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October 1978

ALL TAX DECISIONS, COURT ACTIONS, REVENUE RULINGS ISSUED EACH MONTH ARE SUMMARIZED IN THE DEPARTMENT COVERING THE POINT AT ISSUE

NEW DEVELOPMENTS IN

Payroll taxes

Steps to take to minimize a client's employment taxes as proposed on audit

by **PETER WINSLOW**

The client who is faced with an employment tax audit has many opportunities to reduce his potential liability. Mr. Winslow explains the available routes which may be taken to cut any alleged underpayment of employment taxes. He concentrates on income tax withholding, employee FICA, employer taxes, penalties and interest.

THE INTERNAL REVENUE Service has become concerned with the degree of voluntary compliance in the employment tax area and has significantly increased the number of audits.[1] If, as a result of an audit, assessments are made for all years not barred by the statute of limitations, the result can be disastrous. Not infrequently, the revenue agent's proposed assessment will result in double taxation where the employee has already paid his income and social security taxes. By taking advantage of several relief provisions available under the Code, an employer may be able to avoid this double taxation and substantially reduce, and in some cases virtually eliminate, this liability for the additional taxes proposed.

The employer's potential liability for underpaid employment taxes can generally be broken down into three components: (1) the taxes directly imposed on the employer (the Federal Unemployment Tax Act (FUTA)) tax under Section 3301 and the employer's portion of the Federal Insurance Contributions Act (FICA) tax under Section 3111; (2) the taxes imposed on the employee but required to be withheld and paid by the employer (the employee's portion of FICA and the income withholding tax);[2] and (3) penalties and interest imposed due to the employer's failure to timely pay or deposit the proper amount of tax.

Income tax withholding

The employer's greatest potential liability in an employment tax audit is for unpaid income withholding tax. However, the employer who has an understanding of the mechanics of Section 3402(d) and is familiar with the Service's application of that section may be able to avoid this liability, either entirely, or at least partially.

Section 3402(d) provides that a taxpayer is entitled to a credit against his withholding tax liability for the amount of income tax which he failed to withhold but which was paid by his employees. The most common application of the Section 3402(d) credit is within the context of "employee v. independent contractor" controversies; *i.e.,* the Service seeks to reclassify as an employee an individual initially classified by his employer as an independent contractor.[3] Because the individual was not considered an employee during the taxable quarters in audit, the employer did not withhold the proper amount of income tax.

If Section 3402 (d) relief is not sought, the Service determines the employer's liability for additional withholding taxes without regard to the income tax that may have been paid by his employees. The revenue agent simply computes the tax due on the total compensation paid to the reclassified employees. In recognition of the fact that a substantial part of the employer's liability may duplicate income taxes already paid by the employees, Section 3402(d) represents a statutory remedy aimed at minimizing the impact of this double taxation.

In order to avail himself of the Section 3402(d) credit, current Service procedures require the employer to file a Request for Relief from Payment of Income Withholding, Form 4670, together with attached Employee Wage Statements, Forms 4669. The Form 4669, which should be signed by each of the employees in issue, represents a personal certification that the employee reported and paid income tax on the amount of compensation received from the employer. After obtaining as many statements as possible, the employer submits the Forms 4669 and the Form 4670 to the agent, or if the audit has terminated, to the appropriate Service Center. Upon receipt of these forms, the Service will reduce the income withholding tax assessment by the amount of taxes paid on compensation as shown on the wage statements.

Prompt submission to the agent of the completed Forms 4669 and 4670 is necessary to forestall a large assessment and possible collection activity. However, employers must often spend considerable time trying to locate terminated employees, that is, employees no longer with the business but who were erroneously treated as independent contractors in the periods under audit. This problem is particularly acute where the employee turnover rate is high. Moreover, convincing employees to sign the employee wage statements is independently time consuming, particularly so since many employees maintain inadequate income tax records. Underlying these logistical problems is Reg. 31.3402 (d)-1, which imposes on the employer the burden of proving that the employees satisfied their income tax liability.[4]

