MORE CARROTS, FEWER STICKS: WHY EMPLOYERS SHOULD BE OFFERED IN PAYROLL TAX AND EXECUTIVE COMPENSATION AUDITS ALL THE PROTECTIONS OF REV. PROC. 64-22

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I. INTRODUCTION

The principles of tax administration outlined by Commissioner Mortimer Caplin in Revenue Procedure 64-22 are as sound today as they were forty-five years ago, when both the Internal Revenue Code (Code) and the taxpaying populace were less than one-tenth their current size. More particularly, the Code in 1964 was a single slender
volume, and is two ponderous volumes today, printed with smaller type, thinner paper, and copious textual notes referencing the nearly 400 tax bills enacted since the Code was last recodified in 1954. The numbers of taxpayers and return filers have grown exponentially as well, reflecting not only population growth, but also a dramatic expansion in the numbers and types of taxing entities and of tax and information returns. Despite this growth in the Code's complexity and in the numbers of affected taxpayers, Mr. Caplin's basic point holds true, that taxpayers will not continue to make the voluntary tax payments that are fundamental to our income tax system unless all federal tax administrators:

(1) treat taxpayers "with great courtesy and considerateness";

(2) administer the laws and conduct audits "with as little delay as possible";

(3) attack relentlessly any "unreal tax devices and fraud";

(4) raise issues on audit only if they have merit, "never arbitrarily or for trading," and where the issues fairly and reasonably reflect the true "meaning of various Code provisions in light of the Congressional purpose in enacting them"; and

(5) never raise an issue either in audit or in litigation that is

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partner David R. Fuller and former partner Dean R. Morley.

2 Notably, although the current Code is entitled the "Internal Revenue Code of 1986," the 1986 revision was technically not a recodification, but only a change in name and date. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 2 (1986) (providing that: (a) the 1954 Code was simply "redesignated," and thus "may be cited as the "Internal Revenue Code of 1986"; and (b) "Except when inappropriate, any reference in any law, Executive order, or other document—(1) to the Internal Revenue Code of 1954 shall include a reference to the Internal Revenue Code of 1986, and (2) to the Internal Revenue Code of 1986 shall include a reference to the provisions of law formerly known as the Internal Revenue Code of 1954.") We are thus essentially still living with Mr. Caplin's Code, but a lot more of it.
4 Id.
5 Id.
6 Id.
7 Id.
"inconsistent with an established Service position."

The co-contributors to this article are asked to evaluate the continuing relevance of these instructions, including both the Internal Revenue Service's (Service) continuing compliance with them, and whether any additional points should be added to the list above, for consideration by both the Service National Office attorneys who write the regulations, rulings, and all other tax guidance, and the Service agents who apply these rules. My perspective is based on a career spent advising corporations about tax withholding and information reporting of payments made to other taxpayers (including employees, independent contractors, and entity payees), as well as about the deductibility of those payments on my corporate clients' tax returns.

In my view, this information reporting and withholding system is just as critical to "voluntary compliance" as all of the principles outlined above, because without information reporting and withholding, the payees of potentially taxable income would be far less likely to report one hundred percent of their taxable income, and the Service would be unable to detect underreporting outside the context of individual audits. Admittedly, the information reporting and withholding rules impose both tax burdens and potential penalties upon the employers, payors, and other entities that file these information returns, and collect and deposit withholding taxes, in order to ensure compliance with the information return filing, withholding and deposit requirements. However, because these payor entities are effectively working as the intermediaries between the Service and the income recipients, ensuring that the income recipients do in fact continue to pay their taxes "voluntarily," all the above-

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8 Id.

9 According to Statistics of Income (SOI) data for 2006 (the most recent reporting year), the Internal Revenue Service (Service) processed 138 million individual income tax returns, reporting $5.6 trillion of income, of which only $37 billion was “income not reported elsewhere” (as reflected on line 21 of Form 1040), vividly demonstrating the importance of information reporting to taxpayers’ decisions to report income on their personal tax returns. Statistics of Income Division of the Internal Revenue Service, Individual Income Tax Returns - Table 1, SOI Bull. Winter 2009, available at http://www.irs.gov/pub/irs-soi/06in01ar.xls. The same 2006 SOI data reported total individual income tax payments of $1.1 trillion, of which income tax withholding represented $843 billion, and estimated taxes only $253 billion. Id. Separate from the income tax payments, payments of Social Security taxes in 2006 totaled $675 billion, and Medicare taxes $200 billion. Id. Stated differently, over eighty-seven percent of U.S. federal individual income tax collections in 2006 were attributable to payroll taxes.
outlined administrative guidelines should be applied with special care to them.

In my experience, although most Service personnel generally continue to follow all of Mr. Caplin's sound tenets of tax administration, there have been some shortfalls, particularly in the context of both Service guidance dealing with employee compensation, and some payroll tax audits. Certainly the first principle, calling for courteous and considerate treatment of taxpayers, is one that Service agents and National Office attorneys have routinely followed. As for the second tenet, "avoiding delay," over the last eight years, after the implementation of the last Service reorganization, the Service has become much more current in commencing audits, but these audits can drag on for over a year, and it still takes, on average, ten to sixteen months after a protest is filed before a meeting is scheduled with Service Appeals. There are also still considerable delays in the publication of Service guidance, despite the Service's efforts to meet the deadlines set in the annual "Guidance Plan" detailing the regulations and rulings that Service plans to issue over the course of each fiscal year. More particularly (as is explained in Part V. below), there are many guidance projects in the areas of worker compensation and information reporting, where the Service guidance has remained proposed (or nonexistent) since each relevant statute's enactment; and in other instances, the Service has reversed longstanding positions, without notice and comment, through revenue rulings, revenue procedures, or even private letter rulings.

By contrast to these delays in processing some audits and in issuing certain guidance, in the case of the third tenet, the Service's general coordination of its audit programs, and speed in issuing guidance affecting perceived "unreal tax devices and fraud" has been impressive in recent years. "Coordinated issue papers" have been published for specific industries and issues, notifying taxpayers of the Service's detection and analysis of perceived tax abuses. Very few of these challenges have affected payroll tax withholding or information reporting issues. As a practical matter, there would be little incentive for an employer or other payor to design or apply a fraudulent or unreal tax device to withheld taxes, which are not the payor's taxes in any event.

My principal concern (and my reason for writing this paper) is that the Service not deviate from the last two of Mr. Caplin's tenets, particularly in the area of withholding tax and information reporting audits. The Service has recently announced plans to audit 6,000
employers. Based upon the procedures followed by the Service in the most recent round of audits of certain issues involving executive compensation, I am concerned that in this new round of audits, the Service may use standardized audit questions, adopt a policy mandating identical treatment of all taxpayers, propose payroll tax deficiencies for a wide variety of cash and noncash fringes, and increase those proposed adjustments by both tax and information reporting penalties, even in instances where the company’s position was based on either published substantial authority, or a genuine confusion about a particular income or withholding exclusion, often created by the lack of published guidance. I would instead urge the Service, in conducting all these audits, to be much more attentive to the facts and circumstances behind each company’s reporting and withholding positions, and to the companies’ explanations of any tax deposit deficiencies or timing errors. Indeed, the “reasonable belief” standard in most of the Code’s withholding exceptions, as well as the regulatory definitions of “reasonable cause” for penalty abatements, appears to mandate that treatment, as is explained in more detail in Parts III. and IV. below.

Finally, to supplement the principles outlined in Rev. Proc. 64-22, I recommend that the Service expand its program to encourage employers and other payors to correct prior years’ information reporting errors and withholding deficiencies. Until very recently, this program has operated with relative efficiency, but (as is explained in more detail in Part VI. below) certain changes currently under consideration would significantly reduce its effectiveness. Indeed, in my experience, there have been some instances in which the Service has initiated an audit after a company has proposed voluntary payments, and has proposed not only taxes exceeding those that have

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10 See Michael Joe, IRS to Audit 6,000 Companies for Employment Tax Compliance 2009 TNT 183-4 (Sept. 24, 2009) (explaining that “[t]he IRS plans to audit 6,000 U.S. companies over the next several years to ensure compliance with federal employment tax obligations as part of a research program that begins in February [2010]”); see also Lee A. Sheppard, Tax Schemes are Proliferating, Official Tells NYU Conference 2009 TNT 200-1 (Oct. 20, 2009) (explaining that this research program “will look at causes of nonpayment, including executive compensation and worker classification,” and also noting that “withholding has become a Tier 1 issue”).

