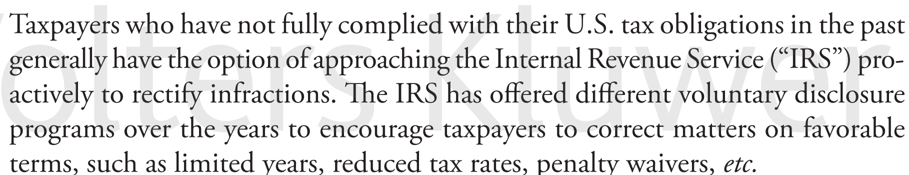
Small Employment Tax Case Triggers Big Ruling for All Voluntary Disclosure Programs

By Hale E. Sheppard*

I. Introduction



Taxpayers who have not fully complied with their U.S. tax obligations in the past generally have the option of approaching the Internal Revenue Service ("IRS") proactively to rectify infractions. The IRS has offered different voluntary disclosure programs over the years to encourage taxpayers to correct matters on favorable terms, such as limited years, reduced tax rates, penalty waivers, *etc.*

This sounds appealing in theory, but taxpayers often discover a problem in practice: The IRS sometimes takes an extreme stance regarding eligibility. One scenario is where a taxpayer applies for a disclosure program and supplies lots of confidential information about his non-compliance, the IRS unilaterally decides that the taxpayer does not satisfy all the eligibility requirements, the IRS rejects the application and starts a normal audit, the IRS issues a Notice of Deficiency asserting all possible taxes and penalties for all open years, the taxpayer opposes the IRS by filing a Petition in Tax Court, and the IRS cites cases holding that taxpayers ordinarily do not have the right to challenge in Tax Court any actions by the IRS that took place before issuance of the Notice of Deficiency, including a determination of ineligibility for a disclosure program.

This article explains four main categories of workers, key aspects of the voluntary classification settlement program ("VCSP"), evolving rules concerning jurisdiction of the Tax Court in worker-classification litigation, impactful rulings in a new case, *Treece Financial Services Group v. Commissioner*, and potential positive effects of such rulings for taxpayers applying for *any* voluntary disclosure program.[1]

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II. Categories of Workers

Readers must understand the four main categories of workers to appreciate this article. They consist of statutory employees, statutory non-employees, common law employees, and independent contractors.

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Statutory employees are, like they sound, workers defined as employees in a statute. These include officers of corporations, certain delivery drivers, insurance salespersons, homeworkers, and traveling salespersons.[2] For their part, statutory non-employees are workers specifically excluded from the definition of employee by a statute. Among them are direct sellers, who peddle consumer products, personally or through others, in a place that is not a permanent retail establishment, according to a written contract, and on a performance-driven basis.[3] Unlike the preceding two categories, common law employees are not contemplated in tax statutes; rather, they are the result of judicial evolution. One of the key factors in determining whether a particular worker is a common law employee is the degree of control that the company possesses and/or exercises over the worker.[4] The IRS released several decades ago 20 factors that still serve as a guide in this analysis.[5] Finally, independent contractors are those workers, characterized by flexibility in the manner of performing services, who do not fall into any of the preceding three categories.

Treatment of workers as employees or independent contractors is critical for many reasons, not the least of which is taxes. It is enough for purposes of this article to know that classification dictates whether a company must withhold income taxes on compensation paid to workers and remit them to the IRS, file certain forms with the IRS, pay Federal Insurance Contributions Act ("FICA") taxes and Federal Unemployment Tax Act ("FUTA") taxes, and more.[6] For legal, financial, tax, compliance, liability and other reasons, companies often prefer to categorize workers as independent contractors. The IRS, by contrast, generally prefers that companies treat workers as employees. This triggers frequent disputes.

III. Voluntary Classification Settlement Program

The IRS announced the VCSP in late 2011. Over the years, it has supplied details about the VCSP through five sources, namely, Announcement 2011-64, Announcement 2012-45, Announcement 2012-26, a set of Frequently Asked Questions ("FAQs"), and Form 8952 (*Application for Voluntary Classification Settlement Program*).

A. Purpose

The IRS has a longstanding arrangement pursuant to which certain companies that are already undergoing an employment tax audit can favorably resolve issues with the IRS. This is the Classification Settlement Program ("CSP"), which might be called an *involuntary* reclassification mechanism. Extrapolating from the CSP, the IRS decided in 2011 that a similar arrangement, exclusively for companies not currently under audit, would increase tax compliance, facilitate resolution of worker-classification disputes, and provide certainty for companies, workers, and the IRS. This is the VCSP, which is a *voluntary* reclassification mechanism.[7]

B. Settlement Terms

Announcement 2011-64 indicated that an interested company must (i) properly apply for the VSCP, (ii) pay 10 percent of the employment taxes due, only for the most recent year, as determined using the reduced rates in Code Sec. 3509, (iii) treat the relevant workers as employees in the future, (iv) extend the assessment-period for three years after reclassifying the workers, (v) execute a Closing Agreement, and (vi) make full payment. In exchange, the IRS agreed not to assert penalties, not to impose interest charges, and not to conduct a worker-classification audit.[8]

C. Triple Tax Reduction

Companies resolving matters through the VCSP get a tax break in three ways. First, the IRS only imposes employment taxes for one year, instead of for all years whose assessment period has not expired. Second, the IRS decreases the taxes for that one year by calculating them using the special rules in Code Sec. 3509. Third, after limiting the years and the rates, the IRS only charges 10 percent of taxes due.

