintain his or her own qualified Keogh plan (Regs. §1.401-

10), or if a corporation, a qualified corporate pension plan. This allows the worker to determine how much he or she will contribute to a qualified pension plan, subject to applicable limitations, in contrast to an employee who is subject to the employer's decision. In addition, the amount of the contribution may not be dependent upon the amount contributed for other workers as is the case in a plan sponsored by an employer for the benefit of its employees.

Loan-Out Corporation. If a loan-out corporation is utilized, the worker is treated as an employee of the corporation and the corporation is required to pay employment taxes and withhold taxes as described above for employees.

C. Motivation of Parties to Classify Workers as Independent Contractors

There are a number of reasons why both employers and workers may prefer that their relationship be structured as an independent contractor relationship. Hiring independent contractors enables the employer to match labor to its business needs and not be encumbered by large, permanent payrolls; to simplify accounting burdens; and to avoid union and collective bargaining agreements. Hiring independent contractors further serves to reduce the employer's workers' compensation insurance premiums but may expose the employer to greater liability under general tort laws in the event of injury. From the worker's perspective, he or she may be able to earn greater income working as an independent contractor for multiple employers since his or her compensation is not reduced by the cost of employee benefit plans. In addition, the independent contractor may have greater flexibility in timing tax payments.

II. IRS Tests for Determining Classification

The IRS is not bound by the parties' characterization of their relationship and will independently evaluate whether the worker is an employee or an independent contractor. In Rev. Rul. 87-41, 1987-1 C.B. 296, the IRS set forth 20 factors it will review in making this determination. These factors are:

Instructions or Degree of Control. An employer generally exercises a much greater degree of supervision and control over the details of the work being done (i.e., to instruct when, where, and how the work is to be done) by employees than by independent contractors.

Furnishing of Training. An employer generally does not provide any training to independent contractors or to employees of an independent contractor.

Integration. An independent contractor generally engages in projects that are not a part of the day-to-day operations of the company.

Services Rendered Personally; Right to Delegate

Work. An employee is generally required to render the requested services personally whereas an independent contractor has the right to bring in whomever he or she pleases to accomplish the purpose of the contract.

Right to Hire, Supervise, Pay, and Fire Assistants. An independent contractor agrees to provide the labor necessary to accomplish the purpose of the contract and has the right to hire, supervise, pay, and fire assistants. In contrast, if the person for whom the services are performed has these rights, an employee relationship is indicated.

Continuing Relationship. An independent contractor is generally hired for a specified time period whereas an employee is generally hired for an indefinite period of time.

Control Over Hours of Work. The employer's right to set the hours worked indicates employee status. Independent contractors are generally allowed to set their own hours, subject to reasonable requests from the employer, *e.g.*, that work not be performed during specified hours.

Independent Trade; Full Time Work. An employer for whom services are provided, has greater control over a worker who must work full time for him. An independent contractor is generally not required to work full-time or exclusively for the employer and may work for multiple employers simultaneously.

Place of Work. Working on the employer's premises indicates employer control and employee status.

Sequence of Work. An employer does not direct an independent contractor as to the sequence in which the work should be performed; the employer directs only the outcome of the work to be obtained and not the manner in which it is obtained.

Reports Required. An independent contractor is generally not required to submit regular reports or attend regular company meetings.

Payment by Hour, Week or Month. An independent contractor is generally paid by the job whereas an employee is generally paid by the hour, week or month.

Payment of Business and/or Travel Expenses. A worker whose business and/or travel expenses are reimbursed by the person for whom services are performed is ordinarily an employee, whereas an independent contractor typically bears his or her own expenses.

Furnishing of Tools. An independent contractor generally provides his or her own tools whereas an employee is provided tools by the employer.

Investment in Facilities. Independent contractor status is indicated where the worker has made a significant investment in facilities used in performing services. Lack of an investment in facilities indicates dependence upon the person for whom services are provided and employee status.

Profit and Loss. An independent contractor gener-

ally bears the risk of making a profit or loss on a job, *e.g.*, the real risk of economic loss from significant facility investments or through bona fide liability for expenses incurred in performing services. An employee generally does not bear a real economic risk.