11 See, e.g., Mary Hughes, Official Says IRS Compliance Initiatives Include Executive Compensation, Audits, Daily Tax Rep. (BNA) No. 217, at G-2 (Nov. 10, 2003) (explaining the Service audit initiative focusing on various executive compensation issues, including golden parachutes, deferred compensation, the $1 million cap on certain compensation deductions under section 162(m), split dollar life insurance, offshore employee leasing, and sales of options to family partnerships).
been voluntarily paid, but also penalties on both the voluntarily paid taxes and on the additional taxes. Such a response to any employers that are merely trying to correct a perceived prior underreporting error would eliminate any incentive for employers to correct prior years’ mistakes.

II. APPRECIATION OF FUNCTIONS OF PAYROLL AND ACCOUNTS PAYABLE DEPARTMENTS.

As part of the recommended “considerate” treatment of taxpayers (the first of Mr. Caplin’s tenets of tax administration), it is important for all auditing agents not merely to be polite, but also to be fully appreciative of the myriad responsibilities of both payroll tax departments and accounts payable departments, so that the agents fully understand the burdens placed on department personnel. These responsibilities include not only paying wages in compliance with state and federal wage/hour laws, but also identifying taxable versus nontaxable compensation, identifying the types and amounts of payments that might be subject to federal and multi-state withholding (and at what rates), calculating and collecting withholdings from payments (including noncash payments not susceptible to withholding), depositing withholdings timely, filing all required information returns, payroll tax returns and other withholding reporting forms, dealing with tax levies on workers’ wages, and with other garnishments, withholding orders, bankruptcy orders, and debt collections. The Service National Office and any auditing agents should take these myriad and diverse responsibilities into consideration in drafting guidance, and in determining liability for the taxes and penalties potentially triggered if these responsibilities are violated.

III. POTENTIAL TAXES AND PENALTIES IMPOSABLE FOR WITHHOLDING, DEPOSIT, AND INFORMATION REPORTING ERRORS.

A. “Secondary Liability” Rules Applicable to Payroll and Backup Withholding Taxes.

1. Overview of Payor Liability.

Employers responsible for deducting and withholding federal income taxes from any employee’s wages are liable to the Service (under section 3403) for any taxes that are not in fact timely withheld
and deposited.\textsuperscript{12} This statutory rule is only one sentence long, and the underlying regulations are not much longer, but this simple rule contains a very strict warning to employers as to their responsibilities and obligations with respect to federal income tax withholding. In its entirety, section 3403 provides:

The employer shall be liable for the payment of the tax required to be deducted and withheld under this chapter, and shall not be liable to any person for the amount of any such payment.

The underlying regulation additionally warns employers that they are liable "whether or not [the taxes are] collected from the employee by the employer."\textsuperscript{13} The same provision applies to any entity making a payment subject to backup withholding.\textsuperscript{14} This payor liability is generally referred to as "secondary liability," a term not used in the statute, but which makes clear that the taxes at issue are primarily (and independently) the liability of the recipient of the wages or other payments. If the employer (or other paying entity) is assessed for any such previously non-withheld payroll taxes, that liability is abatable, if and only if the payor can prove that the taxes in question were already paid by the employee (or other payee).\textsuperscript{15} Moreover, if the payor makes such a payment in a calendar year after the year for which the taxes were originally owed (which is almost always the case, since these assessments typically arise on audit of prior years' returns), the payor is not entitled to recoup its payment from the payee.\textsuperscript{16}

\textsuperscript{12} The employer's liability for income tax withholding is typically calculated at the "supplemental withholding" rate, which is currently twenty-five percent for regular federal income tax withholding, and thirty-five percent for any payments of "supplemental wages" (e.g., bonuses or equity compensation) which exceed $1 million in any year to any individual employee. Treas. Reg. § 31.3402(g)-1 (2007). Also, any "excess parachute payments" are subject to a twenty-five percent excise tax, which must be collected as additional income tax withholding. I.R.C. § 4999(c)(1). Similar secondary liability rules apply to FICA taxes. I.R.C. §§ 3101, 3102(b).

\textsuperscript{13} Treas. Reg. § 31.3403-1 (1960).

\textsuperscript{14} I.R.C. § 3406(h)(10) (providing that backup withholding is treated as wage withholding for all purposes of the Code).

\textsuperscript{15} See I.R.C. § 3402(d) (providing for abatement of income tax withholding liability based on proof of income tax payment by the employee). There is no direct equivalent to section 3402(d) in the FICA statute for totally abating the employer's liability for nonwithheld FICA taxes, simply because employees generally have no ability to "self-pay" their share of FICA taxes, and thus it is not likely that any such abatement would ever be available.

These "secondary liability" taxes do not apply to taxable income that is statutorily exempt from withholding, such as the taxable value of employer-provided cars,\(^\text{17}\) imputed income for any employer loans to employees,\(^\text{18}\) group term life insurance provided to former employees,\(^\text{19}\) income generated by incentive stock options (ISOs) or employee stock purchase plan (ESPP) options,\(^\text{20}\) payments under qualified retirement plans where the employee has not elected voluntary withholding,\(^\text{21}\) and amounts paid to any independent contractor or other non-employee payee, provided that the payor has collected the Taxpayer Identification Number (TIN) of the payee prior to making the payment.\(^\text{22}\) These secondary liability taxes are also not applicable where the employer had a "reasonable belief" (albeit an incorrect belief) that a particular payment was excludable from income (as is discussed in Part IV.B. below). Finally, the secondary

\(^{17}\) I.R.C. § 3402(s) (providing an exemption from income tax withholding, but not from FICA taxes, for any income attributable to an employer-provided vehicle, provided that such income is properly reported on the employee’s Form W-2).

\(^{18}\) I.R.C. § 7872(f)(9) (exempting imputed interest income from federal income tax withholding, but not from FICA taxes).

\(^{19}\) I.R.C. § 3102(d) (providing for payment of the employer share of FICA taxes directly by covered former employees). There is no similar exemption for noncash fringe benefits generally, even where the benefit being provided to former employees is a noncash benefit not susceptible to "withholding." See Treas. Reg. § 31.3501(a)-1T, Q&A (1985). The only other type of income subject to such self-paid employee FICA taxes is tip income. I.R.C. § 3102(c).

\(^{20}\) See I.R.C. §§ 421(b), 423(c) (exempting from federal income tax withholding the income from dispositions of ISO or ESPP stock); I.R.C. § 3121(a)(22) (exempting ISO and ESPP options from FICA taxes).

\(^{21}\) I.R.C. § 3405(a)(2).

\(^{22}\) The backup withholding rules of section 3406 apply if and only if any payments are made to payees in violation of the relatively complex rules for advance collection of TINs, or made after the Service has repeatedly notified the payor that the TIN provided on a previously filed information return is incorrect. See I.R.C. § 3406(a)(1).
liability taxes do not apply to the incremental income taxes on nonqualified deferred compensation triggered by violations of section 409A (governing deferral election timing, benefit payments, plan design, and certain benefit funding), because those taxes are owed only by the service-provider.