Some historical context is helpful here. In 1982, Congress realized that two "major problems" existed with forcing a company to reclassify its workers as employees. The company could be assessed income taxes, FICA taxes, and FUTA taxes for *all* open years. In addition, overpayments of federal income taxes and FICA taxes would occur if the IRS obligated a company to pay these taxes in situations where workers had independently complied with their duties and paid such amounts already.[9] Congress, therefore, enacted Code Sec. 3509. Its goal was to simplify the law, reduce financial burdens on companies, and better approximate the true tax liabilities of a company.[10]

Here is how Code Sec. 3509 works. When a company incorrectly treats a worker as an independent contractor instead of an employee, it normally is liable for the federal income tax withholding, the worker's share of FICA taxes, the company's share of the FICA taxes, and all the FUTA taxes. However, assuming the company did not intentionally disregard its duties, Code Sec. 3509 sets reduced levels of payback. In cases where the company filed annual Forms 1099 for the workers, it merely needs to pay income tax withholding equal to 1.5 percent of the total wages

and 20 percent (instead of 100 percent) of the worker's share of FICA taxes.[11] Putting this into perspective, the percentage of the total wages that a company would have paid in 2020 to cover everything under Code Sec. 3509 was 10.68 percent.[12]

The following example shows the outcome for a company paying just 10 percent of the tax liability thanks to the VCSP, *after* it was first calculated using the special rates in Code Sec. 3509.

> In 2019, you paid $1.5 million to relevant workers. All the workers identified in the VCSP application were compensated at or below the Social Security Wage base for 2019 (*e.g.*, under $132,900). You submit the VCSP application on October 1, 2020 and intend to treat the workers as employees starting January 1, 2021. You look to amounts paid to the workers in 2019 for purposes of calculating the VCSP amount because 2019 was the most recent completed tax year. Under Section 3509, the employment taxes applicable to $1.5 million in wages would be $160,200 (*i.e.*, $1.5 million times 10.68 percent). Under the VCSP, your payment would be merely 10 percent of $160,200, which is $16,020.[13]

The preceding demonstrates that a company participating in the VCSP would only need to pay $16,200 in employment taxes on wages of $1.5 million. By contrast, a company audited by the IRS and forced to reclassify workers under normal procedures likely would have to (i) address issues for $4.5 million of wages, covering three years, instead of $1.5 million of wages, covering just one year, (ii) calculate the normal income tax withholding and FICA taxes, not the reduced amounts under Code Sec. 3509, (iii) pay 100 percent of the liability, not the 10 percent offered by the VSCP, and (iv) suffer various penalties and interest charges. Without getting into the weeds, logic dictates that the financial difference to a company between participating and not participating in the VCSP could be massive.

D. Eligibility Requirements

Announcement 2011-64 stated that, in order to be eligible for the VCSP, a company must have consistently treated the relevant workers as independent contractors and must have filed all Forms 1099 for the past three years.[14] It went on to exclude from the VCSP a company currently under *any* audit by the IRS, as well as one presently subject to a worker-classification audit by the Department of Labor or a state government agency.[15] The IRS further explained that a company previously subjected to a worker-classification audit would be ineligible, unless it has complied with the results of the earlier audit.[16] Importantly for purposes of this article, the IRS stated, without citing any authority for the proposition, that "[t]he IRS retains discretion whether to accept a taxpayer's application for the VCSP."[17]

The IRS modified the eligibility requirements approximately one year later, when it issued Announcement 2012-45. The IRS indicated that it decided to make some changes based on "feedback" from the public.[18] Regarding which companies can apply for the VCSP, the IRS tweaked the criteria in order to (i) permit participation by a company under any IRS audit, other than an employment tax audit, (ii) clarify that a company cannot partake if it is part of an affiliated group and any member of a such group is under an employment tax audit, (iii) confirm that a company cannot participate if it is engaged in worker-classification litigation stemming from an audit by the IRS or Department of Labor, and (iv) eliminate the need for a company to extend the assessment period for various years as a condition to qualify.[19] The IRS repeated in Announcement 2012-45, again without citing any legal support, that "[t]he IRS retains discretion whether to accept a taxpayer's application for the VCSP."[20]

The IRS then offered some short-term clemency in Announcement 2012-46. It introduced the "VCSP Temporary Eligibility Expansion," which allowed companies that had failed to file Forms 1099 for workers a chance to participate, too. This reprieve closed in June 2013.[21]

The FAQs supplied additional information about eligibility for the VCSP. They indicated that an inquiry by the IRS in response to a Form SS-8 (*Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*) filed by a worker is *not* considered an audit and does *not* render a company ineligible for the VCSP. They also explained that filing Forms 1099 late, but within six months of the deadline, would be considered timely for purposes of qualifying for the VCSP. Finally, they stated that a company involved in discussions with the Appeals Office after disputing an Examination Report regarding employment tax issues could not apply for the VCSP.[22]

IV. Evolving Rules regarding Tax Court Litigation

Litigation often ensues if taxpayers are unable to resolve employment tax issues during an audit or an administrative appeal. Taxpayers historically could not fight such issues in the Tax Court, which normally is the most efficient and least expensive venue for such a legal battle.[23]

This changed in 1997 when Congress passed Code Sec. 7436.[24]

A. Overview

The original law generally provided that, if in connection with an IRS examination of any person, there is "an actual controversy" involving a "determination" by the IRS that one or more workers are employees, or that the person is not entitled to Code Sec. 530 relief with respect to such workers, then the Tax Court has jurisdiction to decide whether the IRS's "determination" was correct.[25] The law further stated that only the person for whom the relevant services were performed could seek review by the Tax Court.[26] That meant that just the company, not the workers or a third party, could file a Petition with the Tax Court. In addition, the law explicitly stated that it was limited to employment taxes imposed under Subtitle C of the Internal Revenue Code, which only encompasses federal income taxes subject to withholding, FICA and FUTA.[27] Finally, the legislative history noted that "a failure to agree" would constitute a "determination" to the extent permitted under the Tax Court rules.[28]

B. Initial IRS Guidance

The IRS did not issue regulations swiftly, opting instead to provide guidance to taxpayers about Code Sec. 7436 through Notice 98-43 ("First Notice").[29] It created parameters for what, exactly, the Tax Court could resolve. The First Notice acknowledged that the Tax Court had jurisdiction to review an IRS determination about whether certain workers were employees and whether a company was entitled to Code Sec. 530 relief. However, it warned that Code Sec. 7436 did *not* authorize the Tax Court to (i) decide "any amount of employment tax or penalties," (ii) address employment tax issues beyond those in Subtitle C of the Internal Revenue Code, such as the classification of workers for pension plan purposes or the proper treatment of income tax deductions, or (iii) consider any IRS determinations not made as part of an examination, like those in Private Letter Rulings, Technical Advice Memoranda, or responses to Forms SS-8.[30]

