

**Office of Chief Counsel  
Internal Revenue Service  
memorandum**

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to: Barbara Wulf  
Program Manager  
(Specialty Exam Policy & Quality, ET policy)

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subject: Notice of Employment Tax Determination under IRC §7436 - Additional  
Compensation to Officer Employees

This memorandum responds to your request for assistance. This document may not be used or cited as precedent.

**QUESTIONS**

1. Whether the Tax Court has jurisdiction under Internal Revenue Code (Code) section 7436 to review a determination that a corporation is liable for additional employment taxes<sup>1</sup> due to the Service's recharacterization of payments made to, or on behalf of, corporate officer employees as wages?
2. Whether the Service should issue a Notice of Determination of Worker Classification (Letter 3523)<sup>2</sup> prior to the assessment of the additional employment taxes resulting from the Service's recharacterization of payments made to, or on behalf of, the corporate officer employees?

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<sup>1</sup> For purposes of this memo, employment taxes mean Federal Insurance Contributions Act (FICA) taxes, Federal Unemployment Tax Act (FUTA) taxes, and Federal income tax withholding.

<sup>2</sup> Letter 3523 is used to provide taxpayers with notice of the determinations on Code section 7436 issues that are not agreed to after all administrative appeals are completed. It allows the taxpayer 90 days to petition Tax Court for a review of these determinations. It will be renamed to reflect changes to current administrative processing.

## CONCLUSIONS

1. The Tax Court does not have jurisdiction under Code section 7436 to review a determination that a corporation is liable for additional employment taxes due to the Service's recharacterization of payments made to, or on behalf of, corporate officers who were treated as employees.
2. The Service should not issue Letter 3523. The additional taxes resulting from the recharacterized payments should be directly assessed pursuant to Code section 6201.

## FACTS

You asked whether the Tax Court has jurisdiction to review the Service's recharacterization of payments made by a corporation to, or on behalf of, its corporate officers as wages under the following scenario that arises in examinations.

A corporation pays wages to its corporate officers and reports the wages on Form 940, *Employer's Annual Federal Unemployment (FUTA) Tax Return*, Form 941, *Employer's Quarterly Federal Tax Return*, and Form W-2, *Employee Tax Statement*. The corporation also makes additional payments to the officers, or pays personal expenses on behalf of the officers, and does not report these additional payments as wages on Forms 940, 941, or W-2. The corporation may characterize these payments as dividends or distributions, return of capital, loan repayments, or other non service-related type payments.

As part of an employment tax audit of the corporation, the Service determines that the additional payments should be recharacterized as wages of the corporate officer employees and assesses additional employment taxes against the corporation with regard to the payments.

Taxpayer agrees that the corporate officers are employees under Code section 3121(d)(1) and that the additional payments were made to, or on behalf of, the officers. Taxpayer does not claim that it is entitled to relief under Section 530 of the Revenue Act of 1978 (Section 530).

## LAW AND ANALYSIS

### QUESTION 1

Code section 7436(a) provides the Tax Court with limited jurisdiction to review certain employment tax determinations made by the Service and the proper amount of employment tax under such determinations. Specifically, the Court has jurisdiction to review determinations that (1) individuals are employees for purposes of employment taxes under subtitle C of the Code (i.e., requiring reclassification of a nonemployee to employee status), or (2) the person for whom services are performed is not entitled to

relief under Section 530. The Tax Court has held that it has jurisdiction with respect to an employment status controversy when four required elements are present:

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

American Airlines, Inc. v. Commissioner, 144 T.C. 24, 32 (2015). See also, SECC Corp. v. Commissioner, 142 T.C. 225 (2014).

In the scenario you provided, there is no dispute that the corporate officers are employees of the taxpayer under section 3121(d)(1) and that certain amounts were treated as wages for employment tax purposes. Rather, the dispute is limited to the correct amount of payments required to be treated as "wages" for employment tax purposes, i.e. whether the additional payments constitute wages, rather than dividends or distributions, return of capital, loan repayments, distributions in excess of reasonable compensation, or other non-service related type payments. Nor is there any dispute concerning entitlement to Section 530 relief.

