NATP
National Association of Tax Professionals

TAXPRO JOURNAL

Vol. 28 / Issue 1 / 2021

Earn 1 CPE inside: Page 9

Contents

TAXPRO JOURNAL
Vol. 28 / Issue 1 / 2021

Features

Columns

Welcome to 2021

An ordinary year?

By Brett A. Rosser, EA

As you settle into the new tax season and beyond, know that NATP is here for you.

In early 2020, I wrote an article for the *TAXPRO Journal* entitled "A New Season of Change" and how NATP was in the process of changing. I refuse to say the word "change" in *this* message! Boy, was 2020 a roller coaster of a year, and the transformation NATP has gone through is nothing short of amazing. This transformation most likely occurred in your tax practice as well.

How has your business transformed—new technology, video calls with clients instead of in-person meetings, online education? The list can go on and on.

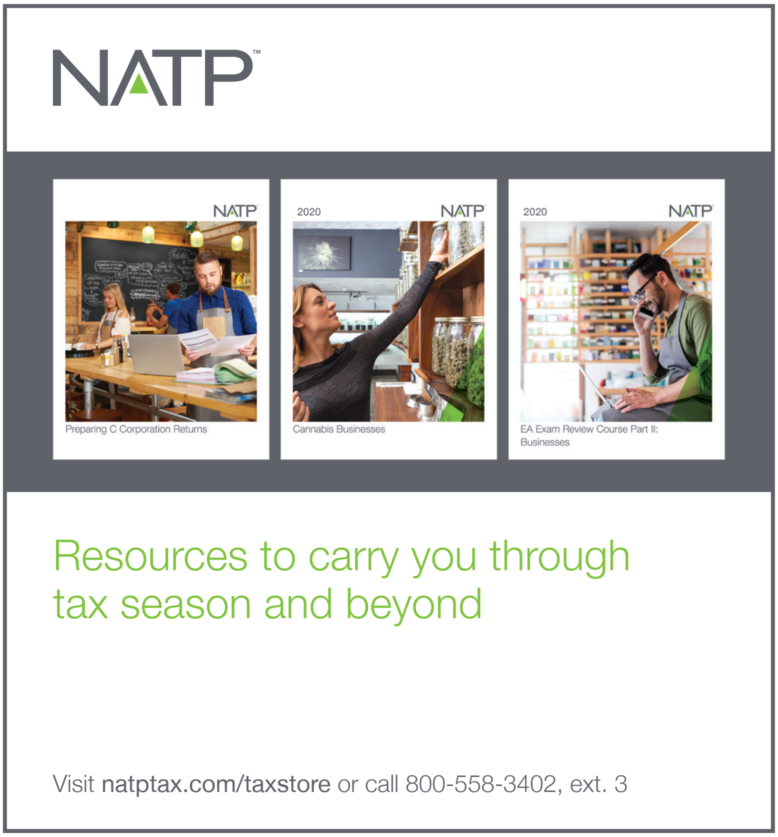
In 2021, NATP will continue *its* transformation to be the absolute best tax professional organization it can be. We are embarking on a content initiative, a review of our association strategy and a re-evaluation of our risk management policies and procedures. As always, our goal is to continue moving NATP forward and providing a bright future for the association and our members.

So, how will this affect you? By reviewing our strategy and assessing NATP's risks, the board and staff are helping to ensure NATP will remain strong and viable, and continue to serve its members for the next 40 years. The content review will look at NATP's content and how it is delivered to make sure it encompasses the many issues we all face in our day-to-day business in this fast-paced, ever-changing modern industry in which we work. NATP will continue to review the methods of delivery and education options available to our members. Many of us realized that, while we could sit for a few hours and watch a webinar, it may be hard to do so for an extended period of time. Yet, while I prefer in-person education, many others prefer to be online, as reflected in the many first-time attendees to our virtual events.

As we move into 2021, I look forward to the possibility of in-person, live education. I relish the ability to meet face-to-face with my fellow tax practitioners at National Conference, NATP Tax Forums and the Tax Season Updates. If we can't meet in person, please keep NATP in mind as your preferred online source for education.

As we move into 2021, with all the IRS and Congressional "adjustments," keep in mind that NATP is your most trusted source for information and education. Our priority isn't just to get you the information you need in a timely manner, but more importantly, provide information that is accurate, relevant and appropriate. As always, if you have specific topics of interest or concerns, please let staff, me or any other board member know so we can put your ideas to work.

In closing, many of you may have met Kelly Nokleby at an NATP event. If not, then you missed meeting a true NATP leader and great supporter. As she has completed her third term, Kelly is no longer on NATP's National Board. I personally wish her the best. If you have ever considered running for a chapter or national board position, please request a candidate packet from NATP (natpgovernance@natptax.com). I believe Kelly would agree with me that serving on the State or National Board is a great honor and a privilege.



TAXPRO JOURNAL

Mission Statement:

The *TAXPRO Journal* provides a diverse group of tax professionals with the tools, information and resources necessary to succeed in business while accurately and ethically applying the tax law to best serve their clients.

How to reach us:

Please share your comments and suggestions regarding the *TAXPRO Journal* with Cindy Van Beckum at 800-558-3402, ext. 1119 or vcindyvb@natptax.com.

Ideas and opinions expressed in the *TAXPRO Journal* are those of individual contributors and may differ from the views of NATP.

The *TAXPRO Journal* (ISSN 1536-5875) is published quarterly by the National Association of Tax Professionals (NATP), 3517 N. McCarthy Road, Appleton, WI 54913. 800-558-3402. Periodicals postage paid at Appleton, WI 54911 and additional mailing office. The TAXPRO Journal is the official publication of the National Association of Tax Professionals. ©2021 National Association of Tax Professionals, Inc. Annual dues are based on membership level: $99 for Basic, $205 for Professional and $660 for Premium. Postmaster: Send address changes to NATP, TAXPRO Journal, 3517 N. McCarthy Road, Appleton, WI 54913. Canada Agreement number: PM40063731. Return undeliverable Canadian addresses to Station A, PO Box 54, Windsor, ON N9A 6J5. Email: returnsil@imex.pb.com.

About NATP

NATP is the largest association dedicated to equipping tax professionals with the resources, connections and education they need to provide the highest level of service to their clients. NATP is comprised of over 22,000 leading tax professionals who believe in a superior standard of ethics and exemplify professional excellence. Members rely on NATP to deliver professional connections, content expertise and advocacy that provides them with the support they need to best serve their clients. The organization welcomes all tax professionals in their quest to continually meet the needs of the public, no matter where they are in their careers.

NATP, 3517 N. McCarthy Road, Appleton, WI 54913
• Phone: 800-558-3402 • Fax: 800-839-0001
• Email: natp@natptax.com • Web: natptax.com

The $900 Billion COVID-19 Relief Package

What it means to tax professionals

By Larry Gray, CPA, CGMA

True to form, Congress passed new legislation in the midnight hour. The *Consolidated Appropriations Act, 2021* (CAA) contains 72 tax-related provisions. What we need now is guidance.

Before I get into the technical part of this article, I would like to take a moment to look back over this past year and how the COVID-19 pandemic has changed our tax profession.

We are nearly a year into an unprecedented time in the world of tax — a year of many ups and downs, new norms, new laws, new guidance, new guidance changes, new law that changes guidance, and on and on.

As tax professionals, we must deal with the pandemic not only personally, but also professionally. We have had to learn how to manage our practices and serve our clients under new guidelines and under ever-changing legislation and guidance.

To put these changes into perspective, the newest legislation, the *Consolidated Appropriations Act, 2021* (CAA), in total contains 72 separate tax-related provisions either created, changed or modified by this act. This doesn't include all the new legislation that was passed in 2020 and overviewed in my last article.

All these changes required me to take a hard look at my own practice. In that process, I realized how we — you and I — are the spoke in this wheel for our clients.

As tax professionals, we assist in banking by helping our clients get the numbers together to provide to the banks for the Payroll Protection Program (PPP) that was issued under the *Coronavirus Aid, Relief, and Economic Security Act* (CARES Act).

We are the payroll masters, reporting the numbers needed for the *Families First Coronavirus Response Act* (FFCRA) and the employee retention credit (ERC), also enacted under the CARES Act.

We are the financial advisers, consulting with our clients on how they can stay in business.

And finally, we are the tax professionals, advising our clients on whether its taxable or deductible, and preparing and reconciling their various 2020 returns, on several new forms.

In the 40+ years that I've been working in this industry, never have I experienced a year like 2020. Financially, the first quarter was reason for concern. However, as more and more new legislation was enacted, the calls started coming in and my calendar began filling up with Zoom meetings, conference calls, and masked and social-distanced office appointments. The year ended on a good note financially, and I had more clients say "thank you" than ever before, for the assistance in helping them navigate this new landscape.