The IRS declared in the First Notice that the Notice of Employment Tax Determination under Code Sec. 7436 ("Notice of Employment Tax Determination") constitutes its "determination" for purposes of Code Sec. 7436 and thus is a "prerequisite to invoking the Tax Court's jurisdiction."[31]

C. First Critical Case

Only a few years passed before issues arose. Specifically, a Tax Court battle occurred in 1999, which focused on whether the Tax Court had the power to determine *the amount* of employment taxes due. Based on the text of law, legislative history, and a comparison of various types of judicial actions, the Tax Court held in *Henry Randolph Consulting v. Commissioner* that it lacked the ability to decide the amount of employment taxes a company owed during a case brought under Code Sec. 7436.[32]

D. Amending the Law

Congress was displeased with the Tax Court ruling in *Henry Randolph Consulting v. Commissioner*. Accordingly, it amended the law the next year to address the jurisdictional shortcoming highlighted by that case. Code Sec. 7436 initially said that the Tax Court could judge the IRS's determination that certain workers were employees (instead of independent contractors) and/or that the company was not entitled to Code Sec. 530 relief.[33] In 2000, Congress supplemented Code Sec. 7436, stating that the Tax Court could also rule on "the proper amount of employment taxes."[34]

E. Updated IRS Guidance

The IRS needed to modernize its interpretation of Code Sec. 7436 in view of the congressional amendment in 2000. Therefore, it issued Notice 2002-5 ("Second Notice").[35] It retained much of the original information from the First Notice, while adding details focused on the Tax Court's ability to calculate the amount of an employment tax liability. Among other things, the Second Notice explained that the term "employment taxes" includes not only taxes but also related penalties.[36]

F. Two More Impactful Cases

Two cases served to refine Code Sec. 7436.

1. First Case

SECC Corporation v. Commissioner involved a worker-classification dispute in which the IRS never issued a Notice of Employment Tax Determination.[37] The taxpayer treated its workers in a dual capacity, as employees in certain contexts, and as independent contractors in others. The IRS audited and concluded that certain payments to workers should have been treated as wages. The IRS then issued an Examination Report stating that the IRS had made a "final determination on the issue," but suggesting that it did not base the proposed tax adjustments and penalties on a worker-classification determination.[38]

The taxpayer challenged the Examination Report by filing a Protest Letter. Ultimately, the Appeals Office sent the taxpayer a letter indicating that it sided with the audit team, such that the IRS would be assessing the

employment taxes and penalties.[39] Even though neither the Revenue Agent nor the Appeals Office issued a Notice of Employment Tax Determination regarding worker classification or Code Sec. 530 relief, the taxpayer filed a Petition with the Tax Court.

The Tax Court addressed the issue by analyzing other tax provisions requiring the IRS to make a "determination," the legislative history to Code Sec. 7436, the Examination Report, the letter from the Appeals Office, and the Case Memo prepared by the Appeals Office. Together, these sources indicated that the IRS can make a "determination" in non-traditional ways, a disagreement between the IRS and the taxpayer can constitute a "determination," and the IRS's own documents explain in detail the disagreement over the taxpayer's position.[40] The Tax Court concluded that "a taxpayer who is the subject of a determination by the IRS under Code Sec. 7436(a) can file suit [in the Tax Court] *without receiving a Notice of Determination*."[41]

2. Second Case

American Airlines, Inc. v. Commissioner involved payments to certain flight attendants who were based abroad, had limited contact with the United States, and worked pursuant to a restricted visa.[42] The IRS conducted an audit and took the position that the company was liable for employment taxes and mandatory income tax withholding. Wrangling before the Appeals Office ensued, with the company arguing that it was eligible for relief under Code Sec. 530. The parties could not agree, so the IRS issued a Notice of Deficiency regarding the tax withholding issue. It did not send the company a Notice of Employment Tax Determination, though.

The company filed a Petition with the Tax Court, disputing the tax withholding issues noted in the Notice of Deficiency and arguing that the Tax Court had jurisdiction to decide the worker classification and Code Sec. 530 relief matters, too, despite the fact that the IRS never issued a Notice of Employment Tax Determination.[43]

The IRS maintained that it never made a "determination," which is necessary to trigger involvement by the Tax Court. Citing *SECC Corporation v. Commissioner*, the Tax Court referenced a Technical Advice Memo issued during the audit, the Examination Report, and the Case Memo prepared by the Appeals Office. It explained that these three documents show a "clear failure to agree" about the applicability of Code Sec. 530 relief, which satisfies the concept of determination under the legislative history.[44] The Tax Court then reasoned that the IRS's assessment of employment taxes "was obviously a memorialization of [its] determination" and "was preceded by a determination rejecting" the claim of Code Sec. 530 relief by the company.[45] It also concluded that the "absence of a Notice of Determination of worker classification or any other document bearing a particular title does not bar our jurisdiction."[46]

G. More Updated IRS Guidance

The IRS found itself in need of updating its guidance regarding Code Sec. 7436 yet again after the Tax Court decisions in *SECC Corporation v. Commissioner* and *American Airlines, Inc. v. Commissioner*. It did so by releasing Rev. Proc. 2022-13 ("Third Notice").[47]

The Third Notice acknowledges that the IRS previously stated that (i) a company must receive a Notice of Employment Tax Determination from the IRS before it can file a Petition with the Tax Court, and (ii) the IRS would only issue a Notice of Employment Tax Determination after it had determined that *both* certain workers were employees *and* the company was not eligible for Code Sec. 530 relief.[48] The Third Notice then explains that the two recent cases expanded the Tax Court's jurisdiction beyond the earlier limits described in the First Notice and Second Notice.[49] According to the Third Notice, taxpayers may now lodge a Petition with the Tax Court regarding determinations by the IRS about worker classification or Code Sec. 530 relief, even if the IRS fails to issue a Notice of Employment Tax Determination, as long as certain criteria are met.[50]

V. Newest Tax Court Case

The Tax Court issued a decision in April 2022, *Treece Financial Services Group v. Commissioner*, which facially appears to affect *only* employment tax issues.[51] It has much broader significance, though.