Importantly, employees and other payees have no legal right to demand payroll taxes should be paid over to them instead of to the Service. Neither can payees demand that the payor's payment erases their independent liability for these taxes. 23 Instead, the employees (or other payees) are independently liable to pay income taxes on any wages that were never subjected to federal income tax withholding during the calendar year of the original payment. 24 As a practical matter, however, at least in the case of employment tax audits, the Service typically does not proceed against employees to collect taxes from the employee once the secondary liability taxes have been

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23 Stated differently, employees have no Code provision protecting them, like I.R.C. § 3401(d)(1), which eliminates the employer's liability, if the employee pays the tax. See Edwards v. Commissioner, 39 T.C. 78, 84 (1962), aff'd on this issue, 323 F.2d 751 (9th Cir. 1963) (holding that the Service can collect taxes from either the employer or the employee when the taxes were not previously withheld); see also Goins v. Commissioner, 74 T.C.M. (CCH) 1243 (1997), aff'd 83 A.F.T.R. 2d 98-5077 (4th Cir. 1998) (holding that the worker and the employer are both liable for federal income tax withholding, and noting that "[The employee] may indeed be entitled to additional income from [his employer], but that is an issue between him and the company. We cannot require the Service to collect [an employee's] income from [an employer]. In effect, that would be asking respondent to enforce petitioner's private right of action against the company in lieu of collecting the taxes from petitioner directly."). Notably, too, when an employer makes a secondary liability payment, that payment is not reflected as "income tax withholding" in Box 2 of Form W-2, because the employer's tax payment was not, in fact, "withheld" from the employee's wages. Accordingly, the employee is never officially given "credit" for the employer's payment of secondary liability taxes, which the employee might reflect on a Form 1040 as "taxes" previously paid by the employee.

24 The Service almost never decides to collect these taxes from the employee, however, after it has received a secondary liability payment from an employer. If the employee is in a higher income tax bracket than the "supplemental rate" bracket normally used for assessing federal income tax withholding under section 3403, the Service may proceed with such collection. However, in the case of section 4999 excise taxes, the employer pays at the same rate as the employee, so there would be no point for the Service to proceed against the employee after receiving a section 3403 payment from the employer.
collected from the employer, for several reasons. First, by the time the employer's payroll tax audit has been completed, the employees' statutes of limitation typically have typically closed on those audit years. Second, it is very time consuming to proceed against the employees on an individual basis. Third, if the employees are held liable, any taxes paid by the employee automatically entitle the employer to a refund (with interest) of federal income withholding taxes that it may previously have paid under section 3403.25


Because the regulations provide that the employee does not "owe" the employer anything when an employer pays income tax withholding deficiencies for prior years (due to the above-explained regulations blocking an employer from collecting any tax reimbursement from the employee), there is no debt forgiveness income (or any other type of compensation income that might trigger a gross-up obligation) when the employer satisfies its secondary liability. This result was confirmed in Field Service Advice (FSA) 200022004 (February 3, 2000), which provides as follows:

Generally, if an employer makes a payment in year 2 (or a subsequent year) of income tax withholding liability incurred with respect to a wage payment to an employee in Year 1 from which income tax was erroneously not withheld, there is no effect on the gross income or income tax liability of the employee. The employer is satisfying the liability of the employer under section 3402 for the income tax withholding, and the employee cannot get credit under section 31 with respect to his or her income tax liability under section 1 for such amounts paid by the employer that were never withheld from the employee's wages. The employer in making the payment in Year 2 is not satisfying the income tax liability of the employee with respect to income tax in Year 1, and is not making a payment which may be credited or refunded to the employee. The distinction between income tax withholding made by the employer in the calendar year of the payment of wages and the payments of income tax withholding by the employer in subsequent years is reflected in the section 6205 regulations cited above, which provide that the employer can recover from the employee only income tax withholding

25 I.R.C. § 3401(d)(1).
during the calendar year of the payment, and cannot recover from the employee the income tax withholding after the end of the calendar year. Because the employer payment of income tax withholding in this situation does not relieve the liability of the employee for income tax with respect to the back wages, the employee’s gross incomes for Year 1 and Year 2 remain unaffected.26

This result has been particularly useful to employers and other payors who settle their secondary liability for previously nonwithheld income taxes, either as a result of audit, or on a voluntary basis, because it ensures that the payments can be made without triggering any tax gross-up, since they are not considered to be income to the affected employees.

B. Responsible Person Penalty for Unpaid Withholding Taxes.

Section 6672(a) imposes a one hundred percent liability upon “responsible persons” for their willful failure to “collect […], truthfully account for and pay over” payroll and other withholding taxes (including backup withholding taxes).27 The penalty does not apply to payroll taxes (such as unemployment taxes and the employer’s share of FICA taxes) that are imposed directly on the employer as opposed to payroll taxes that are withheld from employees’ wages.28 The Service typically uses this penalty under section 6672 as a last resort to collect taxes that it has been unable to collect from the employer or other payor that is required to withhold

26 I.R.S. Field Service Advice 200022004 (Feb. 3, 2000) (footnote omitted).

27 “Responsible person” is defined broadly by the courts to include any person who has decision-making authority with respect to the control of funds, including check-writing authority at the time the decision not to pay the liability was made. This authority need not be exclusive; it may be shared with others and need only be substantial. Potentially responsible parties include (a) human resources or payroll department employees with significant control over disbursement of funds; (b) corporate officers; (c) corporate directors; and (d) companies receiving the services of leased employees. Under certain circumstances, even bookkeepers, lenders, sureties, banks, and receivers have been held to be responsible persons, if they are involved in the daily operations of the corporation and made decisions regarding the disbursement of funds and payment of creditors. See IRM 5.7.3.3, Internal Revenue Manual (Apr. 4, 2006); Gordon D. Henderson & Stuart J. Goldring, Failing and Failed Businesses §§ 103, 1102.4 (2000 ed.).

28 Treas. Reg. § 301.6672-1 (1967); IRM 5.17.7.1.6, Internal Revenue Manual (Nov. 2, 2007).
the taxes. However, the total penalty is limited to the aggregate amount of uncollected taxes, pursuant to sections 6103(e)(9) and 6672(d), which cap the penalty amount, and ensure that in instances where more than one person is liable for the penalty, any responsible person who pays it can recover from other persons who are liable for the penalty an amount equal to their proportionate share of the penalty.

This "responsible person" penalty is not limited to instances where the payroll taxes were collected but not deposited (although, admittedly, the vast majority of cases in which this penalty has been applied involve these facts). Instead, it also applies to instances where the taxes were not withheld to begin with. However, the section 6672 penalty is only applicable where the failure to collect taxes was "willful." For this purpose, "willful" generally includes acting in reckless disregard. Actually, this is generally a strict liability standard and means that a person knew (or had reason to know) of the unpaid trust fund taxes and, having the means, failed to ensure that the taxes were paid. However, as is discussed in Part IV.C. below, some courts have applied different standards, refusing to apply the penalty where the decision not to pay the taxes had some reasonable basis.

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30 These provisions, added to the Code in 1996 by the Taxpayer Bill of Rights 2, established a federal cause of action for a right of contribution to allow jointly liable responsible persons to recover a proportionate share of the section 6672 penalty from the other responsible persons. See H.R. REP. NO. 104-506 (1996). The Service has not yet issued any formal guidance concerning how these actions are to be filed or how the other responsible persons are to be identified, but section 6103(e)(9) requires the Service to disclose, upon written request, to any person it has determined to be a responsible person, the name of any other persons it has determined to be responsible persons, the general nature of any collection action against such persons, and the amount collected.

31 No negligence or fraud penalty can be assessed in the event the section 6672 penalty is assessed, per section 6672(a). As a result, this penalty, which carries one-hundred percent liability, is always assessed rather than the negligence penalty under section 6672 (twenty percent liability) or the fraud penalty under I.R.C. § 6663 (seventy-five percent liability).

32 Godfrey v. United States, 748 F.2d 1568 (Fed. Cir. 1984).

33 See Klotz v. United States, 602 F.2d 920 (9th Cir. 1979); Garsky v. United States, 600 F.2d 86 (7th Cir. 1979).
C. Deposit Penalties for Late Deposits of Withholding Taxes.