So, what's new, technically speaking? In a nutshell, the CAA, signed by President Trump on Dec. 27, 2020, provides $284 billion for small businesses through the *Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act*, commonly referred to as the *Payroll Protection Program 2 Act* (PPP2 Act).

This relief package limits loans to $2 million and makes funds available to first-time qualified borrowers and to those who previously received a PPP loan, provided they have used or will use all their first PPP loan. There are additional limitations to qualify for the PPP2 loan, such as the business must (1) have been operating as of Feb. 15, 2020; (2) have a 25% reduction of gross receipts in any one quarter compared to same quarter 2019; and (3) have no more than 300 employees. Additional limitations apply.

This act also reversed the tax treatment of expenses paid with PPP proceeds that are forgiven. Those expenses will now be tax deductible.

The CAA changed most of the Dec. 31, 2020, timelines and expanded covered expenses to include covered operations expenditures, property damage costs, supplier costs and worker protection expenditures

CAA also states that proceeds from any economic injury disaster loan (EIDL) advances will no longer need to be reduced from the amount eligible for PPP loan forgiveness.

And, new with the CAA, were major changes to the ERC:

- Under CARES, the refundable tax credit equals 50% of qualified wages through Dec. 31, 2020. The CAA changed this credit to 70% of qualified wages for the first two quarters of 2021.
- The CAA increased the potential credit per employee from a cap of $5,000/employee for the year through Dec. 31, 2020, to $7,000/employee/quarter through July 1, 2021.
- Under CARES, you could only qualify for PPP or ERC. Under CAA, you can qualify for PPP1, PPP2 and ERC for 2020 and 2021 through July 1, 2021, as long as you don't use the same qualified wages.

So, what does all this new legislation mean for our 2021 filing season?

At the time of this writing, there have been many law changes, but there hasn't been adequate time for guidance, notices and announcements from the Treasury and the IRS. This will likely put us in a position of doing tax returns before we have clear direction needed to do so; however, we can expect further guidance in all these areas over the next few weeks.

I hope this article helps you to realize just how valuable you are. You are valuable to your clients, and you are valuable to NATP. Recognizing your value, NATP's team of professionals are here to keep you updated and current through education, research and advocacy on tax law changes as they occur.

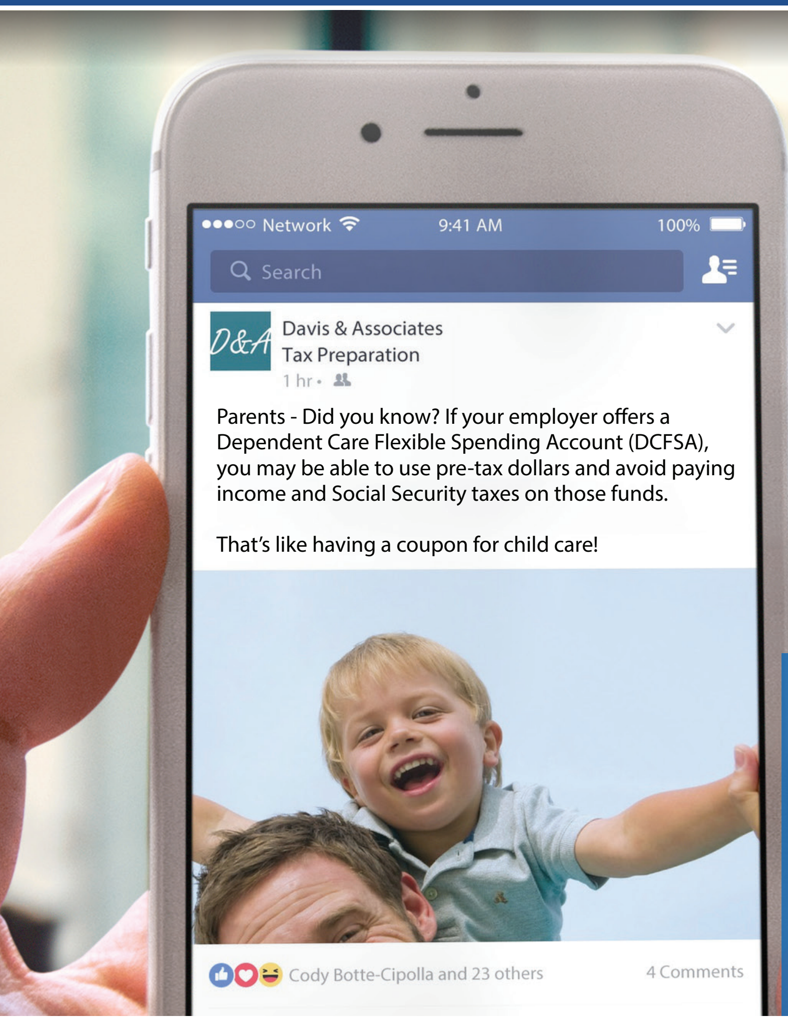
If you would like a more in-depth review of CAA, NATP covers the changes in the Are You Ready for Tax Season on-demand webinar. Go to natptax.com/webinars to register.

I hope all of you stay safe and healthy and have a remarkably successful 2021 filing season.

getnetset®

NEW

WE DO IT FOR YOU
SOCIAL MEDIA
FOR TAX & ACCOUNTING PROFESSIONALS



Promo Code: NATP451

$299 /yr

Regular Price $399/yr

Exp: 3/12/2021

How Does It Work?

1. We set up your Business Facebook Page.
2. We help invite your clients to "Follow" you.
3. We post relevant tax tips on your behalf.
4. As people "Like" and "Share" your tips, they promote your practice to their own friends and family.

support@getnetset.com

Partner NATP™ National Association of Tax Professionals

Earn 1 CPE
Exam on Page 20

Classifying Workers

Common-law employee or independent contractor?

By Anthony Tocco, Ph.D. and Jamison Shipman, LL.M., J.D.

Most accountants and tax professionals have the same goals when tax planning for a client—to reduce the client's tax obligation and minimize overpayment of tax liability. However, these professionals can add value to many small business clients by also considering how the tax planning for the client can be beneficial to the client's employees.

The *Tax Cuts and Jobs Act of 2017* (TCJA) provides several tax planning opportunities for clients. One such opportunity that can benefit the client and the client's employees relates to the TCJA's elimination of the itemized deduction for unreimbursed business expenses for employees, which for some employees was a significant tax deduction. Accountants should consider opportunities to adjust the way employees are compensated to benefit the employee and tax neutral to the client. In some cases, it can be tax beneficial to the client.

One such opportunity is to analyze whether a client's workers have been properly classified as a common-law employee, independent contractor or statutory employee. The objective of this article is twofold:

- Assist the accountant in understanding whether a worker should be classified as a common-law employee, independent contractor or statutory employee
- Highlight the tax and legal issues associated with such classification, including differences

Determining worker classification

The starting point for this analysis is determining whether a worker should be classified as a common-law employee or independent contractor. A worker with particular assigned responsibilities can either be a common-law employee or independent contractor, but not both. It is possible that workers who serve an employer in two separate capacities can be treated as employees in one capacity and independent contractors in another. For example, an individual who is an officer of a corporation and is paid for providing services in such capacity generally will be classified as a common-law employee. If the same individual is also an attorney and agrees to provide legal services unrelated to the role as an officer, they may well be classified as an independent contractor after analyzing the factors discussed below. But those circumstances tend to be rare, and this article will focus on the classification of a worker serving in one particular capacity with respect to a business.

If a worker is classified as a common-law employee, the classification analysis is finished. The analysis then shifts to the tax and other legal ramifications of such classification. If the worker is classified as an independent contractor, it is necessary to consider whether the worker should be classified as either an independent contractor or statutory employee. Then the analysis turns to the tax ramifications of such classification.

> If the worker is classified as an independent contractor, it is necessary to consider whether the worker should be classified as either an independent contractor or statutory employee.

Common-law employee or independent contractor: A common-law employee is an individual who provides services to a business and is not classified as an independent contractor. The IRS focuses on three components when determining whether an individual should be classified as a common-law employee or an independent contractor.[1] Those components are behavior control, financial control and the type of relationship between the parties.