The company filed a Form 8952 with the IRS in October 2018, seeking to participate in the VCSP. The IRS rejected such Form 8952 a few months later, in February 2019, stating that the company was ineligible because it was "under an employment tax examination by the IRS."[52]

Then, in October 2019, the IRS completed its audit and sent the company a Notice of Employment Tax Determination Under Code Sec. 7436 ("Notice of Employment Tax Determination") reclassifying just one individual, Mr. Treece, as an employee instead of an independent contractor. The Notice of Employment Tax Determination demanded employment taxes for 2015, 2016, and 2017, as well as various penalties and interest. The company filed a timely Petition with the Tax Court disputing the IRS's claims.[53]

The parties agreed to dispense with various issues after some reflection. For instance, the parties stipulated that

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Mr. Treece was the sole corporate officer of the company, he was a statutory employee, and the company was not entitled to Code Sec. 530 relief, which would have eliminated all employment taxes for past years and allowed the company to continue treating Mr. Treece as an independent contractor going forward. The parties further concurred about the amount of employment taxes that the company would owe for 2015, 2016, and 2017, if it were not eligible for the VCSP. However, the parties diverged over whether the company was eligible for the VCSP and who, exactly, gets to decide this paramount issue.[54]

The parties sought guidance from the Tax Court, with the IRS filing a Motion to Partially Dismiss for Lack of Jurisdiction, and the company submitting a Motion for Summary Judgment. The IRS essentially argued that the Tax Court lacks authority in worker-classification cases brought under Code Sec. 7436 to review the IRS's earlier decision that the company was not suitable for the VCSP. For its part, the company contended that it met all the VCSP criteria, the IRS abused its discretion in denying its Form 8952, and the tax liability should be calculated according to the terms of the VCSP. This would mean tax exposure for only 2017, application of special rates under Code Sec. 3509, payment of only 10 percent of the reduced tax liability, and waiver of penalties and interest.[55]

The Tax Court began by clarifying that it has authority to decide whether it has jurisdiction over a particular case or issue. It then explained that, when it comes to worker-classification disputes filed pursuant to Code Sec. 7436, the Tax Court generally can decide whether (i) workers are employees or independent contractors, (ii) the company can benefit from Code Sec. 530 relief, if workers are deemed employees, and (iii) the proper amount of employment taxes.

Next, citing a long line of authorities, the Tax Court indicated that its jurisdiction "includes reviewing administrative determinations [by the IRS] that are necessary to determine the merits of the deficiency determinations." Referencing the same authorities and others, the Tax Court went on to emphasize that "[t]here is a strong presumption that an act of administrative discretion [by the IRS] is subject to judicial review." The Tax Court also underscored that Congress amended Code Sec. 7436 in 2000 to confirm that the Tax Court had authority to figure the amount of employment taxes due. The Tax Court then arrived at the following conclusion:

> [W]e conclude that this Court has jurisdiction to determine whether the liability is correct in proceedings for determination of employment status. *Because the denial of a taxpayer's eligibility for VCSP directly affects the amounts of tax, the procedures that Congress has established for judicial review of the [IRS's] determination logically contemplate review of such denial as one element of the determination*.[56]

It is helpful to take a step back at this point. There is a general presumption in federal tax disputes that determinations made by the IRS during an audit are correct.[57] In other words, when the IRS alleges in a Notice of Deficiency or similar document that a taxpayer owes additional taxes, penalties, and interest, the Tax Court starts with the notion that what the IRS claims is true.[58] What occurred before that time, such as during the audit and/or any administrative appeal, normally is irrelevant to the Tax Court.[59] Tax professionals often refer to this as the prohibition against "looking behind" a final notice from the IRS.

Anticipating complaints by the IRS in *Treece*, the Tax Court took the initiative to state that its ruling does not violate the general policy of not looking behind a final notice to examine the IRS's motives or conduct in determining a liability, because review by the Tax Court "is necessary to determine the merits of the [IRS's] determinations."[60]

In reaching the preceding conclusion in *Treece*, the Tax Court referenced *Estate of Gardner v. Commissioner*, a case of first impression analyzing whether the Tax Court had jurisdiction to review a denial by the IRS of a taxpayer's request under Code Sec. 6081 for an extension to file an estate tax return.[61] The Tax Court observed the following about its authority in that earlier case:

> This and other courts have been generally unsympathetic in the past to [the IRS's] arguments, express or implied, for unreviewable administrative discretion. We think [the IRS] should fare no better in this case, for [it] has failed to rebut the strong presumption that administrative discretion remains subject to judicial review.
>
> We note that we are *not* asserting broad general authority to review [the IRS's] discretionary actions. Our jurisdiction is carefully circumscribed both in its scope and the manner in which it may be invoked. However, once our deficiency jurisdiction has been properly invoked, we will examine *de novo* the merits of [the IRS's] deficiency determinations, including his exercise of discretion under Section 6081, to the extent that the alleged deficiency and any addition to tax within our deficiency jurisdiction turn upon [the IRS's] discretionary actions.
>
> We also note that reviewing [the IRS's] exercise of discretion under Section 6081 is not contrary to

our general policy of not looking behind a statutory Notice of Deficiency to examine [the IRS's] motives or conduct in determining that deficiency … Our examination of [the IRS's] exercise of discretion under Section 6081 does not involve the method or procedure by which [the IRS made its] administrative determination of a deficiency. Rather, our review … in this case is necessary for us to determine the merits of [the IRS's] substantive determination of a deficiency. Here, the sole reason for denial of the Section 2032A special use election (and hence the basis for the major portion of the asserted deficiency) is the assertion that the estate tax return was not timely filed.

