



Self-Employed or Not?

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FICA and Self-Employment

In a recent presentation at the Arizona Federal Tax Institute, James Hamill referred to the fact that those in our generation of CPAs (that started before LLCs) “knew” there were two categories of partners under the IRC for self-employment tax purposes—limited partners that did not pay self-employment tax and general partners who did. The only hitch was that, in fact, the Code never made a reference to general partners, so the “rule” fell apart when LLCs appeared on the scene.

Today we are going to look at another similar “rule” that many tax professionals proceed under—that if you don't pay FICA on earned income then the self-employment tax must be paid. In reality, while both taxes cannot apply to the same payment, failure to pay one doesn't automatically trigger the other. Rather the key question becomes whether one is an employee.¹

¹ In fact, as we discussed in one our very first podcasts, in certain cases it's possible for neither tax to be imposed if an amount is paid to employee for services, but paid by an entity that is not the taxpayer's

The Tax Court looked at this issue in the case of *McWhorter v. Commissioner*, TC Memo 2008-263. Mr. McWhorter ran into a number of IRS issues after he failed to file his 2002 income tax return. But by the time the trial began the only issues remaining to be decided were:

- If Mr. McWhorter was liable for self-employment taxes on payments received from Boyle Energy;
- Whether he was liable for the failure to pay penalty under §6651(a) for having failed to file a return for 2002 and
- Whether he was liable for the penalty for failing to pay estimated taxes under §6654

While the IRS would carry two of these, they would find that the court did not agree Mr. McWhorter owed the self-employment tax.

Self-Employment Taxes and FICA Taxes

The self employment tax is imposed under §1401 on self-employment income as defined in §1402. The general definition is found at §1402(a) which provides:

(a) Net earnings from self-employment

The term "net earnings from self-employment" means the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed by this subtitle which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member; except that in computing such gross income and deductions and such distributive share of partnership ordinary income or loss

Generally an employee is considered in a trade or business, so this would seem to include all employees. However, most employees are excluded by an exception found at §1402(c)(2) which provides

(2) the performance of service by an individual as an employee, other than--

- (A) service described in section 3121(b)(14)(B) performed by an individual who has attained the age of 18,
- (B) service described in section 3121(b)(16),
- (C) service described in section 3121(b)(11), (12), or (15) performed in the

employer (the issue of "SPIFFs" for car salespersons).

United States (as defined in section 3121(e)(2)) by a citizen of the United States, except service which constitutes "employment" under section 3121(y),

(D) service described in paragraph (4) of this subsection,

(E) service performed by an individual as an employee of a State or a political subdivision thereof in a position compensated solely on a fee basis with respect to fees received in any period in which such service is not covered under an agreement entered into by such State and the Commissioner of Social Security pursuant to section 218 of the Social Security Act,

(F) service described in section 3121(b)(20), and

(G) service described in section 3121(b)(8)(B);

§3121 contains the definition of wages, which is the type of income on which the FICA and Medicare taxes are imposed by §3101.

McWhorter Case

As noted initially, Mr. McWhorter failed to file a tax return for 2002, a fact that brought him to the attention of the IRS when Boyle Energy, for which he had performed services in 2002, issued a 1099-MISC reporting \$126,760 as nonemployee compensation.

The key issue is what was the nature of the relationship between Boyle Energy and Mr. McWhorter. The court outlines the general arrangement background as follows:

Commencing in 2001 and ending in 2004, petitioner performed services as a project manager for Boyle Energy Services and Technology, Inc. (Boyle Energy). Boyle Energy hired petitioner because of his knowledge of power plants and specialized knowledge and expertise in industrial pipe fitting. His work for Boyle Energy focused on industrial cleaning of steam piping in power plants as part of the process of recommissioning the plants. Petitioner received no training from Boyle Energy regarding either its procedures or on industrial pipe fitting. Petitioner's training by Boyle Energy was restricted to teaching him the recommissioning process of the company.

Petitioner's work for Boyle Energy was on a project-by-project basis. He had authority to supervise the personnel of Boyle Energy and of client companies. Petitioner did not have any hiring or firing authority over Boyle Energy personnel and had to contact Boyle Energy before removing its personnel from a job site. Petitioner had a credit card with the name of Boyle Energy on it and a business card with the company logo on it.

Petitioner invoiced Boyle Energy for services rendered per project. The invoices and the subsequent payments were at a rate of \$500 per day for petitioner's labor during 2002.

Petitioner did not provide Boyle Energy with timesheets. Boyle Energy paid the amount shown on petitioner's invoices and issued to petitioner a Form 1099-MISC, Miscellaneous Income, for 2002, reporting \$126,760 as nonemployee compensation. Petitioner received a Form 1099 from Boyle Energy for each of the years 2001, 2002, 2003, and 2004. He never received a Form W-2, Wage and Tax Statement, from Boyle Energy.