Working for More than One Firm. An independent contractor frequently works for many firms simultaneously.

Making Work Available to the General Public. A worker who makes his or her services available to the general public on a regular and consistent basis is generally an independent contractor.

Right to Discharge. As an independent contractor relationship is contractual in nature, an employer cannot terminate an independent contractor who is fulfilling obligations under his contract without incurring liability for breach of contract. In contrast, an employer may terminate an employee at will, absent a written employment contract and subject to limitations under applicable labor and tort laws.

Right to Terminate. If a worker has the right to terminate the relationship at any time without incurring liability, an employee relationship is indicated.

A. Case Law

In determining independent contractor/employee status, in addition to the 20 factors listed in Rev. Rul. 87-41, the courts have frequently considered the following factors:

1. *Skill Required.* A worker is more likely to be an independent contractor if either a special or a high degree of skill is required. Generally, other attributes of independence are present as well, for example, highly skilled workers typically do not receive training, set their own order or sequence for accomplishing the work, are not given detailed instructions, and make their services available to the general public.

2. *Intent of the Parties.* The mutual, good faith expectations of the parties is evidence of the manner in which they deal with each other.

3. *Custom In the Industry.* The existence of an independent trade, business or profession indicates independent contractor status. Generally, in these cases, the workers are either highly skilled, offer their services to the general public, are not subject to instructions, bear the risk of profit or loss, or some combination thereof.

B. Statutory Employees

For FICA tax purposes under §3121(d), the following are deemed to be employees without regard to their status under the common law test:

- any officer of a corporation;
- any of the following types of workers *except* where the worker has a substantial investment in the facilities used in connection with the perform-

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ance of services (other than transportation vehicles), or the services are in the nature of a single transaction that is not part of a continuing relationship:

A. a driver, paid as an agent or on commission, who distributes meat products, vegetable products, food products, bakery products, beverages (other than milk), or laundry or dry cleaning services;

B. a full-time life insurance salesman;

C. a homemaker performing work, according to specifications furnished by the person for whom services are performed, on materials or goods furnished by such person to whom the materials or goods are returned upon completion of the services; and

D. a full-time traveling or city salesman who solicits and transmits orders on behalf of a single principal from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments.⁴

C. Statutory Independent Contractors

Section 3508 and Regs. §31.3508-1 provide that two classes of workers are statutory independent contractors:

1. licensed real estate agents; and
2. direct sellers engaged in the trade or business of selling or soliciting the sale of consumer products.

Under these provisions, eligible real estate agents and direct sellers are statutory independent contractors only if:

- substantially all of the remuneration for the services performed is directly related to sales or other output rather than to the number of hours worked; and
- the services are performed pursuant to a written contract between the worker and the service recipient, and such contract provides that the worker will not be treated as an employee for federal tax purposes.

D. Section 530 of the Revenue Act of 1978

Section 530 of the Revenue Act of 1978 (hereinafter "§530" or "Section 530"), as amended by §269 of the Tax Equity and Fiscal Responsibility Act of 1982 and §1706 of the Tax Reform Act of 1986 (1986

⁴ Rev. Rul. 90-93, 1990-2 C.B. 33, provides that a statutory employee's business expenses are deductible on Schedule C, since statutory employees are not employees for purposes of §§62 and 67.

TRA),⁵ prohibits the IRS from reclassifying independent contractors as employees in certain limited circumstances. Section 530 provides that if a business:

- did not treat an individual as an employee for any period;
- filed all tax returns (including Form 1099) on a basis consistent with its tax position for all post-December 31, 1978, tax periods; and
- had a "reasonable basis" for treating the worker as an independent contractor,

then the business will not be liable for back taxes or penalties or obligated to withhold employment taxes in the future.