> For the reasons stated above, we hold that [the IRS's] denial of an extension of time for filing is not immune from review in this Court.[62]

Finally, the Tax Court in *Treece* held that whether the IRS properly precluded the company from participating in the VCSP because it supposedly failed to meet all the eligibility criteria involves a dispute of material fact, such that the case cannot be resolved, without a trial, by summary judgment.[63] Although the Tax Court did not supply details, potential issues regarding whether the company was under audit at the time it applied for the VCSP abound. Here are just a few. Did the company treat all workers falling into a particular class as independent contractors during the relevant period? Did the company file Forms 1099 in a timely manner, even though it did so after the normal deadline? Was the company under an income tax audit, employment tax audit, or some ambiguous hybrid? What type of audit notices did the IRS send the company? Was the IRS auditing the company, a related entity, or an individual? Was the IRS truly auditing or just processing a Form SS-8 request by a worker? Was the company under audit, pursuing an administrative appeal, or engaging in tax litigation? Does a correspondence audit or receipt of a computer-generated notice from the IRS constitute an audit for purposes of the VCSP?[64]

VI. Potential Impact on Other Disclosure Programs

Treece holds that the Tax Court, in an employment tax case filed by a company to challenge a Notice of Employment Tax Determination, has the power to analyze whether the IRS's earlier decision about eligibility for the VCSP was appropriate. That ruling is important, of course, but it acquires additional significance when applied to a long list of *other* voluntary disclosure programs, all of which entail an eligibility analysis by the IRS. This article examines just a few of these programs.

A. International Tax Programs

Taxpayers who inadvertently fall into U.S. international tax non-compliance often explore ways of resolving issues with the IRS with the least amount of pain. Among the current options are participating in the Streamline Foreign Offshore Procedure ("SFOP"), Streamline Domestic Offshore Procedure ("SDOP"), Delinquent International Information Return Submission Procedures ("DIIRSP"), or Delinquent FBAR Submission Procedure ("DFSP").[65]

To be eligible for the SFOP, a taxpayer (who is a U.S. citizen or Green Card holder) must meet all the following criteria: (i) he was physically outside the United States for at least 330 days in one or more of the past three years; (ii) he did not have an "abode" in the United States during the relevant years; (iii) he either did not file Forms 1040 with the IRS or he filed inaccurate Forms 1040; (iv) he failed to file proper international information returns; (v) the violations were due to "non-willful" conduct; (vi) neither the IRS nor the Department of Justice ("DOJ") has initiated a civil examination or criminal investigation of the taxpayer or a related party; and (vii) the taxpayer is an individual or the estate of an individual, because the SFOP is not open to entities. Taxpayers gaining admission to the SFOP are only required to file Forms 1040 or Forms 1040X for the past three years, international information returns for the past three years, and Reports of Foreign Bank and Financial Accounts (FBARs) for the past six years. Taxpayers must pay all resulting tax liabilities and interest, but the IRS waives all penalties.

The SDOP is similar to the SFOP, with three critical distinctions. First, participants in the SDOP do not satisfy the foreign-residency requirement because they spent too much time in the United States. Second, they must have filed timely Forms 1040 with the IRS each year, but neglected to report all worldwide income and/or enclose all required international information returns. Finally, if taxpayers are accepted into the SDOP, the IRS does not mitigate all penalties, imposing instead an "offshore" penalty equal to just five percent of the highest total value of all non-compliant assets during the relevant period.

The DIIRSP provides that taxpayers who have not filed one or more international information returns can file them now, on a penalty-free basis, if they meet certain conditions. In the case of individual taxpayers, they must have previously filed annual Forms 1040 reporting all income, demonstrate "reasonable cause" for not filing information returns, and not be under civil examination or a criminal investigation.

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The DFSP is geared toward taxpayers who previously filed timely Forms 1040 each year reporting all worldwide income (including income generated by foreign accounts), yet neglected to file FBARs. The DFSP allows taxpayers to rectify FBAR issues without incurring penalties, if they previously paid all income taxes, have "reasonable cause" for their FBAR oversights, and are not under civil examination or a criminal investigation.

B. International Tax Withholding

Complying with the U.S. international tax withholding rules involves reviewing ultra-dense regulations promulgated under different parts of the Internal Revenue Code, classifying foreign entities, obtaining and verifying forms from foreign payees regarding their status, identifying ultimate beneficiaries, analyzing the effect of relevant treaties, and more. The IRS recognizes that significant non-compliance exists, confusion about the rules causes many of the problems, taxpayers are reluctant to remedy matters if doing so triggers unreasonable penalties, and getting as many taxpayers as possible back in the system is fundamental. Therefore, the IRS issued a memorandum in 2019 describing a mechanism for resolving past infractions ("Foreign Payment Program").[66]

Eligibility for the Foreign Payment Program is limited, of course. Only a U.S. withholding agent ("USWA") that is not a "qualified intermediary," "withholding foreign partnership," or "withholding foreign trust" can participate.[67] Moreover, a USWA is not eligible if it is already under examination with respect to tax withholding. For these purposes, an examination begins on the date that the USWA receives notice "of an impending examination or of an impending referral for examination." In addition, a USWA will not qualify if it has the same issues currently before the Appeals Office or the courts.[68] Finally, the IRS has discretion in deciding penalty-abatement requests filed by a USWA under the Foreign Payment Program.[69]

C. Expatriation Taxes

Code Sec. 877A generally imposes an exit tax on certain taxpayers, including U.S. citizens, who decide to abandon the United States. In essence, taxpayers must pretend to sell all their property at fair market value the day before their "expatriation date" and pay the corresponding U.S. income taxes on any fictional gains.[70]

The exit tax applies only to "covered" expatriates.[71] This means those who have an average annual U.S. income tax liability for the past five years over a particular amount ("Tax Liability Test"), *or* who have a net worth exceeding a certain threshold ("Net Worth Test"), *or* who cannot certify to the IRS that they maintained full U.S. tax compliance during the past five years ("Certification Test").[72] Stated another way, individuals failing *any one* of the preceding three tests normally are considered covered expatriates.