Due to his failure to file a return, the IRS prepared a substitute for return as noted below:

The Internal Revenue Service (IRS) prepared a substitute for return under section 6020(b) with respect to petitioner's Federal income tax liability. In the notice of deficiency, the IRS determined that petitioner was liable for self-employment tax on the income received from Boyle Energy.

The Dispute

Mr. McWhorter initially disputed the entire assessment, since it appears that in his view this issue wasn't really his fault, as his employer should have withheld the taxes necessary. However, by the end of the trial only the three issues originally noted were the ones he was still disputing.

On the self-employment tax issue, the IRS outlined the tests it believed applied as follows:

Respondent contends that petitioner is liable for self-employment tax under sections 1401(a) and 1402. Respondent argues that petitioner was not an employee under the definition set out in section 3121(d). See sec. 1.1402(c)-3(a), Income Tax Regs. Respondent relies on the test set out in *Breaux & Daigle, Inc. v. United States*, 900 F.2d 49, 51 (5th Cir. 1990) (citing *United States v. Silk*, 331 U.S. 704, 716 (1947)), and the following factors: (1) Degree of control, (2) opportunities for profit or loss, (3) investment in facilities, (4) permanency of relation, and (5) skill required in the operation in question. The list is not exclusive, and no one factor is controlling. *Id.*

The IRS came to the conclusion that, on balance, Mr. McWhorter was not an employee—an interesting position since it's one that many would note payroll tax examiners don't seem to come to often. The IRS conceded that the following factors would argue against their position:

- Lack of opportunity for profit or loss—Mr. McWhorter had no real expenses and was simply paid a fee for the service he performed, thus there was no real risk of loss in the enterprise
- Lack of investment in facilities—Mr. McWhorter did not need to invest in any sorts of equipment, rather making use of Boyle's facilities as needed. Again, this

argues against treating Mr. McWhorter as an employee, since employees tend to use the employer's equipment while those not in employment relationship tend to supply their own

However, the IRS felt the following factors argued that Mr. McWhorter was not an employee, but truly was an independent contractor:

- Lack of permanency in the relationship—employment relationship tend to be more permanent in nature, while contractors tend to work on specific projects for a client of a short term nature
- Degree of control—an employer tends to exercise control over the work of the employee, while contractors generally have more flexibility in the approach to getting the job done.
- Skill required in the operation—contractors are often brought in for their specialized skills, skills that could not necessarily be used consistently by the service recipient, so hiring it out makes more sense than putting an employee on the payroll

Finally, the IRS argues that:

Recognizing that this is a close case, respondent argues that the understanding of the parties to the contract should be given weight. See *McCormick v. United States*, 209 Ct. Cl. 331, 531 F.2d 554, 560 (1976); *Herman v. Commissioner*, T.C. Memo. 1986-590; *Steffens v. Commissioner*, T.C. Memo. 1984-592; *Bothke v. Commissioner*, T.C. Memo. 1980-1; *Springfield Prods., Inc. v. Commissioner*, T.C. Memo. 1979-23; *Harris v. Commissioner*, T.C. Memo. 1977-358.

The fact that Mr. McWhorter continued to work under the arrangement where Boyle treated him as an independent contractor is taken by the IRS as a concession that he implicitly agreed with that characterization. The IRS notes:

Petitioner contends that there was an ongoing dispute with Boyle Energy regarding his status. Petitioner acknowledges, however, that he worked under this arrangement from 2001 until he ended the relationship in 2004 for unrelated reasons. If there was a valid dispute as to his status, petitioner essentially acquiesced to Boyle Energy's understanding of his status by continuing to work under this arrangement. And despite the availability of persons aware of his employment status and relationship with Boyle Engineering [sic] over the period in question, such as Mike Boyle and Diane Gagnon, petitioner did not obtain any evidence to corroborate his testimony where it is at variance with documentary evidence.

The Tax Court noted, though, that the IRS could have produced its own evidence regarding the nature of the relationship, but failed to do so. The court noted that it found

Mr. McWhorter's testimony to be believable, and felt that the lack of other corroborating evidence did not overcome his testimony. As we've noted before, quite often the taxpayer's impression when telling his story is key. In this case it's even more interesting since quite often the Tax Court doesn't seem predisposed to believe the testimony of a nonfiler. I would presume that Mr. McWhorter made an extremely favorable impression on the Court in this matter, given the handicap he appeared to give himself by not having filed.

The Court agreed with the IRS that his acceptance of the status quo for so long was an issue, but noted

Petitioner's acquiescence in Boyle Energy's treatment of him as an independent contractor for tax purposes is troubling. As discussed below, he has presented no reasonable excuse for his failure to file a return and pay the income tax due. On the limited record that we have, however, we conclude that petitioner was an employee of Boyle Energy during 2002 and should have been treated as such for tax purposes.

Mr. McWhorter appears to have barely skated by on this one, overcoming what was obvious initial skepticism on the part of the Tax Court.