A penalty under section 6656 applies where taxes are withheld but deposited late (or not at all). The penalty equals ten percent of the underpaid withholdings. (Lower penalties apply to deposit delays of under sixteen days; specifically, the penalty is only two percent for deposit delays of one to five days; and five percent for delays of six to fifteen days. However, if an employer refuses to pay after notice and demand, the penalty increases to fifteen percent.) There is no possibility of a failure to deposit penalty being assessed under section 6656, when an employer makes a retroactive deposit of secondary liability taxes for a prior year, because that penalty is not applicable where there also has been a failure to withhold taxes.\(^{34}\)

D. Information Reporting Penalties for Unfiled Information Returns and Unreported Income.

Two separate penalties apply under the Code for incorrect information returns: one for errors in returns filed with the Service, and the second for errors in returns sent to payees.\(^{35}\) The first penalty, under section 6721, is $50 per erroneous Form W-2 or 1099 (reduced to $15, if corrected within thirty days after January 31 information return filing deadline, or $30, if corrected on or before August 1), but is capped (except in cases of intentional disregard\(^{36}\)) at a maximum of $250,000 for all such failures in the aggregate for the year. The second penalty under section 6721, is $50 per erroneous Form W-2 or Form 1099, again capped (except in cases of intentional disregard\(^{37}\)) at $100,000 for all such failures in the aggregate for the year.

As a practical matter, the Service historically has applied only one of these two penalties, in recognition of the fact that the penalties are essentially duplicative that any error made on the Service copy of any information return would likely be duplicated on the payee's copy as well. In recognition of this duplication, the Internal Revenue Manual implies that only one penalty (i.e., the standard $50 penalty per Form W-2, the section 6721 reduced penalty of $15 or $30, or $100 or ten

\(^{34}\) See Rev. Rul. 75-191, 1975-1 C.B. 376.

\(^{35}\) A third penalty is also applicable under section 6674, for willfully failing to furnish a Form W-2 or furnishing of a false or fraudulent Form W-2, but that penalty is only very rarely cited.

\(^{36}\) In the case of intentional disregard, this penalty equals the greater of ten percent of underreported amount or $100 per incorrect return. I.R.C. § 6721(e).

\(^{37}\) Id.
percent for intentional disregard) per return or payee statement should be assessed per incorrect return. The penalty will be the largest one applicable. 38

IV. EXEMPTIONS FROM SECONDARY LIABILITY TAXES, "RESPONSIBLE PERSON" PENALTIES, AND OTHER PENALTIES, WHERE PAYORS "REASONABLY BELIEVE" THAT AN INCOME EXEMPTION EXISTS, WHERE THE LAW IS "CONFUSING," OR WHERE OTHER "REASONABLE CAUSE" SUPPORTS PENALTY ABATEMENT.

A. Reasonable Belief.

Most of the Code's exemptions from payroll tax withholding provide an exemption from withholding that is not based simply upon whether an item is or is not "taxable income," but instead upon whether it was "reasonable" for the paying employer to believe that the compensation in question was excludable from income under one or more of the statutory exemptions applicable to employee compensation. This exception applies not only to federal income tax withholding, but also to FICA and FUTA taxes. 39

In enacting these statutory exceptions from withholding, Congress has never provided any detailed discussion of the analysis that should be applied in determining whether an employer in fact has a "reasonable belief" that a particular exception applied. The Service also has issued surprisingly limited guidance explaining this special exemption. Treasury Regulations sections 31.3121(a)(11)-1(a) (1975) and 31.3401(a)(15)-1(a) (1977) pertaining to moving expenses provide some insight into what constitutes "reasonable belief" than other regulations:

The reasonable belief contemplated by the statute may be based upon any evidence reasonably sufficient to induce such belief, even though such evidence may be insufficient upon closer examination by the district director or the courts finally

38 See IRM 20.1.7.1.5 (2), Internal Revenue Manual (Nov. 16, 2007).
39 See I.R.C. §§ 3401(a)(8)(A)(i), (B), (C) (applying the test to the section 911 exclusion); I.R.C. § 3401 (a)(15) (moving expenses); I.R.C. § 3401(a)(18) (educational expenses, dependent care and certain military benefits); I.R.C. § 3401(a)(19) (employee achievement awards, certain loan repayments, qualified scholarships, and certain fringe benefits); I.R.C. § 3401(a)(21) (contributions to Archer MSAs); I.R.C. § 3401(a)(22) (contributions to health savings accounts). There are separate, although not exactly correlative, FICA and FUTA tax "reasonable belief" exceptions contained in sections 3121 and 3306.
to establish that a deduction is allowable under section 217. The reasonable belief shall be based upon the application of section 217 and the regulations thereunder . . . . 40

There are also a few private letter rulings and technical advice memoranda that discuss this reasonable belief standard. In Private Letter Ruling (PLR) 8734046 (May 28, 1987) (addressing the excludability from payroll taxes of a particular mileage allowance), the Service stated that:

Whether or not a reasonable basis exists for anticipating that Company’s drivers will meet the requirements for excluding the reimbursements from gross income under section 132 of the Code is a question of fact that must be determined on the basis of the circumstances of each particular case. No opinion is expressed herein as to whether Company has a reasonable basis for anticipating that the 6 cents per mile allowance will meet the requirements.

In Technical Advice Memorandum (TAM) 9038001 (June 7, 1990) (also dealing with truckers’ mileage allowances), the Service explained more particularly that in evaluating reasonable belief under sections 3121(a)(20) and 3401(a)(19), the employer’s state of mind is relevant. As with PLR 8734046, this TAM left the determination of the application of the reasonable belief exemption to the District Director, but explained that the analysis must be based upon the employer’s reasoning at the time the payment was made, and must depend upon the facts and circumstances of each case.

In TAM 9112001 (December 13, 1990) (dealing with airline flight attendant per diem allowances), the Service reiterated these prior points, and also introduced the following “reasoned judgment” test as a shorthand way of referring to the requirements for establishing reasonable belief:

Although actual substantiation of the amount is not required, the Taxpayer must have had a reasonable belief that the amount of the expenses would be substantiated under section 274 of the Code, either through actual or deemed substantiation. In this instance, the deemed substantiation

methods provided under Rev. Rul. 84-164 could only be relied upon by the Taxpayer in determining the reasonable belief that expenses were substantiated in the amount of $14 per day (the amount deemed substantiated under Rev. Rul. 84-164). For amounts in excess of $14, the Taxpayer must have reasonably believed that its employees would actually substantiate their expenses pursuant to section 274(d). If the Taxpayer had knowledge that its employees were not substantiating these amounts, then the reasonableness of the Taxpayer's belief is called into question.

At a minimum, the existence of a reasonable belief requires an understanding of the law and an application of the facts to the law to arrive at a reasoned judgment. If the Taxpayer had undertaken such an examination during each of the years in issue, then it would at the very least have reported these payments on the Forms W-2 prior to 1987. Although reporting under section 6041 of the Code is not identical to withholding wages for FICA and income tax purposes, this failure to report indicates that the Taxpayer never examined the issue to establish or determine a reasonable belief.

TAM 9112001 continues with the observation that “[t]he District Director is in the best position to reconcile any conflicting factual allegations and to make a final determination as to what the Taxpayer actually believed and whether the Taxpayer's belief was reasonable at the time the payment was made.” (Emphasis added).

This “reasoned judgment” test was repeated in TAM 9148001 (February 15, 1991) (dealing with overtime meal allowances provided to utility workers), which states that:

The exclusion from wages found in sections 3121(a)(20) and 3401(a)(19) is not triggered merely by an employer's assertion that it applies. If an employer seeks to rely on the exclusion, it is obligated to have, at minimum, an understanding of the law and to apply the law to the particular facts. In this way, the existence of a reasonable belief for excluding the benefits is based on a reasoned judgment.