For this purpose, "reasonable basis" means:

- reliance on a case or published ruling or technical advice memorandum, private letter ruling or a determination letter pertaining to the taxpayer, that supports the taxpayer's classification (see TAM 8711004; TAM 8216003; and TAM 8127010);
- reliance on a previous IRS audit in which the independent contractor treatment resulted in no assessment (see *Lambert's Nursery and Landscaping Inc. v. U.S.*, 90-1 USTC ¶50,184 (5th Cir. 1990); Rev. Rul. 83-152, 1983-2 C.B. 172); or
- reliance on long-standing practice of a significant segment of the taxpayer's industry in treating workers of the type in question as independent contractors.⁶

The IRS has taken a very restrictive view as to the scope of §530. In *General Investment Corp. v. U.S.*, 823 F.2d 337 (9th Cir. 1987), the IRS argued that, to obtain §530 relief, the taxpayer must show that the industry practice in question was nationwide and not only regional. The Ninth Circuit rejected this view, agreeing with the taxpayer that it need only prove the practice of like companies operating in the taxpayer's immediate vicinity. In TAM 8733004, the IRS interpreted the phrase "significant segment" to mean "nearly all" and ruled that 60% of similarly situated employers in the applicable area was insufficient. In TAM 8749001, the IRS ruled that the industry prac-

⁵ Section 1706 of the 1986 TRA amended §530 to exclude certain technical workers from §530 relief, including engineers, designers, draftsmen, computer programmers, systems analysts or other similarly situated workers engaged in a similar line of work where the worker provides services pursuant to an arrangement entered into by the taxpayer and another person, e.g., a broker. A technical service worker providing services through a personal service corporation would appear to be subject to this amendment. Section 530 applies only to employment taxes and not with respect to other matters, e.g., eligibility to establish a qualified pension plan.

⁶ Rev. Proc. 85-18, 1985-1 C.B. 518, generally discusses the applicability of §530.

tice safe harbor is not available in the case of a new industry that did not exist in 1978 when §530 was originally enacted and the industry practice, therefore, was not "long-standing."

Rev. Proc. 85-18, ¶3.03, provides that withholding of either income taxes or FICA taxes or the filing of any employment tax return with respect to a worker constitutes "treatment of the worker as an employee," in which case §530 is not available. This does not include the filing of a delinquent or amended tax return for the tax periods *under audit* so long as the filing is a result of IRS "compliance procedures." If the taxpayer withholds employment taxes or files employment tax returns for tax periods after those that were under audit, such actions may constitute inconsistent treatment and §530 relief will be denied. In *Henry v. U.S.*, 793 F.2d 289 (Fed. Cir. 1986), the "consistent treatment" limitation was invoked to deny §530 relief where the taxpayer began treating its workers as employees following a IRS imposed change. The IRS ruled in Rev. Rul. 81-224, 1981-2 C.B. 197, that the "consistent treatment" requirement precludes §530 relief if a Form 1099 was not timely filed for the worker in question. Treatment of some similarly situated workers as employees and others as independent contractors also violates the consistency requirement.

If a taxpayer does not satisfy one of the safe harbors, the taxpayer may nevertheless qualify for §530 relief if it can demonstrate that another reasonable basis exists for not treating the workers as employees.⁷

E. Dual Status Workers

An individual can be both an employee and an independent contractor with respect to a single employer, *e.g.*, both an officer (employee) and a director (independent contractor) of a corporation. Rev. Rul. 57-246, 1957-1 C.B. 338. In Rev. Rul. 58-505, 1958-2 C.B. 728, the IRS acknowledged that a person may be an officer, and therefore a statutory employee, while at the same time being an independent contractor under the common law test regarding sales commissions received from the same company. In Rev.

⁷ See *American Institute of Family Relations v. U.S.*, 79-1 USTC ¶9364 (D.C. Cal.) (holding that a taxpayer is entitled to §530 relief where it had reasonably concluded that it did not exercise sufficient control over the workers in question to be deemed employees under the common law test); PLR 9004040 (acknowledging that a letter from the Social Security Administration provides a reasonable basis for §530 relief); *but see* TAM 8925001 (where the IRS narrowly read the *American Institute* case) and TAM 9033003 (where the IRS ruled that a written statement by an IRS Revenue Officer, made in connection with a compliance interview, that it was local industry practice to treat a certain type of worker as an independent contractor was not sufficient authority to constitute a reasonable basis for such treatment).