A business exerts behavioral control if it controls and directs how the individual accomplishes the assigned work. Key factors to consider when evaluating the extent of behavioral control include:

- Instructions that the business gives to the worker, including how, when and where to do the work;
- What tools to use to complete the work;
- What workers to use to assist with the work;
- What supplies, equipment and services should be purchased; and
- Training provided by the business on how to perform the work.[2]

A business exercises financial control if it directs or controls financial aspects of a worker's job. Key factors to consider when evaluating the extent of financial control include:

- The extent of the worker's investment in the facilities or tools used in performing services;
- The extent to which the worker makes their services available to the relevant market;

- How the business compensates the worker for services rendered; and
- The extent to which the worker can realize a profit or incur a loss.[3]

The relationship between the employer and worker, and how the parties perceive their relationship, is the other key component. Key factors to consider when evaluating the parties' relationship include:

- Written contracts describing the relationship the parties intended to create;
- Whether the business provides the individual with employee-type benefits, such as insurance, a pension plan, and vacation or sick pay;
- The permanency of the relationship;
- The extent to which services performed by the individual are a key aspect of the regular business of the employer; and
- The extent to which the worker has unreimbursed business expenses.[4]

Court cases are useful for tax accountants to help analyze and weigh the application of the factors used by the IRS to determine whether an individual should be classified as an employee. In *Dean Cibotti, et ux. v. Comm.*, T.C. Summary Opinion 2012-21, the tax court analyzed whether the taxpayer should be classified as an employee versus independent contractor to determine whether the taxpayer was able to claim certain expenses as business expense deductions on Schedule C. The taxpayer owned one-third of a mortgage company, and was the president and loan officer of the company. There wasn't a written agreement between the parties documenting the terms of their agreement. The mortgage company did not provide the taxpayer with an office in which to conduct his business, and he performed much of his work at his home and in meetings and closings with clients at various locations. The taxpayer was compensated by the company in his role as loan officer solely based on commissions, which were subsequently unilaterally reduced by the company because of market fluctuation. The taxpayer did not perform any services because, as president of the corporation, he was not entitled to nor did he receive any base pay or employee benefits.[5] The company did not provide the taxpayer with potential clients or direct any facet of the solicitation of clients or closing of mortgage loans. The taxpayer used gift certificates and sporting event tickets as incentives for clients to purchase mortgage loans. The taxpayer claimed his expenses incurred as a loan officer as a deduction on Schedule C.

The court stated that it is necessary to "consider all of the facts and circumstances of each case, and no single factor is determinative." The court noted in its analysis of the facts that selling mortgages was the company's regular business, which was the activity the taxpayer was engaged in, and that the parties had worked together for several years, indicating common-law employee classification. The court's opinion also highlighted that the company did not control or dictate the taxpayer's hours of business, total hours, route, office location or methods of obtaining clients. Additionally, the company did not supervise or control the manner or the means by which the taxpayer sold mortgages. The taxpayer obtained most of his clients through personal contacts and did not have an office at the company. His only interactions with the company centered around a weekly meeting and the payment of commissions, which provided the taxpayer with the opportunity for profit and loss. The court determined these factors supported the taxpayer's classification as an independent contractor and that they outweighed the factors indicating common-law employee classification. Accordingly, the taxpayer was classified as an independent contractor.

Example: Tim is a tax attorney who provides a variety of services to a medium-sized law firm based on his tax expertise. The parties do not have a written contract in place but have agreed that Tim would receive a base salary and an annual bonus if he meets certain billable-hour goals set by the firm. In addition, if he is responsible for originating new business for the firm, he is entitled to receive 25% of the fees collected from the client. The firm is responsible for billing and collecting the fees associated with Tim's work. He works for a few of the firm's clients and is required to provide regular status updates to the attorneys responsible for billing each client. Otherwise, the firm's management and other attorneys leave him alone because they know nothing about tax. Tim can use the help of younger attorneys at the firm if needed. In addition, Tim helps the firm complete its annual partnership income tax return and other tax filings. Tim works mainly from his home but will occasionally stop by the office and use an empty office if one is available. He also bought his own laptop to perform his work because the firm-issued laptop was a cheap model and did not meet his standards. The firm does provide Tim with coverage under its malpractice insurance coverage, and he is also eligible to participate in the firm's 401(k) plan. The firm did not reimburse Tim for the laptop purchase, nor does it reimburse him for any entertainment expenses associated with developing clients.

Should Tim be classified as a common-law employee or independent contractor of the firm? Let's analyze the facts based on the three components noted above: (1) behavior control, (2) financial control and (3) relationship. See Table 1 on Page 13.

A count of the factors indicates that eight are in favor of employee classification, five are in favor of independent contractor classification and one favors neither. Although close, Tim would be classified as an employee if the analysis was based simply on adding up the factors in support of each classification and going by whichever one is greater. However, it is necessary to look closer at the specific factors and consider whether it is a close decision for each factor in concluding that it leans more toward one classification or not. For example, of the eight factors in favor of employee classification, 3, 7, 8, 9 and 13 heavily lean toward employee, while 4, 6 and 11 less so. All five factors in favor of independent contractor classification lean more toward independent contractor status. It becomes more evident that Tim should be classified as an employee once the weighting of the factors is considered.

Additionally, it is often helpful to consider the industry that is involved when evaluating the various factors. Doing so allows practitioners to consider how relevant or important each factor is with respect to the industry and the role served by the worker. Given the nature of the legal practice, the factors indicating independent contractor carry less sway given there is usually less instruction and training provided to lawyers on how to complete the work regardless of whether the worker is an employee or independent contractor. Thus, the appropriate classification for the worker in this example is as an employee.

Statutory employee: If a worker is classified as an independent contractor based on the analysis discussed above, then the work is not over. An independent contractor may be classified as a statutory employee for employment tax purposes. The term "statutory employee" is used by the IRS in Pub. 15-A to refer to an individual worker who is classified as an independent contractor under the common-law employee classification rules discussed above but is treated as an employee for employment tax purposes if certain requirements are met. To be classified as a statutory employee, the individual's performance of services must fit within one of four categories specified in §3121(d)(3) of the Internal Revenue Code (IRC) and satisfy all three conditions specified in §3121(d)(3), regardless of the category.

The four categories of services from §3121(d)(3) and IRS Pub. 15-A, pg. 6 (2020) are:

- As a driver who distributes beverages (other than milk) or meat, vegetable, fruit or bakery products; or who picks up and delivers laundry or dry cleaning, if the driver is an agent or is paid on commission by the employer;
- As a full-time life insurance sales agent whose principal business activity is selling life insurance or annuity contracts, or both, primarily for one life insurance company;
- As an individual who works at home on materials or goods that the employer supplies and that must be returned to the employer, if the employer also furnishes specifications for the work to be done; or
- As a full-time traveling or city salesperson who works on the employer's behalf and turns in orders to the employer from wholesalers, retailers, contractors or operators of hotels, restaurants or other similar establishments. The goods sold must be merchandise for resale or supplies for use in the buyer's business operation. The work performed for the employer must be the salesperson's principal business activity.

In addition to fitting within one of the four categories listed above, the statutory employee must meet all three of following conditions:

- The service contract states or implies that substantially all the services are to be performed personally by the individual;
- The individual does not have a substantial investment in the facilities, equipment and property used to perform the services (other than an investment in facilities for transportation, such as a car or truck, or items typically provided by employees); and
- The services are performed on a continuing basis for the same employer.

TABLE 1

Behavior Control

Factor	Facts associated with factor	Supportive as employee or independent contractor
1. Instructions that the business gives to the worker	Has special knowledge; provides status updates but otherwise works when he wants	Independent contractor
2. Tools used to complete the work	Bought a better computer and was not reimbursed	Independent contractor
3. Workers used to assist with the work	Uses other attorneys at the firm if needed	Employee
4. Supplies, equipment and services should be purchased	The firm provided Tim with a computer; he was not required to buy one	Employee
5. Training provided by the business	No specific facts provided but given expertise, training unlikely	Independent contractor

Financial Control

Factor	Facts associated with factor	Supportive as employee or independent contractor
6. Extent of the worker's investment in the facilities or tools	Firm did provide a laptop, but Tim bought his own; works from home but can use firm office as needed	Employee
7. Extent to which the worker makes their services available to the relevant market	Provides services to multiple clients provided by the firm and for the firm itself; no indication he works for other firms	Employee
8. How the business compensates the worker for services rendered	Base salary; bonus for performance goals and percentage of fees collected; eligible to participate in retirement plan and is covered by firm's malpractice insurance	Employee
9. Extent to which the worker can realize a profit or incur a loss	Incur profit or loss unlikely given compensation arrangement	Employee

Relationship

Factor	Facts associated with factor	Supportive as employee or independent contractor
10. Written contracts describing the relationship	None	No impact
11. Business provides the individual with employee-type benefits	Salary, retirement plan and malpractice insurance, yes; entertainment expenses and purchase reimbursements, no	Employee (more likely)
12. Permanency of the relationship	Not permanent	Independent contractor
13. Extent to which services performed are a key aspect of the regular business of the employer	Services provided by Tim are key aspect of the firm's business	Employee
14. Extent to which the worker has unreimbursed business expenses	Entertainment expenses and purchases not reimbursed	Independent contractor

Uber and Lyft

Not exactly California dreaming

What do DoorDash, Amazon, Uber, Lyft and Postmates have in common? They all are facing legal challenges to the classification of their workers as independent contractors rather than employees, at least with respect to state laws. California is leading the charge with its recent passage of California AB 5, which is designed to address concerns over those working in the “gig economy” and classified by businesses as independent contractors not having “the basic rights and protections they deserve under the law, including a minimum wage, workers’ compensation if they are injured on the job, unemployment insurance, paid sick leave and paid family leave.” [Legislative Counsel’s Digest, Assembly Bill No. 5, Chapter 296 (9/19/19)]

The California law went into effect on Jan. 1, 2020, and specifies that a business must classify a worker performing services on behalf of the business as an employee under California law unless all three of the following requirements are satisfied:

- The person is free from the control and direction of the “hiring entity” (i.e., the company operating the business) in connection with the performance of the work, both under the contract for the performance of the work and in fact.
- The person performs work that is outside the usual course of the hiring entity’s business.
- The person is customarily engaged in an independently established trade, occupation or business of the same nature as that involved in the work performed.