In order to meet the Certification Test and thus avoid being a covered expatriate, taxpayers must file a Form 8854 (*Initial and Annual Expatriation Statement*) with their final Form 1040 and certify that they have been fully compliant with all U.S. tax laws for the past five years.[73] Many are unable to do so. Mindful of this, the IRS announced an initiative in 2019 called Relief Procedures for Certain Former Citizens ("RPCFC"). Its goal was to allow certain types of taxpayers, particularly so-called "accidental Americans," to avoid the exit tax.[74]

Taxpayers must "strictly meet" all the following criteria to benefit from the RPCFC: (i) they relinquished their U.S. citizenship after March 18, 2010; (ii) they have no tax filing history with the IRS as a U.S. citizen; (iii) they had a net worth of less than $2 million, both at the time of expatriating and at the time of applying for the RPCFC; (iv) they have an aggregate income tax liability of $25,000 or less for the five years before expatriating, omitting any potential exit taxes, penalties, or interest; (v) they completed and filed all necessary Forms 1040 and information returns for the relevant six years (*i.e.*, the year of expatriating and the five preceding ones); and (vi) they did not willfully violate their U.S. tax duties.[75] If individuals meet these eligibility requirements, then they will *not* be covered expatriates, will *not* pay the exit tax, will *not* pay income taxes for prior years, and will *not* pay penalties.[76]

D. Comprehensive Disclosure Program

As shown above, the IRS offers multiple programs designed to allow taxpayers to rectify *specific* types of non-compliance. It also has one *general* program covering essentially all types of violations. This article calls such program the updated voluntary disclosure practice ("UVDP").[77] Its objective is "to provide taxpayers concerned that their conduct is willful or fraudulent, and that may rise to the level of tax and tax-related criminal acts, with a means to come into compliance with the law and potentially avoid criminal prosecution."[78]

The IRS issued major guidance concerning the UVDP in 2018, 2020, and 2022.[79] It describes the criteria that taxpayers must meet to participate in the UVDP. Among other things, they must apply before the IRS has started a civil examination or criminal investigation, before the IRS has received data about the non-compliance from a third party (*e.g.*, an informant, John Doe summons, foreign government, *etc.*), and before the IRS has acquired data from a criminal enforcement action, such as a search warrant or grand jury subpoena.[80]

The UVDP has many features left to the discretion of the IRS. For instance, with respect to the disclosure period,

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UVDP cases normally cover the most recent six closed years. However, if the IRS and taxpayer cannot resolve a case by mutual agreement, then the IRS "has discretion to expand the scope to include the full duration of the non-compliance and may assert maximum penalties under the law with the approval of management."[81]

Similar IRS discretion is followed regarding imposition of fraud penalties in UVDP cases. Generally, the IRS will assert a civil fraud penalty, equal to 75 percent of the tax liability, to the *one year* during the disclosure period with the highest tax liability. In "limited circumstances," though, the IRS may apply the fraud penalty to more than one year, up to all six years, "based on the facts and circumstances of the case."[82] The example provided by the IRS is a situation where a taxpayer and Revenue Agent cannot agree on the tax liability as part of the UVDP process.[83]

The UVDP also grants the IRS discretion when it comes to other penalties. Taxpayers are "not precluded" from seeking an accuracy-related penalty equal to 20 percent of the tax liability, instead of a civil fraud penalty at 75 percent, or requesting non-willful FBAR penalties, in place of willful ones. However, acceptance of lesser penalties by the IRS will be "exceptional," and taxpayers must present "convincing evidence" to justify a reduction.[84]

The IRS claims that it retains ultimate discretion, the ability to "revoke" a taxpayer's participation in the UVDP, in cases where the IRS, solely in its judgment, believes that the taxpayer is not "promptly and fully cooperating" with the process.[85]

VII. Conclusion

Treece appears to be a small employment tax case because it involved just one worker, the dollars at stake were minor, and the parties resolved many of the legal issues before litigation even began. However, it is actually a big case because of its potential applicability in other contexts.

The Tax Court indicated in *Treece* that, in order to determine the employment tax liability, it first needed to decide whether the IRS had abused its discretion in concluding that the company was ineligible for the VCSP. In support of this proposition, the Tax Court explained that (i) it has jurisdiction to review IRS determinations that address the merits of a tax deficiency, (ii) there is a strong presumption that acts of administrative discretion, including those by the IRS, are subject to judicial review, (iii) the denial of the company's application for the VCSP directly affected the amount of employment taxes, and (iv) scrutiny by the Tax Court of the IRS's earlier decision does not violate the general legal presumption that a Notice of Deficiency or similar document is accurate and that taxpayers cannot "look behind" it.

The IRS offers a multitude of voluntary disclosure programs, aside from the VCSP. These include the SFOP, SDOP, DIIRSP, DFSP, Foreign Payment Program, RPCFC, UVDP, and several others. The specifics for each program vary, but a common theme is that the IRS initially serves as the sole decision-maker regarding eligibility of taxpayers. Many of the qualifying criteria are inherently subjective, particularly determinations about whether the conduct of taxpayers was non-willful or attributable to reasonable cause, and whether taxpayers cooperated adequately in the process. In the past, the IRS sometimes adopted a take-it-or-leave-it approach with voluntary disclosure programs, insinuating to taxpayers that it had sole authority to decide the key issue of eligibility. The recent ruling in *Treece* upends that notion. Taxpayers rejected by the IRS from *any* disclosure program, not just the VCSP, should consider how they might be able to utilize *Treece* to their advantage in subsequent Tax Court litigation.

ENDNOTES

* Hale defends businesses and individuals in tax audits, tax appeals, and tax litigation, involving domestic and international issues. You can call Hale at (404) 658-5441 or email him at *hale.sheppard@chamberlainlaw.com*.

1 *Treece Financial Services Group*, 158 TC —, No. 6, Dec. 62,042 (April 19, 2022). The Tax Court released a second opinion, the same day, involving a related company, addressing identical issues, and making identical holdings. *See Treece Investment Advisory Corp.*, Dec. 62,043(M), TC Memo. 2022-38.

2 *See* Code Sec. 3121(d) and Reg. §31.3121(d)-1 (containing the definition of "employee" for FICA purposes), Code Sec. 3306(i) (containing the definition of "employee" for FUTA purposes), and Code Sec. 3401(c) and Reg. §31.3401(c)-1 (containing the definition of "employee" for federal income tax withholding purposes).