Rul. 69-421, 1969-2 C.B. 59, Part 2(j)(4), the IRS acknowledged that it is possible for an attorney to be a salaried employee of a corporation and maintain a separate practice with respect to which he is self-employed.

F. Who is the Employer

In general, the employer of an employee is the party for whom the employee performs services. §3401(d). Where a third party is involved, the "employer" is determined on the basis of which party has the right to control the manner in which the employee performs services. Rev. Rul. 87-41; Rev. Rul. 75-41, 1975-1 C.B. 323; *Packard v. Comr.*, 63 T.C. 621 (1975).

Rev. Rul. 57-93, 1957-1 C.B. 328, and PLR 8822004 indicate that it is possible for a person to have more than one employer with respect to the same services, *e.g.*, where several unrelated employers use a single receptionist.⁸

Section 3401(d)(1) provides that, notwithstanding who would otherwise be an individual's employer, another party who has control over the payment of wages to the employee must be treated as the employer for income tax withholding purposes. For FICA and FUTA tax purposes, the courts have held that control over the payment of wages is likewise determinative.⁹ For example, in TAM 9313004, a union-authorized talent payment agency, through which advertising and production agencies that were not union-authorized signatories paid their performers, was ruled to be the employer for employment tax purposes. The contract between the union and the talent payment agency stated that all compensation paid to performers constituted wages and required the agency to make the required payments, reports, and withholding of payroll taxes. The talent payment agency also calculated the fees due to the various parties and provided billing and payment services. Accordingly, the IRS concluded that the talent payment agency, rather than the advertising or production agencies, had control over the payment of wages.

G. Common Paymaster

Where a single individual performs *concurrent* services for related corporations, such corporations may, for purposes of applying the wage limits under FICA and FUTA, elect to act as a single employer by establishing a "common paymaster." §§3121(s) and 3306(p). A special definition of "related corpora-

⁸ See also Prop. Regs. §1.414(o)-1 for possible employee benefit consequences of using shared employees.

⁹ See *Otte v. U.S.*, 419 U.S. 43 (1974); *In re Armadillo Corp.*, 561 F.2d 1382 (10th Cir. 1977); *In re Southwest Restaurant Systems, Inc.*, 79-2 USTC ¶9578 (9th Cir. 1979).

tions" applies. Regs. §31-3121(s)-1(b)(1). Use of a common paymaster is not available for unincorporated entities.

III. Consequences of Adverse Determination

A. Employer Liability for Unpaid Employment Taxes and Other Consequences

If workers treated by an employer as independent contractors are successfully reclassified as employees, the employer is liable for its share of FICA and FUTA taxes, the employee's share of FICA taxes, employee income tax withholding, and applicable state taxes. Interest accrues on unpaid taxes, and numerous civil penalties may be imposed, including late filing (§6651), failure to deposit employment taxes (§6656), negligence or intentional disregard of the rules/understatement of tax (§6662), fraud (§6663), and aiding the understatement of tax liability (§6701).

The employer may also lose favorable tax treatment as to retirement or other employee benefit plans it maintains if omission of true employees causes it to violate applicable nondiscrimination requirements.¹⁰ Under ERISA, the employees could sue for benefits. On the other hand, if workers are incorrectly classified as employees when they are in fact independent contractors, employee benefit plans could also be adversely affected as not maintained for the "exclusive benefit of employees."¹¹

Income withholding taxes and the employee's share of FICA (the so-called "trust fund" taxes), §6672 penalties, and liabilities under §§3505 and 3509¹² are not dischargeable in the bankruptcy of an individual debtor but are with respect to corporate and other non-individual debtors. 11 USC §§507(a)(7)(C), 523(a)(1) and 1141; *See U.S. v. Sotelo*, 436 U.S. 268 (1978); *In re Push & Pull Enterprises Inc.*, 84 Bankr. 546 (N.D. Ind. 1988); *In re Jake's on the Pike*, 78 Bankr. 461 (E.D. Va. 1987); *In re John Billingsley*, No. 90-40522 (Bankr. S.D. Ill. 10/22/92). FUTA taxes and the employer's share of FICA taxes are dischargeable for corporate taxpayers and may be dischargeable for individual taxpayers, provided required returns were filed and the tax is for a period at least three years before the filing of the bankruptcy petition. 11 USC §507(a)(7)(D).