Uber and Lyft earlier this year filed a motion seeking a preliminary injunction against the enforcement of the law with respect to their drivers. In a ruling dated Aug. 10, 2020, the California Superior Court denied the motion on the basis that the work performed by the drivers was not outside the usual course of Uber and Lyft’s business.* Just a few days later, the California Appeals Court granted Uber and Lyft a stay on the lower court’s order to permit further arguments on the validity of the law. Uber and Lyft pursued other avenues for exemption from the law, including a ballot initiative in the November 2020 election providing for exemption from the law.** The ballot initiative was approved by California voters, meaning ridesharing and delivery drivers are to be classified as independent contractors rather than employees for purposes of California law.

Despite the impact of this law on businesses operating in California and potentially other states that are considering enacting a similar law, the determination whether a worker is classified as an employee or independent contractor for federal income and employment tax purposes is still determined under the three components outlined in this article: behavior control, financial control and the type of relationship between the parties. Thus, it is conceivable that a worker may be classified as an employee for state law purposes but an independent contractor for federal tax law purposes. Practitioners should continue to monitor the situation and keep in mind how classification can depend on the applicable law.

* https://www.investopedia.com/california-assembly-bill-5-ab5-4773201

** https://www.wsj.com/articles/lyft-to-suspend-service-in-california-11597942614?mod=djemCFO

Legal considerations

Business liability for worker's actions: There is a significant and substantial difference between common-law employees and independent contractors/statutory employees with respect to subjecting a business to tort and, to a lesser extent, contractual liability based on agency law. The most common type of tort liability triggered by a common-law employee is negligence (i.e., not acting with reasonable care and causing harm to a person owed a duty of care). Under the theory of *respondeat superior*, a business can be held liable for the negligence of an employee that occurred while the employee was acting within the scope of services provided on behalf of the business. However, an independent contractor/statutory employee generally does not trigger such liability. The primary reason for this is due to the control a business has over an employee as indicated based on the factors described above that is not present with respect to an independent contractor/statutory employee.

As the principal in an agency relationship, a business has the discretion to grant an agent the authority to act on behalf of the business, such as the authority to enter into contracts in the name of the business. A principal can grant this authority to an employee or independent contractor/statutory employee. The risk of granting such authority is that the worker can make bad decisions and enter into a contract on behalf of the principal that is a bad deal, or the principal is unable to meet the obligations provided in the contract. The authority exercisable by an employee tends to be broader than that of an independent contractor/statutory employee for a couple reasons. First, authority granted to an independent contractor/statutory employee tends to be narrower in scope because the business has less ability to monitor and control the independent contractor/statutory employee's activities. Second, a common-law employee tends to have broader implied authority to act on behalf of a business based on the business's control over the employee, and third parties' expectations and assumption made with respect to the employee's relationship with the business. Thus, there is a greater risk to a business to be stuck in a bad contract if a worker is classified as a common-law employee versus independent contractor/statutory employee.

Fair Labor Standards Act (FLSA): The FLSA establishes minimum wage and overtime pay

Review Questions (answers on page 17)

1. Which factor does not relate to behavioral control?

A. What tools to use to complete the work
B. What workers to use to assist with the work
C. What supplies, equipment and services should be purchased
D. Written contracts describing the relationship

2. An employer is required to provide a statutory employee with which of the following:

A. Form W-2 withholding and remitting of federal and state income taxes
B. Form W-2 withholding and remitting of the employee's portion of the FICA taxes
C. Form W-2 withholding and remitting of the employee's portion of FICA taxes and payment of the employer's portion of the FICA taxes
D. Form W-2 payment of the employer's portion of the FICA taxes

3. In *Dean Cibotti, et ux. v. Commissioner*, which rule is the most important in reaching the conclusion that a worker should be classified as an independent contractor?

A. Extent to which the worker has unreimbursed business expenses
B. How the business compensates the worker for services rendered
C. The employer has more control over how the job is to be completed than the worker
D. The worker has more control over how the job is to be completed than the employer

requirements, among other things, that generally apply to common-law employees. A business is subject to the FLSA rules if either: (1) the business has at least two employees who are engaged in interstate commerce and have an annual dollar volume of sales or business done of at least $500,000; or (2) for employees of businesses not meeting the first requirement, any employee who engages in interstate commerce on behalf of the business.[6]

Assuming a business is subject to the FLSA rules, a business must determine whether its workers are considered employees under the FLSA. The factors used to evaluate a worker's classification for purposes of the FLSA are substantially the same as those used by the IRS for purposes of applying the IRC. Assuming a worker is classified as an employee for purposes of FLSA, employees must receive minimum wage and/or overtime pay unless they are exempt employees. The following categories of employees are considered exempt:

- Executive, administrative and professional employees, outside sales employees and employees in certain computer-related occupations;
- Employees of certain seasonal amusement or recreational establishments, employees of certain small newspapers, sailors employed on foreign vessels, employees engaged in fishing operations and employees engaged in newspaper delivery;
- Farmworkers employed by anyone who used no more than 500 "man-days" of farm labor in any calendar quarter of the preceding calendar year; and
- Casual babysitters and persons employed as companions to the elderly or infirm.

There is an incentive for an employer to classify its employees as exempt because the employer is not required to pay overtime (at least time and one-half of regular hourly pay) if the employee is exempt. Therefore, an employer may attempt to push the envelope in classifying an employee as an executive, administrative or professional employee. The FLSA's Field Operation Handbook provides guidance for determining whether an employee is exempt from minimum wage and overtime requirements. For example, an employee classified as an executive must (1) receive a weekly salary or fee-basis compensation equal to at least $684 per week (prior to 2020 it was $455); (2) have a primary duty of management; (3) customarily and regularly direct the work of two or more employees; and (4) have the authority to fire or hire employees, or recommendations to hire and fire are given particular weight. An employer will be required to pay an employee for past due overtime or minimum wage pay if the employer incorrectly treats an employee as exempt, and the employer may be subject to federal and state penalties for violating the rules. The employer will also be obligated to withhold and remit any additional employment tax owed on such payments (see discussion regarding employment taxes below).

Employee benefits: A worker classified as a common-law employee who performs services on a full-time basis for a business is typically eligible to participate in any employee benefits offered by the business, such as medical insurance, qualified retirement plans and dependent care benefits. However, an independent contractor/statutory employee is not eligible for such benefits.

Income and employment taxes

Employee: If an individual is classified as a common-law employee, the business is required to withhold from the employee's wages federal income tax and the employee's portion of the FICA taxes equal to 6.2% of wages up to the applicable wage base limit ($137,700 for 2020 and $142,800 for 2021) for Social Security, and 1.45% for Medicare. In addition, the business must pay the same amount for the employer portion of the FICA taxes. Prior to 2018, a common-law employee who had unreimbursed business expenses related to their employment could deduct those expenses as an itemized deduction on Schedule A to the extent the expenses exceeded 2% of the employee's adjusted gross income. However due to the TCJA, for tax years beginning in or after 2018, an employee may no longer claim these expenses as an itemized deduction. Compare that with either an independent contractor or statutory employee who is permitted to claim business expense deductions on Schedule C.

Independent contractor: If an individual is classified as an independent contractor, the only responsibility of the business is to issue a Form 1099-NEC. For any independent contractor who earns $600 or more, the employer (client) must fill out a Form 1099-NEC. The business enters the amount paid to the independent contractor in Box 1 of the Form 1099-NEC. (Prior to 2020, Form 1099-MISC, Box 7, was used.) The Form 1099-NEC must be filed with the IRS and the applicable state department of revenue, and a copy must be sent to the independent contractor. The deadline for filing a Form 1099-NEC is generally Jan. 31 of the year following the year in which payments were made to the independent contractor. The 2020 Form 1099-NEC has a deadline of Feb. 1, 2021, because Jan. 31 falls on a weekend.

Depending on the amount earned by the independent contractor in any one year, an independent contractor may have to file federal and state estimated taxes to avoid penalties. The independent contractor only pays income taxes on the net income (gross income after deductible expenses) for the tax year. The independent contractor is also responsible for paying both the employee and employer portion of the FICA taxes, but is entitled to deduct one-half of the FICA taxes from gross income in determining the independent contractor's adjusted gross income.