In order to avoid a large assessment for income withholding tax, the employer should follow the procedures necessary to obtain the Section 3402(d) credit as expeditiously as possible while the audit is ongoing. The employer should attempt to locate all terminated employees and have wage statements completed as soon as it becomes clear that the individuals are going to be treated as employees by the agent. Moreover, in cases where it is difficult or impossible to secure wage statements from all employees, the employer need not necessarily abandon his claim to Section 3402(d) relief. Where the number of employees at issue is unusually large, the employer may be able to convince the revenue agent to accept and utilize a sampling technique. For example, through negotiation with the agent, the employer may be able to use a random

sample of from 15 to 30% of the representative employees from whom statements can be obtained to show the percentage of wages on which income tax was paid. The percentage derived through sampling could then be applied to the entire group of reclassified employees to arrive at the allowable Section 3402(d) credit. Such a sampling technique was suggested by the district court in *Standard Chemical Manufacturing Co.,* DC Neb., 5/31/77. The savings in time and money can be substantial for both the employer and the agent if a large number of employees are involved and sampling is utilized.

Employee FICA

With knowledge of the operation of Section 6521, the employer can also minimize his liability for the employee's portion of FICA tax; but because of the limits of this relief provision, some ingenuity is required to obtain the maximum benefit.

As is the case with income withholding tax, double taxation can occur if the employer is required to pay employee FICA tax for individuals erroneously treated as independent contractors who have already paid Self-Employment Contributions Act (SECA) tax under Section 1401 on the compensation received from the employer. Section 6521, like Section 3402(d), provides relief in some cases where the employer can prove that the employees satisfied their SECA tax liability.

Section 6521 by its nature is a mitigation provision and technically does not provide for a credit against the tax as does Section 3402(d). This difference in treatment substantially reduces its usefulness to the employer who is faced with an audit. Like Section 1311 (mitigation of the effect of limitations and other provisions), Section 6521 was intended to eliminate a double tax or avoidance of tax where the Government or the taxpayer obtained an inequitable benefit due to maintenance of inconsistent positions. The wording of Section 6521 is extremely complicated, but in essence, it provides that the employer is entitled to relief from his liability for the employee's portion of FICA if he can show that his employees paid SECA tax and the statute of limitations has run on the employees for filing their own claims for refund (*Rev. Rul.* 78-127, IRB 1978-14, 15).

Unfortunately, in the ordinary audit, the employer is not able to obtain the benefit of mitigation because he cannot show that the statute of limitations has run on his employees. This is because an employment tax audit typically is completed and the additional tax assessed while the statute of limitations for filing the employees' income tax claims for refund remains open. Only where the audit is prolonged beyond the three-year period for filing SECA tax claims, will Section 6521 be applicable. This can happen where the employer has agreed to prolong the audit period by extending his own statute of limitations on assessment. It can also occur where the employer has failed to file an employment tax return, or the return he filed was fraudulent.

In the limited situations where Section 6521 mitigation is available, the employer should obtain from his employees the information necessary to prove that they paid their SECA tax liability, including substantiation that the three-year statute of limitations on filing SECA tax claims for refund has expired. The easiest way to secure this data may be to supplement the Forms 4669 sent to employees, for purposes of proving the Section 3402(d) credit, by including a statement certifying that SECA tax was paid on compensation received from the employer. Where the number of employees at issue makes obtaining SECA tax information unduly burdensome, the employer may wish to urge the agent to adopt a sampling procedure similar to that discussed previously with respect to the Section 3402(d) credit.

One other option is also available to the employer. Since employee FICA tax is imposed on the employee, with the employer only secondarily liable, Reg. 31.6205-1(a)(3) provides that where the employer fails to properly withhold FICA tax, but later pays the employee tax, the obligation of the employee to the employer with respect to the undercollection is a matter of settlement between the parties. For employees still under the employer's control, the Regulation further authorizes the employer to collect the amount of the FICA underpayment by deducting the amount from future compensation paid to the employee. Deductions are authorized even if the future compensation does not constitute wages otherwise subject to withholding.