¹⁰ *See, e.g., Jim's Window Service, Inc. v. Comr.*, 33 T.C.M. 563 (1974); *Dooley v. U.S.*, 75-2 USTC ¶13,085 (E.D. Tenn. 1975).

¹¹ *See Professional and Executive Leasing, Inc. v. Comr.*, 89 T.C. 225 (1987), *aff'd*, 862 F.2d 751 (9th Cir. 1988).

¹² §§6672, 3505, and 3509 are discussed below.

B. Responsible Officer Liability — §6672

Section 6672 imposes a 100% penalty on persons responsible for the willful failure to withhold the employee's income tax and the employee's share of FICA taxes, thereby making them personally responsible for such taxes. Section 6672(b) defines "person" for this purpose to include an officer or employee of a corporation, or a member or employee of a partnership, who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs. In determining who is a "responsible person," the courts seem to look primarily at the following factors:

- Who had the power to disburse funds, *i.e.*, actually sign or co-sign corporate checks or had the authority to sign checks;
- who had responsibility for preparation and payment of the payroll; and
- who had final word as to which bills and creditors should and should not be paid.

In determining whether a failure to pay over employment taxes was "willful," the courts have held that neither an intent to defraud or deprive the government of taxes collected, nor a bad motive is required to establish "willfulness." A voluntary, conscious, and intentional act to prefer other creditors of the corporation over the government was held to be "willful" conduct in *Bloom v. U.S.*, 272 F.2d 215 (9th Cir. 1959). In *Feist v. U.S.*, 607 F.2d 954 (Ct. Cl. 1979), the court held that "willfulness" may be proven by "showing that the responsible person recklessly disregarded his duty to collect, account for, and pay over the trust fund taxes or by showing that the responsible person ignored an obvious and known risk that the trust funds might not be remitted." A fear that failure to pay creditors would be a criminal offense under state law did not negate "willfulness" in *High v. U.S.*, 506 F.2d 755 (5th Cir. 1975).

Under IRS policy, it will look to the corporation first to satisfy the liability for failure to withhold trust fund taxes and, to the extent the corporation cannot pay, only then will it seek payment from the responsible officers. IRM 1218-56.

In a recent IRS Policy Statement, the IRS indicated that it will not impose the §6672 penalty against non-owner employees who are under the dominion and control of others and who are not in a position to make independent decisions on behalf of the business entity. In addition, the penalty will not be imposed against a person who was not actively involved in the corporation at the time the tax was not being paid, unless that person intentionally withholds information to impede the IRS' investigation. Unpaid, volunteer members of a Board of Trustees or Directors of a tax-exempt organization will not be subject to the penalty to the extent they serve only in an honorary capacity,

do not participate in day-to-day or financial operations of the organization, or do not have knowledge of the failure to pay tax. IRS Policy Statement P-5-60 (2/2/93).

Where more than one person is responsible, their liability for unpaid trust fund taxes is joint and several, and the IRS may collect from both of them or from only one of them. In *Greiger v. U.S.*, 78-1 USTC ¶9,395 (D. Md. 1978), the court held that the payer could not seek contribution from other responsible persons because §6672 does not authorize such a claim and the court has no jurisdiction. Other courts have denied contribution on the ground that the §6672 penalty is a true penalty and allowing contribution would subvert its punitive purpose. *Conley v. U.S.*, 773 F. Supp. 1176 (S.D. Ind. 1991); *Marine Bank of Champaign — Urbana v. U.S.*, 739 F. Supp. 1257 (C.D. Ill. 1990). However, other courts have viewed the §6672 penalty as a collection device and allowed contribution. *Schoot v. U.S.*, 664 F. Supp. 293 (N.D. Ill. 1987); *Swift v. Levesque*, 614 F. Supp. 172 (D. Conn. 1985).