As it was a close case, the question of the burden of proof did become relevant. The Tax Court discussed the question of whether the taxpayer had put on credible evidence, concluding that his testimony qualified:

In respondent's pretrial memorandum, respondent referred to section 7491(a) and asserted that petitioner had failed to produce any evidence that he was an employee and not an independent contractor of Boyle Energy. At trial, however, the nature of petitioner's employment was the subject of his testimony, and his testimony was credible. In the posttrial brief, respondent does not challenge the credibility of petitioner's testimony and acknowledges that some of the relevant factors favor petitioner.

The Tax Court concluded that the burden was shifted to the IRS—and then that they had failed to carry their burden.

We are not persuaded that the factors relied on by respondent prove that petitioner was an independent contractor with respect to the services that he performed for Boyle Energy. Neither the degree of control exercised by Boyle Energy nor the amount of skill possessed by petitioner distinguishes his situation from that of a supervisory employee. We are not persuaded that a job that continued from 2001 into 2004 can be described as "impermanent". Respondent acknowledges that other factors favor petitioner. On the record that has been made, we conclude that respondent did not carry the burden of proof. Petitioner is not liable for self-employment tax for 2002.

The Court also notes that deciding that Mr. McWhorter was an employee does open up the question of his responsibility for the employee's share of FICA and Medicare, but notes:

The implication of our holding that petitioner was an employee of Boyle Energy for 2002 is that he may be liable for his share of taxes under the Federal Insurance Contributions Act, section 3101(a) and (b). That determination, however, is not within our jurisdiction in this case. See *Lucas v. Commissioner*, supra n.3; *Grooms v. Commissioner*, T.C. Memo. 1992-291.

Penalties

Mr. McWhorter did not fare as well on the question of the applicability of penalties, since he didn't have any decent explanation for his failure to deal with his 2002 taxes.

On the §6651(a) penalty for failing to file a return, the court noted

Section 6651(a) imposes additions to tax for failure to file a return and failure to pay the amount shown as tax on a return. Petitioner's only explanation of his failure to file a return for 2002 is that he did not want to sign a return saying that he was an independent contractor. He has no reasonable cause, however, for failing to file a return reporting that he received \$126,760 in compensation and other amounts of income during 2002. The failure of Boyle Energy to withhold taxes that should have been withheld neither excuses petitioner's failure to file the return and pay the taxes nor relieves him of the additions to tax under section 6651(a). See *Escandon v. Commissioner*, T.C. Memo. 2007128; *Lucas v. Commissioner*, T.C. Memo. 2000-14.

Mr. McWhorter could have filed a return that reported the income as wage income. It appears he believed he shouldn't have been liable since Boyle had not withheld taxes from his payments, but that ignores the fact that the failure to withhold meant that he had received the amounts that should have been withheld.

Regardless of how payors have reported items, the taxpayer still must file a proper return. If, in fact, Mr. McWhorter believed the proper treatment was as an employee, nothing prevented him from filing his return that way.

The penalty for underpayment of estimated taxes was also found to be due. The court noted

Section 6654 imposes an addition to tax when a taxpayer fails to make a required installment of estimated income tax. Each required installment is equal to 25 percent of the required annual payment. Sec. 6654(d)(1)(A). The required annual payment is the lesser of (1) 90 percent of the tax shown on the return for the taxable year (or, if the taxpayer filed no return, 90 percent of the tax for that year), or (2) 100 percent of the tax

shown on the return for the preceding taxable year. Sec. 6654(d)(1)(B). Because petitioner failed to file a return for 2001, his required annual payment for 2002 was 90 percent of the tax for that year. Because petitioner failed to pay any Federal income tax for 2002, the section 6654 addition to tax applies to the recomputed deficiency.

Conclusion

The issues related to FICA and Medicare taxation and the self-employment tax continue to arise in practice. In this case, the taxpayer was able to show he truly was an employee, and by doing so avoided the self-employment tax. Many of us might have been happier with a result where the IRS had won this issue, if only because most often we find the dispute running in the opposite direction—where the individual is being reclassified as an employee rather than as a contractor.

I continue in CPE presentation mode next week (and it's a principal reason why the podcasts have become less regular as I've been out on the road). Upcoming immediately I do a presentation on tax and accounting issues for construction contractors in Cincinnati, Ohio on Monday, full days on fringe benefits in Dayton, Ohio on Tuesday and Columbus, Ohio on Wednesday, and then I head to Oklahoma City, Oklahoma to present a technology update at the Oklahoma Tax Institute on Friday.

The following week I do two days in Bend, Oregon, with a session on current federal tax developments on Tuesday and basic estate and gift taxes on Wednesday. Finally I close out the next week with two four hour courses in Greensboro, NC on Wednesday, doing one on fringe benefits and another on succession planning. In addition, I have three “in house” presentations during that period for specific firms—so it's a busy time until Christmas.