By utilizing Section 6521 in conjunction with deductions from future compensation, the employer may be able to obtain substantial relief. Perhaps, the best result can be accomplished by enclosing a letter when supplemented Forms 4669 are sent to employees asking them to certify payment of both their income and SECA tax. The attached letter could contain a brief explanation of the information sought and state that if a signed Form 4669 is not returned, the employer will assume that SECA tax has not been paid and deduct the appropriate employee FICA tax from subsequent wage payments. This explanation will not only put employees on notice of possible wage deductions, but may also have the beneficial effect of providing the employees with an incentive to examine their income tax records and return the Forms 4669 certifying payment.

The deduction procedure also provides an opportunity for the employer to reduce his liability even where Section 6521 credits are not available. Nothing in Reg. 31.6205-1(a)(3) precludes an employer from making wage

[1]See Flynn, "Employment Taxes: Resurging Enforcement Activity," *62A.B.A. Journal* 915 (1976).

[2] Section 3101 imposes the employee's portion of FICA on the employee. However, under Section 3102, the employer is liable for the payment of the tax and is required to withhold the proper amount from the employee's wages. Similarly, although income tax withheld is collected at the source from employees pursuant to Section 3402, responsibility for underpayment rests on the employer under Section 3403. Reg. 31.3403-1.

[3] Generally, the status of an individual as an employee is determined under the usual common law rules of Sections 3121(d)(2), 3306(i), 3401(c). The employer-employee relationship 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, but also as to the details and means by which that result is accomplished. Regs. 31.3121(d)-1, 31.3306(i)-1, 31.3401(c)-1.

[4] See *Educational Fund of Electrical Industry,* 426 F.2d 1053 (CA-2, 1970). In *Kurio,* DC Tex., 6/15/70, modified by 429 F. Supp. 42 (DC Tex., 1971), the court recognized that the taxpayer bore the burden of proving the Section 3402(d) credit, but held that he was deprived of the opportunity of satisfying his burden when the Government failed to oppose or comply with the taxpayer's discovery request for production of the employees' returns. One district court has allowed limited discovery of employee return information to substantiate the employer's claim to withholding credits. *Standard Chemical Manufacturing Co.,* DC Neb., 5/31/77. In another case, the Court of Claims ordered the Government to compute the Section 3402(d) credit, but only in the event it prevailed in its argument that the individuals in issue were employees and not independent contractors. *Farm and Home Aluminum Products, Inc.,* Ct. Cls., 8/4/76.

[5] With certain specified exceptions, wages subject to employment taxes include remuneration for services performed by an employee for his employer, including the cash value of all remuneration paid in any medium other than cash. Sections 3121(a), 3306(b), 3401(c).

[6] See Kovey, *Impact of Supreme Court decision limiting withholding on employees' meal allowances,* 48 JTAX 276 (May, 1978).

deductions from employees who may have already paid SECA tax. But, the employer may be reluctant to jeopardize good labor relations by imposing this possible double burden on his employees. Nevertheless, the employer may be able to avoid this potential inequity to his employees and still take advantage of the wage deductions authorized by the Regulations. When the employer provides his employees with Forms 4669, he could also enclose Forms 843 advising them to file SECA tax claims for refund where the tax has been paid and the statute of limitations has not expired. The employer could inform these individuals that it is necessary for them to file the claims since additional wage deductions will subsequently be made in the event they are ultimately determined to be employees. To induce the timely filing of employee claims, the employer could also point out that the employees will obtain a net benefit from the SECA claim for refund—wage deduction procedure due to the higher SECA tax rates. The employer could then indirectly benefit from any SECA tax refunds made to employees through future wage deductions.

The employer who elects to make wage deductions in these circumstances should make sure that his employees have sufficient time to file timely claims for refund. It would also be advisable to take whatever follow-up steps are necessary to make sure that the employees actually file their claims. Finally, the potential adverse effects to employee relations must be carefully weighed.