Statutory employee: If an individual is classified as a statutory-law employee, the employer is required to withhold from the employee's wages the employee's portion of FICA taxes. In addition, the employer must pay the employer portion of the FICA taxes on the compensation paid to the statutory employee. However, the employer is not required to withhold federal income tax from the statutory employee's compensation. The statutory employee is still able to claim any unreimbursed business expenses associated with such services as a deduction (unlike the common-law employee after the TCJA) on Schedule C (Rev. Rul. 90-93, 1990-2 C.B. 33).

The employer is also required to fill out a Form W-2 for the employee. The employer must make the following entries on the Form W-2:

- Check Box 13 noting the employee is a statutory employee.
- Record in Box 1 the compensation paid to the employee (wages paid to the statutory employee are considered other compensation).
- Record in Boxes 3 and 5 the wages subject to Social Security and Medicare taxes. The employer is not responsible for withholding federal or state income taxes.

The IRS does not have any specific statistics on statutory employees because there were so few taxpayers who filed using this status. However, clues to accountants on who might be able to take

Review Answers

1. A. Incorrect. Providing the tools needed to complete the work is a factor that falls under behavioral control.
B. Incorrect. Hiring assistants is a factor that falls under behavioral control.
C. Incorrect. Determining what supplies, equipment and services should be purchased is a factor that falls under behavioral control.
D. **Correct.** Requiring a written contract describing the relationship falls under relationship control.

2. A. Incorrect. An employer with a statutory employee is not required to withhold federal and state income taxes. The employer is only required to withhold the employee's and employer's portion of FICA taxes and remit those to the IRS.
B. Incorrect. An employer with a statutory employee must not only withhold and remit the employee's portion of FICA taxes, but also must remit the employer's portion of FICA taxes to the IRS.
C. **Correct.** If an individual is classified as a statutory-law employee, the employer is required to withhold from the employee's wages the employee's portion of the FICA taxes and remit this to the IRS. In addition, the employer must also pay the IRS the employer's portion of the FICA taxes on the compensation paid to the statutory employee.
D. Incorrect. An employer with a statutory employee must not only withhold and remit the employee's portion of FICA taxes, but also must remit the employer's portion of FICA taxes to the IRS.

3. A. Incorrect. While the tax court looked at the extent to which the worker has unreimbursed business expenses, if the employer had more say or control over Cibotti, the court would have classified him as an employee.
B. Incorrect. While the tax court looked at how the business compensates the worker for services rendered, if the employer had more say or control over Cibotti, the court would have classified him as an employee.
C. Incorrect. Because Cibotti was independent of the employer's control on many factors, the court declared him an independent contractor.
D. **Correct.** In the court case of Dean Cibotti, the tax court's opinion highlighted the company did not control or dictate the taxpayer's hours of business, total hours, route, office location or methods of obtaining clients. Additionally, the company did not supervise or control the manner or the means by which the taxpayer sold mortgages. While A and B are factors the court looked at, if the employer had more say or control over Cibotti, the court would have classified him as an employee. Instead, because Cibotti was independent of the employer's control on many factors, the court declared him an independent contractor.

advantage of being classified as a statutory employee are provided by Form 2106, *Employee Business Expenses*, which reports statistics from before the TCJA enacted restrictions. (After TCJA, Form 2106 is for use only by Armed Forces reservists, qualified performing artists, fee-basis state or local government officials and employees with impairment-related work expenses.) Based on the latest statistics from the IRS, over 14 million taxpayers filed either Form 2106 or Form 2106-EZ in 2016. This represents approximately 10% of all individual returns filed. The total amount deducted on Line 21, unreimbursed employee expenses, on the 2017 version of Schedule A was approximately $100 billion. This comes out to approximately $7,100 per taxpayer prior to application of the 2% of adjusted gross income floor. Even if only one-third of those filing Form 2106 or Form 2106-EZ could be reclassified as a statutory employee, that still leaves over 4.5 million individuals who are losing a substantial tax deduction caused by the TCJA.

Based on the IRS tax numbers for unreimbursed business expenses, it is hard to estimate the impact to particular taxpayers. It is likely that some taxpayers were impacted more than others by the change to the deductibility of unreimbursed employee business expenses. In many cases, an employee is properly classified as a common-law employee and the taxpayer will lose out on the deduction for unreimbursed business expenses. However, a tax accountant working with clients may be able to identify whether certain workers could be classified as statutory employees after taking into consideration the above rules and modifying the contractual relationship between the parties. The ability to change classification could provide a tax benefit for the employee at little cost to the employer.

Table 2, below, highlights the tax differences between the three types of worker classifications.

Impact of the pandemic on the future of the work force

Prior to the pandemic, it was estimated that less than 4% of the work force worked off premise. The longer people work from home the more likely they will want to continue to work remotely from home. In fact, it is estimated that 25–30% of the workforce will be working from home multiple days a week by the end of 2021. Can this be an opportunity for both the employee and the employer to revisit reclassifying their status from employee to statutory or independent contractor? This would be a perfect time for tax accountants, along with labor lawyers, to look over all employees' descriptions to see if any employee could be switched to a statutory or independent contractor. The switch could be beneficial to both the employee and the employer.

The employee must understand the economic impact and be willing to make the change, and the relationship between the employee and business must be sufficiently changed to qualify as either a statutory

TABLE 2

Classification	Income Tax Rate	Employment/ Self-Employment Taxes	Deductible Business Expenses	Eligible for Employee Benefits	Income Reporting Form
Employee	Graduated ordinary tax rates	One-half of FICA taxes (7.65%); employer pays other half	No (after 2017 unless exception met)	Yes	Form W-2
Independent Contractor	Graduated ordinary tax rates (net of business expenses)	15.3% of self-employment taxes	Yes (Schedule C)	No	Form 1099-NEC
Statutory Employee	Graduated ordinary tax rates (net of business expenses)	One-half of FICA taxes (7.65%); employer pays other half	Yes (Schedule C)	No	Form W-2

employee or independent contractor. If they are, some of the benefits that can accrue to the employee/employer are as follows:

- The employee would negotiate significantly higher wages since, under both alternatives (independent contractor or statutory employee), fringe benefits [health insurance, 401(k), life insurance, medical leave, vacation, employer contribution to health savings account, education reimbursement, etc.] would go away because these would represent financial control. Depending on the amount of fringe benefits the employee receives and the employee designation, the potential increase in compensation could be between 20% and 35%.
- The employer would not pay its portion of the FICA taxes if an employee's classification changes to independent contractor.
- A statutory employee and independent contractor would be able to deduct applicable business expenses associated with the business activity. Some examples would be in-home office, mileage, contract labor, legal and professional services, meals and retirement contributions. The employer on the other hand, could reduce occupancy requirements (rent or leasing costs), reduce bookkeeping costs regarding employee benefits, and reduce costs for office supplies.
- A significant benefit to the employee may be eliminating or reducing the cost of child care. While child care cost varies by region, currently it costs approximately $15,000 per year for pre-school child care. If a couple had two pre-school children, eliminating or significantly reducing the cost of child care could result in significant savings for a family. Situations where this may work to the benefit of both parties is when you have both the husband and wife who work and have comparable fringe benefits, especially health insurance. One spouse may be willing to change their work status from employee to statutory employee or independent contractor, but the family would not lose important employee benefits such as health insurance.

Conclusion

There are nuances involved in how a worker is classified. Most tax accountants assume they know the rules of what constitutes an employee but may not be overly familiar with the rules regarding an independent contractor or statutory employee.

Additionally, with tax laws constantly changing and the impact of COVID-19, there is a seismic shift on how and where work will be done by employees. In situations like this, it is important for tax accountants not only to see which taxpayers benefit but also which ones are harmed by the changes. This is easy to do for individual clients. Tax accountants who serve businesses should reach beyond their clients to their client's employees.

Working with lawyers and their business clients to evaluate/re-evaluate whether reclassifying a worker's status from an employee to an independent contractor or statutory employee can be of benefit to both the business and the employees.

Endnotes

1. IRS Pub. 15-A, page 7 (2020).
2. Id.
3. Id. at 8.
4. Id.
5. Thus, the taxpayer was not providing services in a dual capacity.
6. Many states have similar overtime and minimum wage requirements. Employees are generally entitled to receive the higher of the applicable requirements.

About the authors

Anthony Tocco, Ph.D., is a professor of accounting and the division chair of decision sciences at Rockhurst University in Kansas City, MO. He has taught courses in managerial and financial accounting, financial analysis, individual taxation, income tax preparation practicum, professional development for managers, and contemporary issues in finance and accounting.

Jamison Shipman, LL.M., J.D., is an assistant professor of accounting in the Helzberg School of Management at Rockhurst University in Kansas City, MO. He specializes in teaching business law, corporate income tax, individual income tax and various other business courses.

TAXPRO Journal CPE Exam

The following exam will provide one hour of federal tax law credit with the IRS or CTEC. The exam questions are taken from the article, Classifying Workers.