Unlike earlier TAMs, TAM 9148001 actually concludes that the employer did not have the requisite reasonable belief, rather than
deferring the decision to the District Director.\footnote{A few other TAMs issued in 1991 also discussed briefly the reasonable belief exemption of sections 3121(a)(20) and 3401(a)(19). See I.R.S. Tech. Adv. Mem. 91-27-009 (March 29, 1991); I.R.S. Tech Adv. Mem. 91-52-002 (March 29, 1991) (dealing with apartments provided to State legislators); I.R.S. Tech Adv. Mem. 91-46-003 (July 31, 1991) (involving per diem payments to truck drivers). Numerous other rulings reference the exception, without providing any detailed explanation of its operation.}

The most detailed discussion of this "reasonable belief" test is contained in TAM 9401002 (Sept. 24, 1993) (addressing benefits received by participants in a car manufacturer's product testing program). Notably, although the car manufacturer had shown that its belief was based in part upon its participation in the lobbying efforts that resulted in the product testing exclusion reference in the legislative history of the section 132 exclusion, the Service refused to concede that this evidence supported any reasoned judgment about the application of the exclusion, explaining that:

Even if we were to accept the Company's contention that the knowledge it gained as a result of lobbying activities establishes a reasonable basis, we do not believe that this knowledge is relevant in determining whether the Company had a reasonable belief. Instead, we believe that we are obligated to make the determination under section 3121(a)(19) of the Code in a manner that applies equally to all taxpayers, whether or not they were involved in the legislative process. In other words, we are limited to considering whether the Company had a reasonable belief based on the legislative history that was available to all taxpayers when section 132 of the Code was enacted.

The patently strained logic of this TAM does not address the fact that the Service had never issued (and still has not issued) formal guidance explaining the operation of this "reasonable belief" test, outside the context of the exclusions applicable to moving expenses (under Code section 217) and expatriates' income (under Code section 911). The regulations under each of those exclusions state that a withholding exclusion applies if there is "\textit{any evidence reasonably sufficient to induce} [the payor's belief that withholding was not required]." Given that the same "reasonable belief" language appears in all the various withholding exclusions, there seems to be little support for the Service's attempt, in this TAM, to apply a different test to benefits excludable under section 132 than the one that applies
under sections 217 or 911.\textsuperscript{42}

Finally, in a "training guide" on fringe benefits, developed by the Service in 1993 for the benefit of its employment tax specialists, the Service stated that:

It is important to remember that the exclusion from wages found in Code §§ 3121(a)(2), 3306(b)(16) and 3401(a)(19) is \textit{not} triggered merely by an employer's assertion that it applies. For example, the fact that an employer's competitors treat certain benefits as excludable does not support the employer's assertion that it had a reasonable belief for excluding the benefits that it was providing employees. Similarly, an assertion by the employer that it relied on the advice of an accountant or lawyer is not sufficient without inquiry into the specifics of the advice. In short, if an employer seeks to rely on the exclusion, it is obligated, at minimum, to have ascertained the applicable law and to have applied it to the particular facts. In this way, the existence of a reasonable belief for excluding the benefits from the employee's gross income is based on a reasoned judgment.\textsuperscript{43}

In summary, the test appears to require a subjective determination of whether, at the time the benefits were provided, the employer made a "reasoned judgment" about the applicable law, which should, in turn, guarantee an ultimate determination by the Service that the benefit in question had been properly exempted from withholding.

\textit{B. "Confusion Doctrine" Exemption from Employment Taxes (and Information Return Penalties) of Amounts Not Treated as Taxable Income to Employees.}

Completely apart from the statutory "reasonable belief" exceptions, the courts have created a second important limitation upon any employer's potential secondary liability for income tax withholdings and FICA taxes, referred to generally as the "inadequate notice" rule or the "confusion doctrine," established under Central

\textsuperscript{42} Similar language in two different regulations should be interpreted similarly. \textit{See} Bodzy v. Commissioner, 321 F.2d 331, 335 (5th Cir. 1963).

\textsuperscript{43} \textit{More Basics: The Basics of Fringe Benefits}, IRS Doc. 7977 (Rev. 1-94), Cat. #1464341, at 30 (emphasis in original).
Illinois Public Service Co. v. United States, 435 U.S. 21 (1978).\(^{44}\) In essence, the Supreme Court reasoned that, if the employer is to function as the Government's tax collector as opposed to the employees' surety, the tax obligations must be free of vagueness. As the Court stated, "[b]ecause the employer is in a secondary position as to liability for any tax of the employee, it is a matter of obvious concern that, absent further specific Congressional action, the employer's obligation to withhold be precise and not speculative."\(^{45}\) In his concurring opinion, Justice Brennan stated that "additional withholding taxes should not, at least without good reason, be assessed against employers who did not know of increased withholding obligations at the time wages had to be withheld."\(^{46}\) The courts, in cases that have applied this doctrine, have generally refused to assess any secondary liability for unwithheld employment taxes against the employers, under the principle that, before any such assessment could be made, the employer as "deputy tax collector" must have adequate notice so that it will "know what the IRS thinks the law is and therefore what actions they have to take."\(^{47}\) The courts, applying an objective standard (as opposed to the apparently subjective standard applicable under the "reasonable belief" test discussed above\(^{48}\)), concluded that the facts in these cases did not

\(^{44}\) The principle of Central Illinois concerning the need for guidance to employers concerning their withholding obligation has been the subject of several cases, leading up to General Elevator v. United States, 20 Cl. Ct. 345 (1990). See McGraw-Hill, Inc. v. United States, 623 F.2d 700 (Ct. Cl. 1980); Marquette University v. United States, 645 F. Supp. 1007 (E.D. Wis. 1985); Western Reserve Academy v. United States, 619 F. Supp. 394 (N.D. Ohio 1985), aff'd, 801 F.2d 250 (6th Cir. 1986). The doctrine has continued to be followed by the Court of Federal Claims and other circuits after the General Elevator decision, particularly as to all taxes collected through wage withholding. Some circuits do not extend the doctrine to the employer share of FICA taxes. See North Dakota State University v. United States, 84 F. Supp. 2d 1043 (D. N.D. 1999), aff'd, 255 F.3d 599 (8th Cir. 2001), action on dec., 2001-08 (Jan. 1, 2002); HB&R v. United States, 229 F.3d 688 (8th Cir. 2000); IBM v. United States, 87 A.F.T.R. 2d ¶2001-389 (Fed. Ct. Cl. 2001)

\(^{45}\) Central Illinois, 435 U.S. at 31.

\(^{46}\) Central Illinois, 435 U.S. at 37.

\(^{47}\) General Elevator, 20 Cl. Ct. at 353.

\(^{48}\) The only court to address whether reasonable belief is based on an objective or subjective standard is American Airlines, Inc. v. United States, 40 Fed. Cl. 712 (1998), 98-1 USTC ¶50,323, aff'd in part and remanded in part, 204 F.3d 1103 (Fed. Cir. 2000), which concerned the employment taxation of per diem payments. It should be noted that, despite the court's initial conclusion in that particular case that the rules were "not objectively confusing" (in the eyes of the court, or any objective third party), it was nevertheless factually evident that there was confusion about the
establish a "precise and clear duty to withhold." 49

C. Potential Abatement of "Responsible Person" Penalties.

In considering defenses to the "responsible person" penalty, most courts have concluded that, for the section 6672 penalty to apply, all that is necessary is that the decision not to collect the taxes be "voluntary, conscious, and intentional." 50 In most circuits, reasonable cause or justifiable excuse play no part in the determination of willfulness. 51 In the Ninth Circuit, however, a district court has held that the section 6672 penalty should not apply where the taxpayer had a reasonable basis to conclude that no withholding taxes were due. 52 Also notable, the Tenth Circuit has allowed a limited "reasonable cause" defense, although that decision has been widely criticized. 53

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applicable law. Eventually, the taxpayer succeeded in its refund action when the U.S. Court of Federal Claims held for United Airlines in a factually identical case. See United Airlines, Inc. v. United States, 51 Fed. Cl. 722 (2001).

49 General Elevator, 20 Ct. Ct. at 353.

50 See Bloom v. United States, 272 F.2d 215, 223 (9th Cir. 1959) (concerning a taxpayer who made a conscious decision to pay other creditors, rather than the U.S. government, employment taxes that were withheld from employees' wages).

51 Id. at 223-24. Bloom has been cited by the Service in several rulings concerning the application of the section 6672 penalty. See I.R.S. Priv. Ltr. Rul. 9747005 (August 1, 1997); I.R.S. Priv. Ltr. Rul. 9745001 (July 18, 1997); I.R.S. Priv. Ltr. Rul. 9527008 (March 23, 1995); see also IRM 5.17.7.1.3, Internal Revenue Manual (Nov. 2, 2007) (stating that "Generally, a responsible person's willfulness is not negated where the failure to pay was due to reasonable cause. Olsen v. United States, 952 F.2d 236 (8th Cir. 1991)").