Employer taxes

The employer will not be able to avoid his liability for the employer taxes (FUTA and the employer's portion of FICA) and the uncredited employee taxes (income withholding and employee's portion of FICA) without contesting the agent's findings on the merits. One issue that has been arising in audits more frequently is whether meal allowances constitute wages for employment tax purposes.[5] However, the Supreme Court, in *Central Illinois Public Service Co.*, Sup Ct., 2/28/78, held that "reimbursed" lunch expenses of employees on non-overnight travel were not wages subject to income withholding tax. The scope of the Supreme Court's opinion in the fringe benefit area is unclear because it does not lay down a standard to be applied in testing what items are generally included in the definition of wages. Nevertheless, at a minimum, *Central Illinois* can be cited if an agent proposes to impose income withholding on meal allowances.[6]

Even if the agent's audit position cannot be disputed on the merits, the careful employer may be able to reduce the agent's proposed liability. For example, if on audit the employer declines to compute his liability for income withholding tax, the agent may determine the applicable withholding tax rate by the average annual wage of the employees involved. In some cases this method may be beneficial, but where it is not, the employer should compute the correct liability using the graduated withholding rates for the actual wages paid to employees.

The agent's computations of the tax should be closely examined. If FICA and FUTA taxes are at issue, the employer is not liable for taxes on salaries that exceed the wage ceilings for each employee. A recomputation of the agent's figures may reveal that tax has been proposed on wages that exceed the ceilings.

Where the employer's payroll records are used by the agent to compute the proposed employment tax liability the records should be inspected to determine whether they reflect all exclusions from the tax. For example, an employer's payroll records will frequently show gross amounts paid to employees, without indicating items such as sick pay which is excluded from the definition of wages subject to FICA and FUTA taxes.[7] If this is the case, the employer should provide supplemental information to the agent to obtain the benefit of the sick pay exclusions.

In many instances where the agent reclassifies workers treated by the employer as independent contractors, the employer has already contributed or will be forced to contribute to the state unemployment fund. If the employer has made timely contributions to the state fund, he should provide the agent with substantiation of payment to obtain the FUTA tax credit available under Section 3302. Where no state contributions have yet been made, the agent will usually allow the employer an additional 30 days to substantiate payment prior to issuing his final report. In the case of a delinquent state contribution, however, the credit will be reduced to 90% of the amount otherwise allowable under Section 3302(a)(3). The employer who contests his liability for both FUTA and state unemployment tax, and has not yet contributed to the state fund, will not be able to obtain the FUTA tax credit on audit. This employer may wish to ensure his right to the future allowance of the credit by filing a claim for refund after payment of the FUTA tax. The claim could then be allowed in the event state contributions are subsequently required to be made.

One final income tax matter bears mentioning. With the Tax Reform Act of 1976, Congress enacted a new jobs income tax credit (Sections 44B, 51-53) available for 1977 and 1978 measured by the increase in unemployment insurance wages. An employment tax audit relating to 1977 or 1978 in which the agent finds an additional FUTA tax liability may result in an income tax overpayment due to the availability of a new jobs credit. If so, the employer may wish to file an income tax claim for refund.[8]

Penalties

By far the most onerous penalty that can be asserted by the agent in an audit is the 50% fraud penalty of Section 6653(b). This penalty will be imposed if the agent determines that any part of an underpayment of tax required to be shown on the return was due to fraud. The measure of the employment tax fraud penalty varies slightly from that applicable where income, estate, or gift taxes are involved. Under Section 6653 (c)(2), the employment tax fraud penalty is only imposed on the excess of the proper tax liability over the greater of: (1) the amount shown on a timely return or (2) the amount of tax paid prior to the due date of the return, whether or not the return was timely filed. In contrast, where a delinquent income, gift, or estate tax return is filed, Reg. 301.6653-1(c)(1) indicates that the fraud penalty is imposed on the entire liability without reduction for timely paid taxes.

Other penalties that may be assessed include the failure to file penalty of

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Section 6651(a)(1), the failure to pay penalty of Section 6651(a)(2), and the failure to deposit penalty of Section 6656.[9] Typically, these penalties are automatically assessed by the Service Center before an audit occurs. However, it is not uncommon for these penalties to be proposed for the first time on audit or for the amount of previously assessed penalties to be increased. For example, if the employment tax return was delinquently filed or timely deposits were not made, the revenue agent will recompute previous assessments and assert additional penalties on any proposed underpayment of tax. Similarly, a failure to pay penalty may be asserted for the first time on audit if the taxpayer files a delinquent employment tax return during the agent's examination.