3 Code Sec. 3508 and Proposed Reg. §31.3508-1.

4 Reg. §31.3401(c)-1(b). *See also* Reg. §31.31.3121(d)-1(c)(2).

5 Rev. Rul. 87-41, 1987-1 CB 296.

6 Federal Insurance Contributions Act ("FICA") taxes are payments, made partly by employers and partly by employees, which fund Social Security and Medicare. Federal Unemployment Tax Act ("FUTA") taxes are payments, made solely by employers, which fund benefits for people out of work.

7 IRS Announcement 2011-64, IRB 2011-41, 503, Sections I and II (September 21, 2011).

8 IRS Announcement 2011-64, IRB 2011-41, 503 (September 21, 2011).

9 Senate Report 97-494(I), 97th Cong., 2d Sess. (1982), at pg. 1103.

10 Senate Report 97-494(I), 97th Cong., 2d Sess. (1982), at pg. 1104.

11 Code Sec. 3509(a); IRM 4.23.8.5.1 (June 7, 2011). The company must also pay 100 percent of its share of the FICA taxes and 100 percent of the FUTA taxes.

12 FAQ #15. That figure is comprised of 1.5 percent of the income tax withholding, 7.65 percent of the company's share of FICA, and 1.53 percent of the worker's share of FICA. *www.irs.gov/businesses/small-businesses-self-employed/voluntary-classification-settlement-program-vcsp-frequently-asked-questions*.

13 The example has been modified to enhance readability. FAQ #15. *www.irs.gov/businesses/small-businesses-self-employed/voluntary-classification-settlement-program-vcsp-frequently-asked-questions*.

[14] IRS Announcement 2011-64, IRB 2011-41, 503, Section III (September 21, 2011).

[15] IRS Announcement 2011-64, IRB 2011-41, 503, Section III (September 21, 2011).

[16] IRS Announcement 2011-64, IRB 2011-41, 503, Section III (September 21, 2011).

[17] IRS Announcement 2011-64, IRB 2011-41, 503, Section V (September 21, 2011).

[18] IRS Announcement 2012-45, IRB 2012-51, 724, Section I (December 17, 2012).

[19] IRS Announcement 2012-45, IRB 2012-51, 724, Section I and III (December 17, 2012).

[20] IRS Announcement 2012-45, IRB 2012-51, 724, Section V (December 17, 2012).

[21] IRS Announcement 2012-46, IRB 2012-51, 725 (December 17, 2012).

[22] FAQs #16, #19, and #24. *www.irs.gov/businesses/small-businesses-self-employed/voluntary-classification-settlement-program-vcsp-frequently-asked-questions*.

[23] Code Sec. 7442.

[24] Taxpayer Relief Act of 1997, Public Law 105-34, Section 1454(a) (effective August 5, 1997).

[25] Code Sec. 7436(a) (as originally enacted). For more information about the history, rules and benefits of Code Sec. 530 relief, *see* Hale E. Sheppard, *Anatomy of a Worker-Classification Dispute with the IRS: Securing Code Sec. 530 Relief, Avoiding Employee Status, Shifting the Burden of Proof, Recouping Fees, and More*, 103(4) Practical Tax Strategies 4 (2019); Hale E. Sheppard, *Pre-Trial Win in Worker-Classification Dispute Thanks to Code Sec. 530 Does Not Trigger Automatic Fee Recovery under Code Sec. 7430*, 19(2) J. Tax Practice Procedure 21 (2017); Hale E. Sheppard, *Taxpayer Delivers One-Two Punch to IRS in Recent Worker-Classification Dispute: Victory under Code Sec. 530 and Fee Recoupment*, 18(3) J. Tax Practice Procedure 33 (2016); Hale E. Sheppard, *Must Taxpayers File "Timely" Forms 1099 to Obtain Code Sec. 530 Relief? Unexpected Answers from a Recent Worker-Classification Case*, 91(4) Taxes 55 (2013).

[26] Code Sec. 7436(a)(1).

[27] Code Sec. 7436(e) (consisting of Code Secs. 3101 through 3512)

[28] U.S. Joint Committee on Taxation, General Explanation of the Tax Legislation Enacted in1997, JCS-23-97 (December 17, 1997), pg. 428.

[29] Notice 98-43, 1998-2 CB 211 (July 31, 1998).

[30] Notice 98-43, 1998-2 CB 211 (July 31, 1998).

[31] Notice 98-43, 1998-2 CB 211 (July 31, 1998).

[32] *Henry Randolph Consulting*, 11 TC No. 1 (January 6, 1999); *See also Henry Randolph Consulting*, 113 TC No. 20 (October 19, 1999) (stating "we do not have jurisdiction to determine the amount of taxes owing").

[33] Code Sec. 7436(a) (as originally enacted).

[34] Community Renewal Tax Relief Act of 2000, Public Law 106-554, Section 314(f) (December 21, 2000).

[35] Notice 2002-5, 2002-1 CB 320.

[36] Notice 2002-5, 2002-1 CB 320. The Second Notice refers to additions to tax, additional amounts, and penalties, which the author has consolidated into "penalties" for the sake of clarity.

[37] *SECC Corporation*, 142 TC 225, Dec. 59,870 (2014).

[38] *SECC Corporation*, 142 TC 225, 228, Dec. 59,870 (2014).

[39] *SECC Corporation*, 142 TC 225, 229, Dec. 59,870 (2014).

[40] *SECC Corporation*, 142 TC 225, 232-233, Dec. 59,870 (2014).

[41] *SECC Corporation*, 142 TC 225, 234, Dec. 59,870 (2014) (emphasis added).

[42] *American Airlines, Inc.*, 144 TC 24, Dec. 60,212 (2015).

[43] *American Airlines, Inc.*, 144 TC 24, 30, Dec. 60,212 (2015).

[44] *American Airlines, Inc.*, 144 TC 24, 36, Dec. 60,212 (2015).

[45] *American Airlines, Inc.*, 144 TC 24, 34, 36, Dec. 60,212 (2015).

[46] *American Airlines, Inc.*, 144 TC 24, 33-34, Dec. 60,212 (2015).