Since the §6672 penalty applies only to trust fund taxes, *i.e.*, taxes owed by the employee that the employer is obligated to withhold, and does not apply to the employer's share of FICA or FUTA taxes, it is advisable to structure payments to the IRS to apply first to the trust fund taxes.

Rev. Rul. 79-284, 1979-2 C.B. 83, *modifying* Rev. Rul. 73-305, 1973-2 C.B. 43, provides that where a taxpayer gives directions as to which taxes a payment is to be applied, the payment must be applied pursuant to those directions. The taxpayer should include such directions both in a cover letter and by a notation on the check itself. In the absence of a specific direction from the taxpayer, the IRS can allocate a payment in any manner it chooses. *Hewitt v. U.S.*, 377 F.2d 921 (5th Cir. 1967). The same is true when a payment is secured through seizure or other involuntary means. *Burch v. U.S.*, 71-1 USTC ¶9,366 (D. Colo. 1971). However, in a Chapter 11 proceeding, the Bankruptcy Court has authority to order the IRS to apply payments to the trust fund taxes first. *U.S. v. Energy Resources Co., Inc.*, 495 U.S. 545 (1990).

A few cases have held that a third party who was not a corporate official was nevertheless the responsible person. *See, e.g., U.S. v. Northside Deposit Bank*, 83-2 USTC ¶9,503 (W.D. Pa. 1983).

C. Third Party Liability Under §3505

Section 3505(a) provides that a lender, surety, or other person who is not an employer, but who pays wages directly to employees or their agent, is liable for withholding FICA and income tax from the employees' wages. Section 3505(b) provides that if a lender, surety, or other person lends funds to an employer for the purpose of paying wages, and such

person has actual knowledge (or would have had actual knowledge through the exercise of due diligence) that the employer does not intend to collect and pay over FICA and income tax, then the lender, surety, or other person shall be personally liable for such taxes, limited, however, to 25% of the amount of funds provided. The employer is entitled to credit for any taxes collected from third parties under §3505.

D. Reduced Employment Tax Liability Under §3509

Section 3509 provides for reduced employment tax liability to employers where workers are re-characterized from independent contractors to employees if certain conditions are met. If Form 1099's were filed, the employer's liability is reduced to 1.5% of wages paid to the employee (for income tax that should have been withheld), 100% of the employer's share of FICA taxes, and 20% of the employee's share of FICA taxes. If Form 1099's were not filed, the employer's liability is reduced to 3% of wages paid to the employee, 100% of the employer's share of FICA taxes, and 40% of the employee's share of FICA taxes.

No reduction is allowed where the employer intentionally disregarded its withholding obligations. Moreover, §3509 does not apply to FUTA taxes, does not permit any adjustment for interest and penalties, and does not apply where the employer withheld income taxes but did not withhold FICA taxes.

E. Abatement of Tax Under §§3402(d); 6521; and Other Provisions

Under §3402(d), an employer is entitled to a credit against income tax required to be withheld for taxes actually paid by the employee; however, this section does not provide relief from liability for any penalties or additions to the tax applicable as a result of the employer's failure to withhold. Regs. §31.3402(d)-1. Relief under §3402(d) does not apply if the reduced tax rates under §3509 apply.

Section 6521 provides for the mitigation of the effect of the statute of limitations on obtaining a refund of FICA or SECA taxes. In other words, if SECA taxes were erroneously paid when the income was employee wages and FICA taxes should have been withheld, then credit shall be given for SECA taxes paid, even if a refund of such tax would otherwise be precluded because of the statute of limitations. This type of relief is not available if the reduced tax rates under §3509 apply.

Section 6205 allows an interest-free adjustment of erroneous payments of FICA taxes and employee income tax withholding (but not FUTA taxes) if the underpayment is corrected at the time the error is ascertained and proper procedures set forth in regulations under §6205 are followed.