The employer who can obtain credits by showing that his employees paid their income and SECA tax liabilities, will still be subject to penalties. Section 3402(d) expressly provides that the income withholding tax credit does not relieve the employer of his liability for any applicable penalty or additions to tax. (Reg. 31.3402(d)-1). Although no similar provision is included in Section 6521, the agent can be expected to maintain consistency with Section 3402(d) and impose penalties on unpaid FICA tax not assessed due to mitigation.

Because penalties will be proposed in spite of the employment tax relief provisions, the employer will have to convince the agent that under the circumstances penalty assessments would not be appropriate. The employer's failure to file, deposit, or pay may be attributable to the advice of counsel or an honest belief that the employees in question were independent contractors. These factors, when presented to the agent, may satisfy him that the employer's failures were due to reasonable cause and that the penalties should not be assessed.

The employer who is faced with a proposed penalty assessment should also make sure that the agent has computed the correct amount of the penalty. When a fraud penalty is proposed, the employer should check to see that the penalty is only imposed on amounts of tax not paid prior to the due date of the return. Any failure to file or pay penalty imposed with respect to the underpayment should also be abated due to Section 6653 (d). Where both failure to file and failure to pay penalties are asserted, the agent's figures should be examined to insure that under the limitation of Section 6651(c) a total of no more than 5% of the underpayment for any one month is proposed.

Failure to deposit penalties bear particular scrutiny. In *Rev. Rul.* 75-191, 1975-1 CB 376, the Service ruled that the penalty cannot be imposed on employee taxes that the employer has failed to withhold. Since audits generally arise where the employer has underwithheld, the penalty will usually be applied only to the undeposited employer's share of FICA tax. Care should be taken to see that the agent properly limits the scope of the failure to deposit penalty to the employer tax. The proposed penalty should also be checked to make sure that, in accord with Section 6656(b), it is not imposed with respect to any month after the due date of the return.

Interest

There are several methods by which the employer can reduce his liability for interest due on employment tax underpayments. Although the availability of Section 3402(d) and Section 6521 credits will not reduce the employer's liability for penalties, a different rule applies for interest. If withholding credits are allowed, interest will be assessed on the credited amounts, but it will only run from the date the employment tax return was due (January 31, April 30, July 31, or October 31) to the earlier of the due date of the employee's income tax return (April 15) or the date the employee satisfied his income or SECA tax liability.[10] Thus, even if credits are available, interest can run on the unassessed tax for as much as 11½ months. For all amounts not subject to withholding credits, interest will run from the due date of the return to the date of assessment. The Form 4669 used by the employer to substantiate the available Section 3402(d) credit does not have a space for indicating the date the employee satisfied his income tax liability. This omission potentially works to the detriment of the employer since his liability for interest can be reduced if he can show that his employee paid income tax prior to April 15. Thus, the employer may wish to supplement the Form 4669 and add a line seeking information regarding the date of payment.

This action may not be necessary, however. With an awareness of the correct procedures to follow, an employer can completely eliminate his liability for interest on not only the taxes subject to credits, but also for interest on all underpayments of income tax withholding or FICA tax. By utilizing a little-known employment tax relief provision, an employer can make an "interest-free adjustment" and thereby avoid an interest assessment. The authority for interest-free adjustments is contained in Section 6205(a) which provides that if less than the correct amount of income withholding tax or FICA tax (both the employer and employee portions) is paid with respect to compensation, proper adjustment can be made, without interest, in the manner and time prescribed by the regulations. Where the employer has filed a return, but has underreported his income withholding or FICA tax liability, the manner for making an interest-free adjustment is found in Regs. 31.6205-1(b)(2) and 31.6205-1 (c)(2). To avoid an interest assessment by making an adjustment the employer has two options. He can either: (1) report the additional amount due by reason of the underpayment on a timely filed return for the period in which the error is ascertained, or (2) report the underpayment on a supplemental return for the return period in which the payment of wages was made. If the supplemental return route is elected, the return must also be filed before the due date of the return for the period in which the error

[7] Sections 3121(a)(2), 3306(b)(2). Employers must withhold income tax on sick pay unless they meet the requirements of Reg. 31.3401(a)-1(b)(8)(ii). See *Rev. Rul.* 78-224, IRB 1978-28, 22, for an example of what the Service considers to constitute sick pay.