52 See Crowd Mgmt. Servs., Inc. v. United States, 889 F. Supp. 1313 (D. Or. 1995) (holding that where the responsible person consulted with his attorney concerning whether certain workers should be classified as independent contractors, the responsible person had a reasonable basis to conclude that no withholding taxes were due and therefore the section 6672 penalty should not be applied); see also Industrial Communications Sys. v. United States, 70-1 USTC §15,942 (C.D. Cal. 1970) (instructing the jury that if the responsible person "had no reasonable basis to suspect that his [service] was subject to an excise tax" then his failure to collect the tax could not be willful; the jury ultimately found, however, that the individual had willfully failed to collect the tax).

53 Finley v. United States, 123 F.3d 1342 (10th Cir. 1997); see also Howell v. United States, 164 F.3d 523 (10th Cir. 1998) (where the Tenth Circuit continued to apply a reasonable basis standard). To apply this defense, the "responsible person" must show that he acted reasonably throughout the period at issue. See Lee Sheppard, Tenth Circuit Writes Its Own Responsible Person Penalty, 76 TAX NOTES 1280 (Sept. 8, 1997). See generally GORDON D. HENDERSON & STUART J. GOLDRING, FAILING AND FAILED BUSINESSES, § 1006.3.2 (2000 ed.) (discussing the penalties for failure to collect or pay over withholding and other trust fund taxes, particularly in relation to
Despite these cited attempts by the Service and some courts to ignore reasonable causes, or justifiable excuses, it is simply not clear whether an allegedly "responsible person" might be able to demonstrate that a failure to collect was not "willful" if the law governing the liability for the tax was ambiguous (particularly if the person was able to prove that the failure to collect was based upon legal opinions provided by reputable tax counsel). For example, in the case of payroll tax withholding, an employer is excused from any secondary liability for nonwithheld payroll taxes, if it can show (applying the principles of Central Illinois) that its obligation to withhold taxes from this income was not clear because the Service has failed to provide "precise and not speculative" notice of any duty to withhold, as evidenced by the lack of adequate guidance with respect to both the exclusion and valuation provisions.

It seems that if, under Central Illinois, a company is relieved of its liability for payroll or excise taxes, the Service should not be able to assess a responsible person penalty on any individuals who participate in the company's decision not to collect or deposit the taxes. What is less clear is whether an individual can rely on a "confusion doctrine" argument in order to avoid any responsible person penalty if the company's liability for these taxes has not been abated per a Service settlement or a court decision.

D. "Reasonable Cause" for Penalty Abatement.

The penalty for failure to make a deposit of taxes (imposed under section 6656) can be abated if it is "shown that such failure is due to reasonable cause and not due to willful neglect."54 Reasonable cause exists whenever the taxpayer acted in a responsible manner and exercised ordinary business care and prudence in determining its tax obligation but nevertheless was unable to comply with the law.55 The ordinary business care test is further supported by IRS Policy Statement 2-7, which provides that "any sound reason advanced by a taxpayer as the cause for delay in... making deposits under the Federal Tax Deposit System, or paying tax when due, will be carefully analyzed to determine whether the applicable penalty should be

asserted. The Internal Revenue Manual identifies four factors to consider in evaluating whether a taxpayer exercised ordinary business care and prudence. Specifically, the Manual focuses on: (i) the taxpayer's reason for failing to comply; (ii) the taxpayer's compliance history; (iii) the speed with which the taxpayer responded once the problem was identified; and (iv) whether the taxpayer could have anticipated the problem. Similar abatement provisions apply to the penalty to file a required payroll tax return and pay the required payroll tax.

The IRS Consolidated Penalty Handbook instructs Service agents to make waiver determinations "on a case-by-case basis." Courts in many cases, however, have concluded that a taxpayer who makes mistakes despite the exercise of ordinary business care and prudence should not be punished. The Service's general guidelines for penalty abatement similarly provide that "[p]enalties support the Service's mission only if penalties enhance voluntary compliance." In other words, penalties are not intended to raise revenue or to punish for punishment's sake, but instead are intended to promote voluntary compliance. Accordingly, any employer or other payor with both a record of deposit compliance and prompt corrective actions to correct deposit errors should not be subjected to deposit penalties, especially in any case where the error was made following a careful, comprehensive review of the applicable Service guidance controlling the withholding tax deposit requirements.

Similar abatement provisions apply to the information reporting penalties under Code sections 6721 and 6722 if it can be shown that the failure was "due to reasonable cause and not to willful neglect." The regulations under section 6724 provide that reasonable cause exists where the filer can establish that (i) there are significant mitigating factors or events beyond the filer's control, and that (ii) the filer acted in a responsible fashion.

58 See I.R.C. § 6651(a)(1); Treas. Reg. § 301.6651-1(c) (2004).
59 IRM 20.1.1.3.2.3, Internal Revenue Manual (Feb. 22, 2008).
62 I.R.C. § 6724(a).
In brief, the Code and regulations indicate that these penalties, like secondary liability for nonwithheld taxes, should not be applied to payors who have acted "reasonably" and "responsibly," and that Service administrators' decisions about penalty abatement should take into account the payors' reliance on published guidance (or, as discussed below, missing or confusing guidance).

V. CONFUSING AND LATE-ISSUED GUIDANCE ON INCOME EXCLUSIONS.

A. Overview.

This article could be doubled in length if it attempted to provide a comprehensive list of income and withholding exclusions that have continually confused many payors. Instead, it provides a dozen examples of ambiguous (or nonexistent) guidance, organized not only according to the various statutory withholding tax exemptions which are based upon whether it is "reasonable for the employer to believe" that a particular income exclusion applies, but also according to various statutory information reporting provisions. Only a few of these examples are scheduled for imminent update, according to the most recent "Priority Guidance Plan." Guidance is needed in all of these areas, although here again, in issuing that guidance, the Service should adhere to the tenets of tax administration outlined in Rev. Proc. 64-22, by issuing guidance that complies with Congress's original intent in issuing the statute, and that does not conflict with prior outstanding guidance, without providing ample opportunities for notice and comment, and liberally prospective effective dates.

B. Specific Areas of Payor Confusion.

Like the "Priority Guidance Plan" itself, the following list contains bullet point references to examples of the various items of

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63 See infra Part V.
64 As explained in Part III.A. above, the operation of this "reasonable to believe" test is explained in the regulations under only two of the many statutory withholding exclusions which apply the test, although the Service has argued (albeit only in TAMS) that a narrower test applies for purposes of the other withholding exclusions.
compensation that are the subject of constant questions from employers and other payors who are confused about the potentially applicable withholding and reporting requirements.

1. Section 3401(a)(8) (the section 911 exclusion).

Although the Service has issued two notices providing annual adjustments for housing costs in specific locations in response to certain changes to section 911 made by the Tax Increase Prevention and Reconciliation Act of 2005,66 these notices were issued late in the year and applied on a retroactive basis; no additional guidance has been issued to change the existing regulations to reflect the 2005 statutory changes.

2. Section 3401(a)(15) (the moving expense exclusion).

The Service has never updated the regulations under section 217 to reflect the significantly narrowed deduction (and correlative exclusion) for moving expenses. In particular, although “temporary living expenses” in a new location are no longer deductible under section 217, it may be factually unclear when taxpayers might instead claim traveling expense exclusion, particularly for travel to a location where the taxpayer expects to be employed for under a year.

The guidance under Revenue Ruling 2005-74, 2005-51 I.R.B. 1153 (addressing the tax treatment of home sale expenses and home sale losses in three different factual situations) took years to develop and is still not well-understood by many employers.

3. Section 3401(a)(18) (educational assistance and dependent care).

Employers continue to be confused about the overlap of the educational assistance exclusion and the “working condition fringe,” particularly in the case of expenses for MBAs and college degrees.

No regulations have ever been issued under section 129 (the dependent care exclusion), although the statute was enacted in 1978.