The exam must be taken online. This CPE is available for Professional and Premium level members. Go to natptax.com/tpj to register. To qualify for CPE credit, you must answer all exam questions and score a 70% or higher. You have unlimited attempts to pass the exam. Please contact Member Services with any questions at 800-558-3402, ext. 3, or at natp@natptax.com.

1. Distinguishing between employees and independent contractors is important because:
   A. Income tax must be withheld for employees, but not independent contractors
   B. Employers may have fewer legal obligations to independent contractors
   C. There can be significant penalties and payment of back taxes by misclassifying one for the other
   D. All of the above

2. If a worker is an employee, the employer must:
   A. Withhold income taxes
   B. Remit and withhold the employee's share of FICA taxes and pay the employer's share of FICA taxes
   C. Remit the employee's share of FICA taxes without withholding from the employee their share
   D. A and B only

3. Employers are required to send what form to independent contractors if they receive $600 or more in income?
   A. Form 1099-G
   B. Form 1099-C
   C. Form 1099-D
   D. Form 1099-NEC

4. Which of the following is true of independent contractors?
   A. They must provide for their own health insurance
   B. The employer must withhold income taxes from their income
   C. They must be paid a minimum wage and overtime
   D. The employer must provide all necessary supplies, equipment and services to do the job

5. For a statutory employee, the employer must:
   A. Provide fringe benefits
   B. Withhold only the employer portion of the FICA taxes
   C. Withhold and remit the employee portion of FICA taxes and pay the employer portion of the FICA taxes
   D. Issue a Form 1099-NEC if the statutory employee earns $600 or more


PAY
TAX
TAX

Solving Tax Debts in 2021

IR 2020-248 may help

By Eric L. Green, Esq.

There were 25 million taxpayers in tax trouble at the end of 2019, before COVID-19 ever showed up.[1] With 37% of Americans reporting they will be unable to pay their 2019 taxes due to the pandemic,[2] taxpayers are scrambling for help. The IRS is painfully aware of the issues facing Americans right now and have made moves to try and help people pay their taxes. IR 2020-248 was issued on Nov. 2, 2020,[3] and it attempts to provide a means for taxpayers to get relief and pay their taxes. Unfortunately, it's only helpful for those who can pay, not those who are looking to settle the debt for something other than the total balance.

IR 2020-248 is blunt. It states the "IRS makes it easier to set up payment agreements." So, for taxpayers who can pay but simply need time, there are some nice changes the IRS has made to its normal collection procedures that help these taxpayers. These changes include:

- Increasing the length of short-term payment plans from 120 days to 180 days
- Allowing taxpayers additional time to make payments on an accepted offer in compromise
- Automatically adding certain new tax balances to existing installment agreements for individual and out-of-business taxpayers instead of defaulting the agreement
- Allowing individual taxpayers assigned to campus collections who owe less than $250,000 to set up installment agreements without providing a financial statement
- Allowing some individual taxpayers who only owe for the 2019 tax year and who owe less than $250,000 to qualify for an installment agreement without a notice of federal tax lien filed by the IRS
- Enabling qualified taxpayers with existing direct debit installment agreements to use the online payment agreement system to propose lower monthly payment amounts and change their payment due dates

IR 2020-248 allows taxpayers who are making payments on their OIC to request additional time due to the hardship caused by COVID-19.

This all sounds good, but what do these changes actually mean, and what don't they mean? And, what strategies should practitioners consider when trying to help taxpayers?

Increased short-term payment plans

The IRS generally allows taxpayers to pay their balance within 120 days and not provide any financial forms. To try and provide taxpayers some help, the IRS extended the 120-day window to 180 days, with the hope being that taxpayers will be able to get their 2019 tax debts paid. This is a good option for those who just need a little time. From a practical perspective, it can be powerful when combined with some other options, which we'll discuss later in this article.

Additional time for offer in compromise (OIC) payments

The IRS OIC program generally allows for two types of offers: a lump-sum offer and a short-term deferred offer. A lump sum offer is one in which the taxpayer agrees to pay the offered amount within five months of the date of acceptance. A short-term deferred offer, also known as a "periodic payment offer," is one in which the taxpayer will begin making monthly payments while the offer is pending and will pay the balance of the offer in more than six months but not more than 24 months. The short-term deferred offer operates exactly the same as a lump sum offer except the taxpayer must begin making monthly payments and continue making their monthly payments while the offer is being considered, just like an installment agreement.

IR 2020-248 allows taxpayers who are making payments on their OIC to request additional time due to the hardship caused by COVID-19. If requested prior to Dec. 31, 2020, the payment flexibilities include providing an additional 120-day extension for taxpayers to make up missed payments (bring the proposed payment terms completely current) even if the taxpayer was previously granted a 120-day extension or the IRS and the taxpayer can agree to modify the accepted OIC contract by adding the missed payments to the end of the contract terms.

2019 balances added to existing installment agreements

When a taxpayer is in an installment agreement with the IRS, there is a requirement to maintain tax compliance, meaning they will continue to file their tax returns on time and make their tax payments on time. Hence, taxpayers who file their 2019 tax return with either a balance due, or one with underpayment penalties attached to it, would normally have their agreements default.

Normally, when a taxpayer's agreement is in default, they have to submit new financial collection information statements (i.e., IRS Form 433) along with supporting documentation and renegotiate a new payment plan. To make the process easier, and to avoid a massive crush of defaulted agreements, the IRS is agreeing to simply automatically roll the new 2019 balance into the existing installment agreement. Taxpayers should continue to make their installment agreement payments as they did before, though a call to the IRS is always not a bad idea to confirm that the 2019 balance has been included with the existing agreement.

$250,000 streamlined installment agreement

The IRS has always had a streamlined installment agreement available for qualified taxpayers. Basically, a streamlined installment agreement is an agreement with the IRS to repay the debt within the terms laid out. If the taxpayer qualifies and can meet the terms, the taxpayer will not have to submit a financial form (Collection Information Statement) and disclose assets and income. These agreements are beneficial because, aside from avoiding disclosing assets and income, the taxpayer does not need to spend money on a professional to complete the forms and begin negotiating with the IRS. The agreement can be put in place with a simple phone call or by going online and setting it up through the IRS portal.

Streamlined agreements have changed over time, and due to the sheer number of taxpayers the IRS believes will be in trouble due to COVID-19, the IRS has made getting into these agreements easier than ever. See table below.

As you can see, for taxpayers dealing with the automated collections groups at the campuses, the new streamlined rules allow taxpayers to resolve their matters without financial disclosures if they owe, or can pay down, below $250,000. This is advantageous for taxpayers with assets who would otherwise have the IRS seeking to access the equity to pay the debt down.

If you don't routinely deal with IRS Collections, you need to understand the IRS wants to collect as much as it can as quickly as it can, and so therefore will seek to have taxpayers liquidate investments and retirement accounts and tap equity in their home. By utilizing the streamlined procedures above, the taxpayer can avoid that and get into a payment plan to resolve their tax issue.

Installment agreement without a notice of federal tax lien

This new taxpayer relief initiative provision applies to taxpayers who owe for tax year 2019 only and with a new balance less than $250,000 still in notice status that is not yet assigned to the Automated Collection System (ACS) or Field Collection programs. The agreements must propose to pay the full balance with accruals before the collection statute expiration date (CSED).[4]

Strategies

In light of everything above, there are some strategies that can be employed to get the best result for our clients. For instance, assume we have a client who owes $300,000 for 2019 as of December 2020 when the bill arrives. The taxpayer has an IRA with $150,000 and a home with no mortgage worth $450,000. The taxpayer's income and expenses show an ability to make payments of $5,000 a month. Our client, though, does not want to make payments at that rate because, economically, it would make life a bit rough. The taxpayer could do the following:

- Call and set up a short-term (six month) payment plan to pay the balance. Once that's set up,

Year	Field Collections	Campus Collections
Prior to 2012	$25,000 over 60 months	$25,000 over 60 months
2012	$50,000 over 72 months	$50,000 over 72 months
2016	$50,000 over 72 months	$100,000 over 84 months
2020	$50,000 over 72 months	$250,000 over CSED

they could make six payments of $5,000 each. After the six months, they now owe $270,000.

- Call automated collections, explain they could not raise all the money, but ask for first-time penalty abatement. This would remove 1/2 % a month for eight months (from April 2020 – December 2020) for the failure to pay penalty, or 4%. The reduction of the 4% from the $300,000 would remove approximately $12,000 of accumulated penalty, reducing the liability to $258,000.
- Get a home equity line and use $10,000 from that to reduce the liability below $250,000.
- Create a streamlined installment agreement (below $250,000 over the time remaining on the collection statute, which is approximately 114 months). The monthly payment should be around $2,300 a month, and they won't have to liquidate their IRA or get stuck paying $5,000 a month for five to six years.