[8] Treating individuals as employees rather than independent contractors may have several other incidental effects. For example, where the "Massachusetts formula" is used to determine the amount of income of a multistate corporation attributable to one locality, the classification of workers as employees rather than independent contractors directly affects the employer's potential state tax liability. *American Flexible Conduit Co., Inc. v. State Tax Commission*, 186 N.E.2d 445 (Mass. 1962).

[9] Penalties can also be imposed for the failure to file certain information returns or for the failure to furnish certain statements. Sections 6652, 6678. A 100% penalty assessment can be made against responsible officers if the employer-corporation is insolvent and employment taxes have not been paid. Section 6672. The 5% penalty of Section 6653(a) for negligence or intentional disregard of rules and regulations is not applicable to employment taxes.

[10] Reg. 31.6071(a)-1(a); *Rev. Rul.* 58-577, 1958-2 CB 744, as modified by *Rev. Rul.* 66-113, 1966-1 CB 244.

[11] *Green*, 270 F.2d 558 (CA-5, 1959).

[12] *Flora*, 362 U.S. 145 (1960); *Steele*, 280 F.2d 89 (CA-8, 1960); *Spivak*, 234 F. Supp. 517 (DC N. Y., 1966), *aff'd*, 370 F.2d 612 (CA-2, 1967), *cert. den.*

was ascertained. Otherwise, interest will be assessed on the underpayment. Reg. 31.6205-1(a)(6) indicates that in no event can an interest-free adjustment be made after receipt from the district director of notice and demand for payment of the additional amount due.

In order to make sure that the Service will not assess interest on the underpayment, the return on which the additional liability is reported should clearly indicate that an adjustment is being made. If a supplemental return is filed, it should be plainly marked "Supplemental." The employer's full payment of the additional amount of tax should also accompany the return. In making the interest-free adjustment certain information is required to be furnished. A statement must accompany the return explaining the correction and designating the return period in which the error was ascertained and the period to which the error in underpayment relates (Reg. 31.6205-1(a)(3)). If FICA tax is involved, the statement attached to the return must include: (1) the name and account number of each employee whose wages were erroneously reported or omitted from the return; (2) the period for which wages were required to be reported on such return; (3) the amount, if any, of wages actually reported on the return for each employee; and (4) the amount of wages which should have been reported for each employee.

The IRS will provide the appropriate forms (Forms 941c or 941c PR) for making these statements (Reg. 31.6205-1 (a)(5)). In addition to making an adjustment, the employer should also provide his employees with corrected withholding statements and W-2 Forms for the quarters in which the undercollections occurred reflecting the correct amount of FICA tax that should have been withheld and the correct amount of wages subject to income tax withholding (Reg. 31.6051-1(c)).

The Regulations under Section 6205 do not expressly authorize an interest-free adjustment after an audit has commenced. However, in *Rev. Rul.* 75-464, 1975-2 CB 474, the Service ruled that interest could be avoided by making a timely adjustment during, or even after, the audit process. Significantly, the Ruling says that an interest-free adjustment can be made even if the employer contests his liability for the proposed underpayment and even if a claim for refund is subsequently filed and suit is instituted in court.

As stated previously, an interest-free adjustment must be made before the return is due for the quarter in which the employer ascertains his error in underwithholding. The key to *Rev. Rul.* 75-464 is its interpretation of the time an error is "ascertained." Reg. 31.6205-1 (a)(4) provides that an error is ascertained when the employer has sufficient knowledge to be able to correct it. *Rev. Rul.* 75-464 further refines this definition by stating that "to ascertain" means to find out with certainty; to make certain or definite. The Ruling notes that a determination by a revenue agent that additional tax is owing is merely a proposal. If the taxpayer disagrees and pursues his appeal rights, the error is neither definite nor certain until all appeals have been exhausted because the result of the agent's audit is subject to reversal or settlement. The Ruling then lists three situations in which an adjustment can be made while avoiding an interest assessment. In the first situation the employer erroneously failed to treat certain workers as employees. After the revenue agent determined that an additional liability was due, the employer agreed that an error was committed and immediately executed a Form 2504 (Agreement to Assessment and Collection of Additional Tax) and promptly paid the asserted tax liability. Because the employer agreed with the agent's findings, the error was ascertained at the time the additional liability was proposed. The Ruling states that under these circumstances an adjustment has been made and no interest is due on the underpayment. Form 2504 is considered to stand in lieu of a supplemental return.