4. Section 3401(a)(19) (employee achievement awards and other fringe benefits).

The proposed regulations governing the 1986 changes to sections

74 and 274 (governing employee achievement awards) have never been finalized.

Congress's expansion of the "de minimis fringe" exclusion in 1986 to cover gold watches provided at retirement and certain other retirement awards was referenced in Proposed Treasury Regulation section 1.274-8(d)(2), issued in 1989, and was never finalized. No changes were ever made to the fringe benefit regulations under Treasury Regulation section 1.132-6(e).

With respect to "de minimis fringes" in general, although the regulations contain many examples of certain types of de minimis fringes, they do not define the terms "small value" or "occasional," both of which are critical to any determination of the excludability of a "de minimis fringe."

The fringe benefit regulations under section 132 contained many typographical errors and oversights, only part of which were corrected by the issuance of Notice 89-110, 1989-2 C.B. 447. Furthermore, that Notice, as well as the regulations, has become further outdated in many respects due to numerous post-1989 statutory changes, which have caused many statutory cross-references in the regulations to be misleading and confusing.

The definition of "commuting" in Revenue Ruling 99-7, 1999-1 C.B. 361, has perplexed taxpayers for years, but the Service has

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67 Rev. Rul. 99-7, 1999-1 C.B. 361 provides that if a taxpayer has a regular work location away from the taxpayer's residence, the taxpayer may deduct daily transportation expenses incurred in going between the residence and another temporary work location in the same trade or business regardless of distance. If the taxpayer has a qualifying home office, his residence can be his principal place of business, and therefore the taxpayer may deduct daily transportation expenses incurred in going between the residence and another work location in the same trade or business, regardless of whether the work location is regular or temporary. However, if the taxpayer does not have a home office, daily transportation expenses between his residence and another regular place of business are not deductible. In contrast to this rule, however, transportation expenses between two business locations, whether the locations are "regular" or "temporary," are always deductible. Rev. Rul. 99-7 was the third in a series of Service rulings that significantly changed the rules on deducting commuting trips. See also Rev. Rul. 90-23, 1990-1 C.B. 28, as modified by Rev. Rul. 94-47, 1994-2 C.B. 18. Effective starting in 1990, these rulings changed the prior rule (contained in Rev. Rul. 55-109, 1955-1 C.B. 261) which had allowed deductions for trips beyond the general area of a taxpayer's tax home, and also generally allowed deductions for trips exceeding the mileage of the taxpayer's normal commute. The later rulings were designed in order to narrow the circumstances in which a commute could be deductible. See Burleson v. Commissioner, 68 T.C.M. (CCH) 288 (1994) (preventing the Service from applying the narrowed position in Rev. Rul. 94-47 retroactively to a particular taxpayer).
refused to issue private letter rulings addressing individual taxpayers' facts, which might provide additional guidance as to the definition of visits to a "temporary" work location (which counts as a deductible business trip, not a personal commute).

The "line of business" rules in Treasury Regulation section 1.132-4, classify operations into business lines defined by two-digit business codes provided in the "Enterprise Standard Industrial Classification Manual," which was last updated in 1984, and is no longer the preferred statistical method for identifying lines of business. Still more frustratingly, certain Service attorneys have informally indicated that the National Office generally applies the updated classification codes, even though the regulations very clearly refer exclusively to the ESIC codes.

The fringe benefit nondiscrimination rules in Treasury Regulation section 1.132-8(c)(3), providing the classes of excludable employees, still contain cross-references to the exclusion categories in section 89(h), which was retroactively repealed in 1989.

These and many other provisions need to be clarified if the Service expects taxpayers to withhold more taxes or report more income with respect to these cited benefits. Without such additional guidance, payors will be able to point to the confusing current guidance in support of their decisions not to withhold or report. Furthermore, unless and until the Service issues binding guidance under the withholding exemptions explaining its interpretation of the "reasonable belief" test applicable to these withholding exceptions, payors will simply continue to rely upon the test as it has been explained in the regulations under sections 3401(a)(8) and 3401(a)(15), which specifically respects any payor's decisions to apply a withholding exclusion if there is "any evidence reasonably sufficient to induce [the payor's belief that a withholding exclusion applies]," despite the various TAMs attempting to narrow that exclusion (explained in Part IV.A. above).

VI. IMPORTANCE OF CONTINUING INCENTIVES FOR PAYORS’ VOLUNTARY DISCLOSURE OF PRIOR YEARS’ UNDERWITHHOLDING OR UNDERREPORTING.

A. No Interest on Delayed Tax Deposits.

If a genuine dispute exists as to an employer's liability for
employment tax withholdings, and if the employer corrects the underwithholding at the end of the audit process, the late payment of tax withholdings can be deposited interest-free, under the special interest abatement rules of section 6205(a), Treas. Reg. section 31.6205-1, and Rev. Rul. 2009-39, 2009— I.R.B. __.\textsuperscript{69} Essentially, these rules have for many years provided taxpayers with an opportunity to correct underreporting errors, interest-free, if the taxes are paid on or before the due date of the return for the quarter in which the error was "ascertained," either by filing a Form 941-X\textsuperscript{70} and paying the tax by the due date for the Form 941 for the calendar quarter in which the error is "ascertained"\textsuperscript{71} (generally the end of the month after the end of the quarter\textsuperscript{72}), or (if the error is not determined until a Service audit of the taxpayer) by signing a closing agreement with the Service at the end of an employment tax audit (and appeal), and paying the tax before issuance of a notice and demand for same. Unfortunately, as part of the revised regulations under section 6205 that are effective for mistakes discovered starting in 2009, the Service has limited the application of these long-standing interest-free correction rules, by providing (in Treas. Reg. section 31.6205-1(a)(2)) that the interest-free correction procedures are not available if the issue being corrected has been "raised in an examination of a prior return period." Very confusingly, under the literal terms of this regulation, if an issue is "raised," but the employer shows that either during the audit or following an Appeals procedure, its reporting position was determined to have been correct, the Service still is free to deny an interest-free correction if the issue is challenged in a subsequent audit. This provision makes no sense, because if an employer won all or most of the issue, pursuant to an Appeals settlement, there would have been absolutely no reason for the employer to have changed its reporting position, to commence withholding with respect to benefits that the Service had conceded (at


\textsuperscript{70} The Form 941-Z is a new form, issued in connection with the revised regulations under section 6205 that were published July 1, 2008.

\textsuperscript{71} Treas. Reg. § 31.6205-1(a)(5) (2009) ("[A]n error [in underreporting certain employment taxes] is ascertained when the employer has sufficient knowledge of the error to be able to correct it.").

\textsuperscript{72} If the employer has made timely deposits in full payment of its taxes for a quarter, the deadline is ten days later.
Appeals) were more likely than not exempt from withholding. One would hope that the Service, in applying this regulation, would concede that the new regulatory reference to an issue being "raised" during an audit should be interpreted to mean that the issue was both "raised" and "conceded by the taxpayer to have been reported incorrectly." Otherwise, it might be possible for examining agents to issue laundry lists of Information Document Requests (IDRs), asking for information about hundreds of different fringe benefits, subsequently dropping any examination, but then taking the position in a later audit that the mere issuance of prior IDRs blocked the taxpayer from every qualifying for an interest-free adjustment. Such an absurd position would eliminate the incentive to correct reporting errors that was originally created by the pre-2009 regulations under section 6205, and by Rev. Rul. 75-464.

The other situation in which these interest-free correction rules would (justifiably) not apply is in any case where an employer has knowingly underreported its liability, or knowingly underdeposited withheld taxes. However, where the taxpayer can show reasonable grounds for having not paid the taxes, an interest-free adjustment certainly should be allowed, both based on the promise of relief in Rev. Rul. 2009-39, and on what should be general administrative policy of creating a tax incentive for payors to correct withholding errors. Indeed, some taxpayers have claimed that proof of "substantial authority" for a reporting position should automatically qualify a payor for an interest free adjustment, although the Service so far has responded that "there is no statutory or regulatory provision linking the meaning of an 'error' for purposes of section 6205 with the standard for imposing the accuracy-related penalty under section 6662(b)(1)." However, in this same memorandum, the Service conceded that an interest-free adjustment may be warranted even if a penalty was applied under section 6662.