These numbers are rough, but hopefully they illustrate the concept that you can be creative and combine some of these options to get the client into a solution that works to their advantage, or at least is easier to swallow than the IRS's straight analysis. Here, we can abate penalties, use the short-term payment plan to buy time and pay down below the $250,000 streamlined cutoff to avoid the disclosures and get into a monthly payment plan that is more affordable.

Each client's situation is unique. That's why IRS representation is so interesting (at least to the author)! Understanding the rules is the first step to mastering the game, and it's a game that is interesting, challenging and potentially extremely profitable to those of us who handle IRS representation matters.

Endnotes

1. 15,002,000 accounts in IRS Collection (See IRS Databook for 11.8 million accounts in IRS Collection, 3.2 million accounts assigned to private debt collection) and another 10 million non-filers (see TIGTA Report from May 29, 2020).
2. Survey reported by the CPA Tax Practice Advisor, June 25, 2020.
3. https://www.irs.gov/newsroom/irs-makes-it-easier-to-set-up-payment-agreements-offers-other-relief-to-taxpayers-struggling-with-tax-debts.
4. The procedural update related to this relief in Internal Revenue Manual (IRM) section 5.19.1.6.4.1(4) is posted along with other recent changes on irs.gov at the following link: https://www.irs.gov/pub/foia/ig/sbse/sbse-05-1120-1187_Redacted.pdf.

About the author

Eric Green is an NATP member and the managing partner in Green & Sklarz LLC, a boutique tax firm with offices in Connecticut and New York. The focus of his practice is civil and criminal taxpayer representation before the Department of Justice Tax Division, Internal Revenue Service and state Departments of Revenue Services. Eric is a past chair of the Connecticut Tax Bar and a Fellow of the American College of Tax Counsel. He is the founder of Tax Rep LLC, which coaches accountants on building their own IRS representation practices, and is the host of the weekly Tax Rep Network Podcast.

Tax Basic Training

Comprehensive package to learn Form 1040

If you have staff that's new to the field, we have the perfect training for them.

Our Tax Basic Training self-study package is filled with introductory-level education on Form 1040 and popular accompanying schedules!

Courses include:

- Introduction to Tax Preparation - 16 CPE
- Introduction to Schedule C - 8 CPE
- Introduction to Schedule D - 4 CPE
- Introduction to Schedule E - 4 CPE
- Basics of Basis - 4 CPE
- Introduction to Fixed Assets - 4 CPE

Go to **natptax.com** to learn more.

NATP™
National Association of Tax Professionals


CONSULTATION
SUPPORT
ADVICE
ASSISTANCE

The Client Representation Process

Scoping and analysis

By Kathy Morgan, EA, USTCP

When making the decision to take on a client, for any purpose, you should have enough knowledge of the client and their situation to know if you have a possible or actual conflict of interest. Conflicts are not just established at the beginning of an engagement; they can crop up at any time. You must be able to recognize a possible conflict and deal with it at the time it becomes apparent.

Conflict of interest

Circular 230 defines the existence of a conflict of interest for tax practitioners as:

- The services provided to one client (tax preparation or representation) will be directly adverse to another client, or
- There is significant risk that the services provided to one or more clients will be limited by the practitioner's responsibilities to another client, former client, third party or by a personal interest of the practitioner.

The conflict of interest determination involves taking a moment to look at the situation and be honest about the circumstances. If you can't do that, you need to pass on the engagement.

The first type is a conflict between two clients. This happens when you are representing or preparing returns for two clients who may have adverse situations. You must advise both clients of the possible conflict. If you feel you can work with both, without compromising either, *get a waiver signed by both parties* acknowledging they have agreed to the continued engagement.

The obvious example here is a divorced or divorcing couple who has been filing a joint return and wants you to continue to work with them both separately. Other, not so obvious, examples include: preparing an entity return and the returns of its members; representing more than one taxpayer or entity involved in the assessment of trust fund recovery penalties; or preparing or representing two separate individuals who are involved on opposing sides of litigation over another matter.

The second type of conflict is a possible conflict between your best interest and that of the client. You are required to advise the client of the possible conflict. If you both feel you can still adequately represent the client, have the client sign a conflict waiver.

This type of possible conflict represents a bigger danger to you and requires some serious consideration and policies in place to deal with the situation. This type of conflict could result when it is determined the preparer made an error on the return, or the owner of a practice determines an employee has been either negligent or fraudulent in the preparation of returns and clients are being examined.

The gist of this conflict is a question of whether a preparer or practice owner can vigorously serve the client's best interest if the preparer or practice owner is also under examination for items on the same return. Who gets thrown under the bus if it comes right down to it? If you cannot honestly say you would take the fall, then you have a conflict that cannot be resolved.

You are required to make disclosure immediately upon recognition of a possible conflict, avoid conflicts if possible, recuse yourself from a case in which you can't work out a conflict, or request a third-party analysis or evaluation of the situation.

You are required to make disclosure immediately upon recognition of a possible conflict, avoid conflicts if possible, recuse yourself from a case in which you can't work out a conflict, or request a third-party analysis or evaluation of the situation.

Engagement letters

You need to have a good engagement letter in place before you start anything with the potential client. This allows you to scope out the situation without getting involved with something you may not want to handle or may not be capable of handling.

The engagement letter should be a first line of contact for any client before any professional relationship is established. Engagement letters are also your first line of defense in the case of problems, civil or otherwise, between you and your client.

The engagement letter should do several things that cover everyone involved including:

- Outline the specific scope of your services
- Identify all parties involved, including any third parties
- Spell out confidentiality, privilege and disclosure items that may be involved
- Set and clarify timelines
- Disclose all fees, charges and billing practices
- Specify services not provided under the scope of the engagement — this helps with the pre-vention of, for example, a scoping and analysis

engagement turning into a full audit engagement (that should be a separate engagement with a separate letter)
- Include mediation language
- Outline methods of disengaging from the relationship on both sides
- List state/local issues or rules that could affect the engagement

As you can see, the engagement letter is not a "one size fits all" document, nor should you try to craft one that is. Take the time to gather a group of templates that cover most of your conceivable situations. Then, customize each engagement letter for each situation.

Most of the errors and omissions (E&O) insurance carriers provide free sample letters on their websites to help with this process. All E&O carriers that provide any type of true protection for your business also require engagement letters. You may want to consider consulting an attorney to review the letters you plan to use as a base line.

Many of the commercial software programs we use have sample engagement letters in their libraries. For two examples, see the letters on pages 36–38.

You need to review the engagement letter in detail with the prospective client, ensure they have a clear understanding of their rights and responsibilities under the IRS audit process, and understand what they can expect from you and what you expect from them at this point in the relationship.

You also need to make sure you do not get involved in something that may cause you to have to testify against the client. If at any point you believe there may be activity that is, or could become, criminal in nature, you need to immediately cease all actions and refer the client to an attorney. If the attorney needs to consult with a tax professional, they can hire you, which will allow you to continue working within the bounds of privilege. This coverage is called a Kovel letter.

You need to know where client confidentiality ends and privilege begins. Privilege never attaches to the actual preparation of tax returns, regardless of your certifications. You may be able to assert confidentiality, but this does not allow you to be unresponsive to subpoenas and legal summonses.

Section 7525 privilege will apply when the communication between you and the taxpayer is maintained in confidence. A reasonable belief needs to exist to be sufficient evidence of confidentiality. Disclosure of information to a third party can waive the §7525 privilege.

Waiver of privilege disclosure can be through three different means: intentional, implied or inadvertent. Intentional disclosure can occur when you give information to an independent third party. An implied disclosure can occur when the client places the advice in issue. Inadvertent waiver might be avoided if reasonable efforts are made to protect the privilege. Section 7525 only extends to civil administrative proceedings with the IRS or tax lawsuits before the tax court.

Never forget you can't "unknow" what you know and can't "unhear" what you hear. I make sure I start off every engagement with an explanation to the client of what is confidential and what is privileged and how those terms apply to them before they give any but the most basic of information.

Freedom of Information Act (FOIA)

This is where you'll get into the scoping and analysis of the possible engagement. Once you have gathered all the information you can from the client interview and from the documents they have and their understanding of the situation, you'll need to get the other side of the story. To do that, you'll need to know what the IRS has on file.

Let's assume you have determined there is no current conflict of interest, obtained the signed pre-audit engagement letter, thoroughly interviewed the perspective client and collected all the documents they can provide. You've sent them home with a list of homework to obtain any other documents you might need.

Your first step should be to obtain account transcripts and wage and income transcripts for all years the client thinks may be at issue, plus three past and three future years around those years. If the client thinks the problem years are 2010–2012, get a Form 4506T, *Request for Transcript of Tax Return*, Form 8821, *Tax Information Authorization*, and a Form 2848, *Power of Attorney and Declaration of Representative* for 2007–2016. If you have access to e-Services, a Form 8821 will get you the same information at this point that a Form 2848 will, minus the liability incurred on a Form 2848.

A review of the transcripts will give you a better idea of what other information you need from the IRS that your client hasn't provided or can't provide to you. Once you have made that determination, you can file the appropriate document.