In the second situation, the employer disagreed with the agent and appealed the proposed findings. At the appellate conference, a settlement was reached and the employer immediately executed a Form 2504 agreement and paid the tax due. The Ruling says that an interest-free adjustment was made because the error was ascertained at the conclusion of the appellate conference. In the third situation no agreement was reached at either the audit or appellate level, but the employer voluntarily paid the amount the Service claimed was due before a notice and demand for payment was issued. The Ruling says that the error was ascertained at the time of payment. By analogy to the third situation, it seems that an interest-free adjustment can be made at virtually any time during the administrative process provided the employer does not wait until he receives a notice and demand from the Service. Moreover, if the employer agrees with the amount of the underpayment, it appears that he can avoid filing a supplemental return by merely executing a Form 2504 to effect the adjustment. The information normally required to be submitted with the supplemental return will have already been prepared by the revenue agent on a Form 4668 (Employment Tax Audit Changes).

Despite the wide availability of adjustments in the audit context, there are several instances where the Service will assess interest even where an adjustment is attempted. *Rev. Rul.* 75-464 states that the Service will not allow interest-free adjustments in cases in which the taxpayer's returns for prior years were audited and additional tax was found to be due as a result of the same issue involved in the current audit. Adjustments will also not be allowed if, after being informed of his tax status as an employer, the taxpayer has knowingly underreported his liability. Presumably, the rationale for these exceptions from the adjustment process is that the employer discovered his error long before the time of audit.

Another instance where an interest-free adjustment is technically not available is where the employer has failed to file a quarterly employment tax return. Where the undercollection of income withholding and FICA tax is ascertained before the return is filed, an employer is required to report and pay the correct amount with the filing of the initial return. Regs. 31.6205-1(b)(1) and (c)(1) provide that an adjustment cannot be made on an original return. While it is by no means clear, the employer who is faced with an employment tax audit, but has not filed a return because of his belief that no liability existed, may be able to perfect his right to an interest-free adjustment by immediately filing a return reporting no liability. Later, after all appeal rights have been exhausted, the employer could then attempt to avoid interest by making an adjustment prior to receipt of notice and demand for payment.

Although the employer can achieve significant savings by following the adjustment process, the necessity of paying the entire income withholding and FICA tax liability prior to notice and demand represents a serious disadvan-

tage. Even though the employer cannot contest his liability prior to payment by filing a petition in the Tax Court,[11] he can avoid immediate payment of the entire contested tax by merely paying the divisible tax with respect to only one employee for one quarter and then filing a refund suit.[12] Thus, if the employer intends to contest the agent's findings in court, he will have to consider the benefits of deferred payment before he decides to make an interest-free adjustment.

Conclusion

Immediately upon learning that the agent intends to assert an underpayment as a result of an audit, the employer should promptly take steps to secure from his reclassified employees sufficient information to obtain the income withholding and FICA tax credits. Where this is unduly burdensome because of the number of employees at issue, the employer should negotiate with the agent for a modified sampling procedure to determine the maximum relief available. If Section 6521 mitigation is inapplicable, the employer may also wish to consider deducting the underpaid employee FICA tax from future wage payments.

All proposed assessments for tax, interest, and penalties should be examined to ensure that the agent has computed the correct liability. The employer should take full advantage of all exclusions from wages such as the exemption for sick pay. The FUTA tax credit for contributions to the state unemployment fund should also be claimed. Finally, the prudent employer can avoid the imposition of interest on income withholding and FICA taxes by making a timely interest-free adjustment. ★

New payroll decisions this month

Payments to retiree from plan with unspecified retirement age are "wages." (Rev. Rul.)