B. Support for Correlative Penalty Waiver.

As explained above in Part IV.C., in any instance where withholding taxes have never been collected, no penalty applies under section 6656, when an employer makes a retroactive deposit of secondary liability taxes for a prior year. By the same token, it would be reasonable for the Service similarly to promise an automatic waiver

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75 Id.
of penalties under section 6662 or 6672 for incorrect Form 941, if the company had a reasonable basis for its position when the Form 941 was originally filed. Similarly, no penalties for an incorrect Form W-2 or W-2c should be applicable under section 6721, 6722, or 6674, if the company had reasonable cause for the incorrect filing of the original Form W-2 (typically, the Service does not require any Form W-2c to be filed at the end of a payroll audit, but instead simply closes out the payroll audit by accepting the employer’s payment of secondary liability taxes).

C. Need for Expanded Voluntary Disclosure Program.

Eleven years ago, the Service developed a helpful program for correcting “mass errors” in the filings of Form 1099. As originally designed, the program was intended to cover written agreements between the Service and payor-return filers, correcting certain errors affecting numerous Forms 1099, where the error involved a de minimis amount of understated reportable income for each Form 1099.

As originally proposed, these IRP-CAP procedures were not intended to apply to Form W-2, because of IRPAC’s assumption that any corrections in wages would have had to have been coordinated with the Social Security Administration. Until last year, however, the Service has been willing to extend this program even to mass errors in Form W-2, although these types of settlements have been used by the Service field offices only on an ad hoc basis. The closing agreement form is typically “IRS Form 906” entitled “Closing Agreement on Final Determinations Covering Specific Matters,” which is prepared and filed in triplicate, pursuant to section 7121. Oddly, it is neither available to the general public nor accessible through the Service website.

There has been no formal indication that the Service is

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76 This program was announced during an April 1998 meeting of the Service’s “Information Return Program Advisory Committee” (IRPAC), through a memo to Regional Chief Compliance officers from the Assistant Commission (Examinations) dated April 27, 1998, entitled “Implementation of Information Reporting Program—Closing Agreement Procedure (IRP-CAP).” It was later incorporated in IRM Exhibit 8.13.1-12, “Form 906—Pattern Information Reporting Program (IRP) Closing Agreement for Understatement of Income on Form 1099 by a Payee.”

77 This de minimis level originally was $50, but it was expanded in a later Internal Revenue Manual to $100. Furthermore, in some instances, the Service has recently entered into closing agreements where the average error was under $100, even though some individual payees may have had larger errors.
abandoning this program, even though, as a technical matter, the availability of this closing agreement has never been guaranteed or automatic. Unfortunately, the clearance process has typically taken at least a year, and in certain instances the legal fees of negotiating the closing agreements have exceeded the taxes that the payor is voluntarily paying. Moreover, it has been rumored that changes in IRS Manual Procedures are being developed, which will significantly limit this program’s benefits for two reasons. First, it will likely be more difficult to obtain a closing agreement without paying not only the unpaid taxes, but also possible penalties or “compliance fees.”  

Second, the Service will likely require the preparation of a corrected Form W-2 at the end of the process, which would effectively eliminate the program’s promised benefit of permitting payors to voluntarily pay the nonwithheld taxes, with no tax costs to the employee. If instead a Form W-2 is required, the payees would still have to prepare amended tax returns, and any reimbursements of such taxes paid by the employers or other payors would have to be paid subject to tax gross-ups.

Both of these changes, in my view, would be most ill-advised. The voluntary correction program, as it has been historically structured, provides incentives for employers and other payors to correct prior years’ reporting and withholding errors, because the corrections can be made on an interest-free (and generally penalty-free) basis, without annoying employees with amendments to Form 1040, and without treating the payments as income to employees (since, as explained above, any payments under section 3403 satisfy the payor’s secondary liability, which operates independently from the payee’s tax liability). The Service should be encouraging such voluntary corrections, not suppressing them.

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78 Such compliance fees have been routinely incorporated in the closing agreements entered into pursuant to the settlement program applicable to unpaid taxes under section 409A. I.R.S. Notice 2007-18, 2007-9 I.R.B. 625.

79 These Form W-2 corrections were also part of the section 409A settlement program announced in I.R.S. Notice 2007-18. However, because employers are not “secondarily liable” for the unpaid twenty percent additional income tax or the “interest-factor tax” owed under section 409A, as a technical matter any employer payment of these taxes would have had to be treated as a payment of the employee’s taxes, subject to tax gross-up. Any payment of “secondary liability,” by contrast, would not be legally required to be treated as income to the employees or other payees (as is discussed in Part II.A.3. above).

80 See supra Part III.A.1.
VII. CONCLUSION.

The Service has generally assumed that it is much more productive to audit employers (or other payors), rather than the income recipients themselves. Unquestionably, such payor audits would appear to be procedurally more efficient, simply because each such audit generally can be conducted in one location (rather than at the home addresses of all the affected payees). Without considering the protections provided under the "reasonable belief" test, the "confusion doctrine," and the "reasonable cause" exception, the taxes and penalties potentially imposable on payors who have failed to report or withhold on certain payments might indeed be as large, or larger, than the taxes owed by the payees. These payor protections unquestionably exist, however, and must be respected, particularly in light of the sound principles of tax administration outlined in Rev. Proc. 64-22.

Simply stated, employers and other payors need and deserve to be provided timely guidance with reasonable effective dates. Their decisions not to withhold taxes or to report certain payments should be given deferential consideration whenever evidence exists of a reasoned decision as to why a particular payment should not have been subjected to withholding or information reporting. Certainly any entities that have acted in willful disregard of withholding, deposit, or information return filing requirements should be appropriately punished. In my experience, however, such flagrant violations are the exception, not the rule. Most payors try to comply with withholding, deposit, and reporting requirements.

All payroll agents should be routinely instructed to respect employers' withholding decisions, at the very least by agreeing to abate interest and waive penalties, particularly where an employer can point to substantial published authorities supporting its reporting and withholding decisions. In far too many recent instances (in my experience), auditing agents have disregarded the employer's support for excluding numerous fringe benefits from income, and have even proposed penalties under section 6662, ignoring the employer's stated proof of substantial authorities supporting its reporting and withholding decisions. There is simply no support in the regulations for such penalties, and such proposed adjustments violate both not only the general prohibition in Rev. Proc. 64-22 against taking positions "inconsistent with an established Service position," but they also violate the prohibition against raising issues "arbitrarily or for trading."
Rather than embarking on audits designed simply to punish thousands of employers and other payors for perceived prior errors in information reporting and withholding, the Service should adopt more voluntary settlement programs, which permit the correction of prior errors, but which waive taxes for the older years at issue, and waive both interest and penalties for all payments, contingent on a payor's agreement to report the amounts at issue on future returns. Standards like these are applied under the Service's "Classification Settlement Program (designed in 1996 to resolve worker classification disputes at a discount)," which permits eligible business to settle worker classification disputes by reference to the taxes owed under section 3509 for only a single year — the most recent one under audit — and in some instances by paying an amount equal to only twenty-five percent of the taxes for that year, provided that the employer agrees to classify the workers as employees in future years. Similar formal settlement programs should be developed to permit corrections of prior years withholding errors. If employers and other payors were incentivized to join voluntary correction programs, their participation in such programs would only improve the accuracy of the nation's information reporting and withholding system, which is the fundamental driver of our voluntary tax payment system.

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81 See IRS Announces Trial Worker Classification Settlement Program 96 TNT 46-13 (Mar. 5, 1996); see also IRS Releases Outline of Worker Classification Settlement Program Procedures 96 TNT 94-49 (May 10, 1996); Sheryl Stratton, IRS Officials Clarify Scope of Worker Classification Initiatives, 71 TAX NOTES 451 (Apr. 22, 1996). The classification settlement program was so successful it was extended indefinitely in 1998, by I.R.S. Notice 98-21, 1998-15 I.R.B. 14.