[47] Rev. Proc. 2022-13, IRB 2022-6, 477; *See also Guidance Clarifies Tax Court Review of Worker Reclassification*, 2022 Tax Notes Today Federal 13–16 (January 19, 2022).

[48] Rev. Proc. 2022-13, IRB 2022-6, 477, Section 2.03.

[49] Rev. Proc. 2022-13, IRB 2022-6, 477, Section 2.04.

[50] Rev. Proc. 2022-13, IRB 2022-6, 477, Sections 2.05, 3.02, 3.03. 3.04, and 3.05.

[51] *Treece Financial Services Group*, 158 TC —, No. 6, Dec. 62,042 (April 19, 2022). The Tax Court released a second opinion, the same day, involving a related company, addressing identical issues, and making identical holdings. *See Treece Investment Advisory Corp.*, Dec. 62,043(M), TC Memo. 2022-38.

[52] *Treece Financial Services Group*, 158 TC —, No. 6, 3, Dec. 62,042 (April 19, 2022).

[53] *Treece Financial Services Group*, 158 TC —, No. 6, 2-3, Dec. 62,042 (April 19, 2022).

[54] *Treece Financial Services Group*, 158 TC —, No. 6, 2-3, Dec. 62,042 (April 19, 2022).

[55] *Treece Financial Services Group*, 158 TC —, No. 6, 2, Dec. 62,042 (April 19, 2022).

[56] *Treece Financial Services Group*, 158 TC —, No. 6, 5, Dec. 62,042 (April 19, 2022) (internal citations omitted) (emphasis added).

[57] Tax Court Rule 142(a)(1).

[58] U.S. House of Representatives, Internal Revenue Service Restructuring and Reform Act of 1997, 105th Congress, 1st Session, Report 105-364 (October 31, 1997), pg. 55; U.S. Senate, Internal Revenue Service Restructuring and Reform Act of 1998, 105th Congress, 2nd Session, Report 105-174 (April 22, 1998), pg. 43.

[59] *Greenberg's Express, Inc.*, 62 TC 324, 327-328, Dec. 32,640 (1974).

[60] *Treece Financial Services Group*, 158 TC No. 6, 5 (April 19, 2022).

[61] *Estate of Gardner*, 82 TC 989, 994, Dec. 41,293 (1984). The Tax Court also cited *Trimmer,* 148 TC 334, 148 TC 14 (2017), *Capital Federal Savings & Loan Association*, 96 TC 204, Dec. 47,169 (1991), and *Mailman*, 91 TC 1079, Dec. 45,218 (1988).

[62] *Estate of Gardner*, 82 TC 989, 999-1000, Dec. 41,293 (1984).

[63] *Treece Financial Services Group*, 158 TC —, No. 6, 6, Dec. 62,042 (April 19, 2022).

[64] IRM 4.23.20.7 (June 22, 2020) (listing and discussing eligibility criteria for the VCSP).

[65] *See* Hale E. Sheppard, *Alarming U.S. Tax Rules and Information-Reporting Duties for Foreign Retirement Plans and Accounts: Analyzing Problems and Solutions*, 129(4) J. Taxation 14 (2018) (explaining the four remaining international disclosure programs, as well as the now defunct Offshore Voluntary Disclosure Program).

[66] IRS Memorandum LB&I-04-0219-002 (February 27, 2019); Tax Analysts Document 2019-8432.

[67] IRS Memorandum LB&I-04-0219-002 (February 27, 2019); Tax Analysts Document 2019-8432.

[68] IRS Memorandum LB&I-04-0219-002 (February 27, 2019); Tax Analysts Document 2019-8432.

[69] IRS Memorandum LB&I-04-0219-002 (February 27, 2019); Tax Analysts Document 2019-8432.

[70] Code Sec. 877A generally applies to individuals who cease to be U.S. citizens or lawful permanent residents on or after June 17, 2008. *See* Notice 2009-85, IRB 2009-45, 598.

[71] Code Sec. 877A(a)(1).

[72] Code Sec. 877A(g)(1)(A); Notice 2009-85, IRB 2009-45, 598, Section 2(A); Code Sec. 877(a)(2)(A), (B) and (C).

[73] *www.irs.gov/individuals/international-taxpayers/relief-procedures-for-certain-former-citizens*.

[74] IRS News Release IR-2019-151, September 6, 2019.

[75] *www.irs.gov/individuals/international-taxpayers/relief-procedures-for-certain-former-citizens, FAQ #2*.

[76] *www.irs.gov/individuals/international-taxpayers/relief-procedures-for-certain-former-citizens*.

[77] *See* Hale E. Sheppard, *IRS Issues New Form 14457 and Instructions regarding Its Comprehensive Domestic and International Voluntary Disclosure Program: Analyzing Key Aspects*, 46(4) Int'l Tax J. 41 (2020); Hale E. Sheppard, *IRS Amnesty Covers More than Foreign Accounts: Analyzing the Updated Voluntary Disclosure Practice, New International Tax Withholding Procedure, and Guidelines for Late Returns by Foreign Corporations*, 97(6) Taxes 19 (2019), republished in 45(3) Int'l Tax J. — (2019).

[78] IRS Memorandum LB&I-09-1118-014 (November 20, 2018).

[79] IRS Memorandum LB&I-09-1118-014 (November 20, 2018); Form 14457 (*Voluntary Disclosure Practice Preclearance Request and Application*) (April 2020); Internal Revenue Service, IR-2022-33 (February 15, 2022); Form 14457 (February 2022).

[80] Form 14457 (April 2020), Instructions, pg. 7.

[81] IRS Memorandum LB&I-09-1118-014 (November 20, 2018).

[82] IRS Memorandum LB&I-09-1118-014 (November 20, 2018).

[83] IRS Memorandum LB&I-09-1118-014 (November 20, 2018).

[84] IRS Memorandum LB&I-09-1118-014 (November 20, 2018).

[85] IRS Memorandum LB&I-09-1118-014 (November 20, 2018); Andrew Velarde, "Noncooperation in Voluntary Disclosure Won't Blindside Taxpayer," Tax Analysts Doc. 2019-9094 (March 12, 2019) (comments by the Director of Withholding and International Individual Compliance, LB&I Division).

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