Taxpayer "retired" at age 60 and began receiving payments under his company's deferred compensation plan. The plan did not specify a retirement age. The officer was also covered by a qualified pension plan allowing retirement at age 65. The officer was not eligible to participate in the company's separate qualified pension plan for nonsalaried employees allowing retirement at age 60. The payments are not excepted from wages under Sections 3121(a)(13) and 3306(b)(10). There are no applicable exceptions for income tax withholding purposes and the payments are also wages for that purpose. *Rev. Rul.* 78-263, IRB 1978-27.

Proposed Reg. limits reporting of farm rentals as self-employment income. (Prop. Reg.)

The Service has issued a Proposed Regulation to reflect a 1974 amendment to Section 1402 which narrows the circumstances under which owners or tenants of farmland must include farm rentals in their self-employment income. Prop. Reg. 1.1402(a)-4, Fed. Reg. 7/19/78.

Taxpayer guilty of failure to timely file monthly returns and deposit withheld taxes. (CA)

The lower court found taxpayer guilty of failure to file monthly withholding returns and to pay withheld taxes into a special trust account two days after the collection of the taxes, as the IRS ordered him to do pursuant to Section 7512.

Held: Affirmed. Section 7215 imposes strict compliance with the deposit requirements of Section 7512 and any deviation from these provisions constitutes an offense. *Gay,* CA-5, 7/20/78.

Responsible party's liability does not extend to taxes outstanding at the time control is assumed. (DC)

The Commissioner held that taxpayer, an officer and corporate stockholder, was liable for the 100% penalty for failure to collect and pay over withholding taxes.

Held: For the Government, in part. Although taxpayer is the responsible party for the period he had control of the corporation, liability did not extend to taxes outstanding at the time taxpayer assumed control. A bookkeeper who merely followed instructions is not subject to the penalty. *Berg,* DC Ohio, 7/10/78.

Prior Ruling will not be retroactively applied. (Rev. Rul.)

The Service has ruled that *Rev. Rul.* 75-243, 1975-1 CB 322, dealing with the employment status of survey interviewers, will be applied without retroactive effect with respect to wages paid before July 1, 1975. *Rev. Rul.* 78-284, IRB 1978-29.

Section 6672 does not authorize suits against third parties. (DC)

Taxpayer was penalized for failure to collect and pay over payroll taxes. When taxpayer filed a third-party complaint for contribution, the party moved to dismiss.

Held: Third-party action dismissed. The court has no jurisdiction. *Geiger,* DC Ind., 4/12/78.

Limit of 25% on liability of lender for unpaid withholding tax applies to both tax and prejudgment interest. (DC)

A financing company that loaned money to a corporation that did not pay over withholding taxes was held liable under Section 3505(b). Liability under that Section is limited to 25% of the funds advanced. The IRS argued that prejudgement interest does not have to fit within the 25% limit; taxpayer asserted that tax and interest combined cannot exceed the limit.

Held: For taxpayer. The Section, properly read, limits taxes and interest to 25% of the advances. The examples in Reg. 31.3505-1(b)(2), referring to 25% of the advances "plus interest thereon" must refer only to postjudgment interest; otherwise the Regulation is invalid. *Taubman,* DC Mich. (No date given.)

Employer-paid tuition fees are subject to withholding. (Rev. Rul.)

Tuition fees paid by an employer on behalf of employees, and included in the employee's gross income, are considered "wages" for purposes of FICA, FUTA and income tax withholding. *Rev. Rul.* 78-184, IRB 1978-20.

No FICA or withholding tax exception for a minister's nonreligious work. (Rev. Rul.)

Services which are performed by an ordained minister for a manufacturing company and which are neither of a religious nature nor performed pursuant to an assignment by the minister's church, are not "in the exercise of his ministry" for purposes of Section 3121 (b)(8)(A). Thus, such services constitute employment and are subject to FICA tax. Also, the remuneration for the services is not exempt from income tax withholding under Section 3401(a)(9). *Rev. Rul.* 78-229, IRB 1978-25.