Accordingly, the Service is not making a determination regarding the employment status of the corporate officers when it recharacterizes certain payments as wages that were not treated as wages. The Service is also not making a determination with respect to the taxpayer's entitlement to Section 530 relief. Since the Service has not made a determination with respect to either of the two requisite matters specified in § 7436(a)(1) or (2), the Tax Court lacks jurisdiction to determine the correct amount of employment taxes due as a result of the employment tax assessment under section 6201 on the additional wages.

The position taken in this memorandum is consistent with two recent Tax Court Orders with respect to cases described below. (Copies of the Orders are attached to this memorandum).

In Martin S. Azarian, P.A. v. Commissioner, Docket No. 28957-15, Petitioner, an S corporation, treated its sole owner and officer, Mr. Azarian, as an employee during the taxable periods at issue and reported wages paid to Mr. Azarian on Forms W-2. Respondent sent petitioner Forms 4668, Employment Tax Examination Changes Report, which (1) concluded that petitioner failed to report reasonable compensation paid to Mr. Azarian for the taxable periods at issue, (2) proposed increased annual wages to Mr. Azarian for those periods, and (3) concluded that petitioner was liable for

proposed employment tax increases and additions to tax. Respondent did not issue a Letter 3523 to petitioner.

Nevertheless, petitioner filed a petition requesting the Court overturn respondent's findings. Respondent filed a Motion to Dismiss for Lack of Jurisdiction on the grounds that (1) no Notice of Determination of Worker Classification was sent to petitioner, and (2) no other determination was made by respondent which would confer jurisdiction on the Court.<sup>3</sup>

On February 21, 2017, the Tax Court issued an Order dismissing the case for lack of jurisdiction. The Court found that respondent did not make a determination under section 7436(a)(2) regarding whether petitioner was entitled to relief under Section 530. The Court also found that since petitioner consistently treated Mr. Azarian as an employee for the taxable periods at issue, respondent did not make a determination that Mr. Azarian was an employee of petitioner under section 7436(a)(1). The Court stated, "Section 7436(a)(1) only confers jurisdiction upon this Court to determine the ["]correct and the proper amount of employment tax["] when respondent makes a worker classification determination, not when respondent concludes that petitioner underreported reasonable wage compensation, as is the case here."

Similarly, in Patricia Arroyo DDS, Corp., Alex Mansilla and Mercedes P. Arroyo v. Commissioner, Docket No. 5874-15, the Tax Court dismissed the case with respect to Patricia Arroyo DDS Corp. (DDS Corp.) for lack of jurisdiction finding that the Service had not made any determinations for purposes of section 7436. In this case the Service determined that the amounts treated as salaries paid to the corporate officers and reported on Form W-2 as wages were artificially low, recharacterized higher amounts as salaries, and thus as wages, based on nationwide market information, and assessed additional employment taxes. Petitioners asserted that the amounts treated as salaries paid by DDS Corp were appropriate and contended the Court had jurisdiction as to the amount of employment taxes owed.

On February 23, 2017, the Tax Court issued an Order dismissing the case for lack of jurisdiction. The Tax Court stated that petitioner consistently treated the corporate officers as employees and contested only respondent's determination that the compensation paid to the corporate officers was inadequate. The Court stated that because respondent did not make a determination with respect to either of the two requisite matters specified in section 7436(a)(1) or (2), the Court lacked jurisdiction to determine the correct amount of employment taxes due as a result of respondent's determination that DDS Corp under-reported corporate officers' wages during the tax years at issue.

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<sup>3</sup> Motions to dismiss for lack of jurisdiction, citing the grounds that a Notice of Determination of Worker Classification was not issued, were filed in several cases before the Service concluded that such notices were no longer a jurisdictional prerequisite to Tax Court Review in line with the Court's decision in SECC. See Chief Counsel Notice 2016-002.

QUESTION 2

As stated above, in the scenario you provided, the Service is not making a determination with respect to worker classification or with respect to the taxpayer's entitlement to relief pursuant to Section 530. As such, the Service should not issue a Letter 3523. Rather, the additional taxes resulting from the recharacterized payments should be directly assessed pursuant to Code section 6201.

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

Please call Cynthia McGreevy at 202-317-4774 if you have any further questions.



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