If you determine you need the case file, workpapers etc., you'll need to file a FOIA request for the documents, unless there is an assigned IRS employee you can call and get the information from. You may be surprised at how much cooperation you can get out of the IRS once they are convinced you are trying to help get the situation rectified.

With the FOIA request or in your request to the IRS employee, include information for all years at issue. You should request all case file notes, all work papers, all correspondence to and from the client, all documents to and from the client, and any other information relevant to the resolution of the case. You can make some FOIA requests online at www.foia.gov.

What type of preparer are you? Do you whip out a Form 2848 and a FOIA request to order all transcripts and correspondence right out of the gate? Or are you more cautious and file a Form 4506T or Form 8821 to see what clues you can uncover?

Remember, a Form 2848 may be used by specific tax professionals under IRS Circular 230 jurisdiction (EA, CPA, attorney). Tax professionals who have completed the Annual Filing Season Program (AFSP) may only do representation for clients for whom they prepared the original return and then only in exams, not in collections. Form 2848 can still be used in these situations. On the updated Form 2848 (February 2020) Part 1, Box 5a, make sure to check "Access My IRS records via an Intermediate Service Provider." A power of attorney, by its very nature, implies liability to the person being designated; you are figuratively stepping into the client's shoes to stand before the IRS.

A Form 8821 or Form 4506T allows the designated party to receive transcripts and client information without the onus of liability. In most cases, either of these forms will work for an original scoping and analysis engagement and fee schedule.

Speaking of fees, in non-filer cases, you must decide how you are going to bill for your services and spell that out in your engagement letter. Everyone has a different philosophy on billing, and you must do what makes you comfortable. Let me just ask you this: if your potential client hasn't paid the federal government in however long, what makes you think they'll pay you on the backside of the engagement?

Transcripts and FOIA documents

You'll also need to sort out the information in the FOIA work papers. You should receive them or a letter with an expected date within 20 business days of the request. They should contain all the work papers and note all IRS personnel who have dealt with the file, all the correspondence that has gone to or from the IRS in the case, and all documents requested and submitted. You should set everything up on a timeline and go through the sequence of events. Then you must determine the client's status with the IRS (e.g., is the client still in exam, are they done with exam and in collections, do they still have appeal options, are they out of time for appeals, etc.).

Every single case is different based on facts and circumstances. Depending on the specifics, you may have differing options and circumstances for differing tax years. Your client may have issues that they aren't even aware of. Therefore, when requesting information either via Form 2848, 8821 or FOIA, you need to make specific determinations. You need to know when all the timelines are expiring.

You also need to be aware of the following IRS statute of limitations:

- For making assessments (ASED), three years from the due date of the return; if a substantial understatement is made, then it's six years (fraud keeps the statute open forever)
- For getting a refund (RSED), three years from the due date of the return or two years from the payment of a balance
- For collecting assessments (CSED), 10 years from assessment of the liability

When looking at IRS account transcripts, the preliminary codes you are seriously concerned about are:

- Code 150, tax assessed date
- Code 160-167, assessment of penalty for failure to file/abatement of the penalty
- Code 170-177/270-277, assessment of penalty for late payment/abatement of the penalty
- Code 290-313, assessment/abatement of tax due to examination
- Code 388, expiration of refund claims statute
- Code 420-428, examination of return codes

When looking through the account transcripts, you'll see Code 971 showing notice issued. These are the dates that letters were sent to the taxpayer in reference to the return. You can find a listing of all the notice and letters here: https://www.irs.gov/individuals/understanding-your-irs-notice-or-letter. The key point in your scoping and analysis is to know what you should be looking for; the account transcript tells you.

Again, always ask for all years that you know are in issue, plus at least three years backward and forward. If there are years not on the authorization that may be in issue, the IRS cannot release any information to you; however, they may tell you that you need to obtain authorizations for additional years. Better to ask for too many years than too few.

Your preliminary research should include learning about:

- Unfiled returns (personal, state, payroll, sales taxes, etc.)
- Audit adjustments
- Unpaid assessments
- Penalties and interest
- Unapplied or misapplied payments
- Notices and correspondence
- Other authorizations on file

Reviews of returns in years prior and after the year at issue can be highly informative in determining issues that may not be obvious at first glance. This review can also, sometimes, reveal the cause of the audit if returns have been timely filed.

Another item you must check into with any new representation client, especially for a client you have no history with, is looking for indicators of fraud. You do not want to be involved with a client who is involved with fraud, because this is both a criminal and civil offense. You need to immediately refer these clients to an attorney. The Internal Revenue Manual (IRM) lists the specific items to look for in fraud cases.

Types of tax transcripts include:

- Tax return transcripts (this transcript will include significant tax return information)
- Tax account transcripts (this transcript will show account history including payments, penalties and interest, refund history, verification of extension and when response to notice was received)
- Wage and income transcript (this transcript will show earnings of the taxpayer and can be used to file a tax return, answer a notice or verify employment)
- Record of account (the record combines information from the tax account and tax return transcripts)
- Verification of non-filing (the verification of non-filing, or VNF letter, is issued to prove there is no return processed for the requested tax period)

Determining a game plan

There are three types of audits: correspondence, office and field audits. Correspondence audits mean that the IRS needs additional documentation from the taxpayer; this information will need to be mailed in. Field audits are generally conducted at the business location. The office audit requires going to the IRS location for the audit.

Once all the information has been received and you have reviewed everything, you are ready to develop a game plan. As with any plan, it must be flexible and able to stand changes mid-course because it will probably change at least once. Important elements of a good game plan include:

- The years involved
- The status of each year's case (where they are in the machine)
- The validity of the IRS assertions
- The client's ability to enter collection alternatives
- The client's history of tax compliance
- Other issues that may complicate the IRS side of things (state issues, bankruptcy, etc.)

Using a good chart or spreadsheet to keep track of multiple years of issues can be helpful in looking at each year independently and looking at the overall picture at the same time.

You should be tracking the tax year, the primary issues, whether the file is in collections or exams or unfiled, the statute expiration dates, the estimated balances and your next course of action. See Page 34 for an example of a good chart.

Collections options

Determining other payment options for your client takes serious research, compilation of records and information, and a client meeting so you can discuss the reality of the situation. This is where we help them decide on some of those options mentioned earlier:

- The Fresh Start Initiative (full pay installment agreement or partial pay installment agreement)
- Offer in compromise
- Let the collection statute expiration date (CSED) run
- Bankruptcy filing
- CDP/CAP hearing requests
- If available, judicial review of the case
- Other tax matters not in evidence (i.e., state taxes, sales taxes, payroll taxes, etc.)

When helping the client decide on alternative actions or payment options, keep in mind the timelines and statute of limitations we discussed earlier. You must take a big picture approach to this topic.

Representatives also need to be cognizant of actions that toll the CSED statute and which ones don't. The CSED is tolled (the clock stops running) when the IRS is prohibited from taking collections actions.

Year	Primary Issue	Exam/ Collections	ASED/ CSED	Toll Days	Balance Due	Appeals AV	Game Plan
2013	Missing W2 from timely filed return, disregard of CP2000	Collections	4/15/17 5/1/2024	0	$600	Audit recon only	Acquiesce – Taxpayer missed W2 2017 refund will pay this when filed
2014	Exam of 2106 expenses, disregard of exam letters	Collections	4/17/18 10/25/2026	0	$2,500	Audit recon only	Acquiesce – Taxpayer has no records to substantiate deductions 2017 refund will pay this when filed
2015	Exam of 2106 expenses, disregard of exam letters	Collections	4/15/19 10/25/2026	0	$1,500	Audit recon only	Acquiesce – Taxpayer has no records of deductions 2017 refund will partial pay, leaves about $1,000 due
2016	Failed to file tax return, SFR filed by IRS	Collections	4/15/20 12/15/2027	0	$3,500	Audit recon only	Submit reconstructed mileage logs. Taxpayer has emp req diary/ employer non-reimb letter. Estimate of $500–$3,500 due (best case/worst case)
2017	Not yet filed, no SFR yet	N/A	N/A	0	Estimated $3,800 refund	N/A	File ASAP – Refund will be applied to 2013, 2014 and 2015 until exhausted
Overall final options	Collections alternatives for remaining balance	N/A	N/A	0	Estimated balance remaining of between $1,500–$4,000	N/A	Collections alternatives when 2016 audit recon is done, withholding now fixed to keep future balances from happening; best case, let IRS take 2017 refund, IA or full pay now

- Offer in compromise (extends the statute)
- Collections due process and appeals to CDP (extends the statute)
- Collection Appeal Program (does not extend the statute)
- Bankruptcy (extends the statute)
- Installment agreement (does not extend the statute)
- Appeal rejected/terminated installment agreement (extends the statute)
- Voluntary waiver (extends the statute)
- IRS suit to bring the liability to judgment (extends the statute)
- Client is out of the country more than six months (extends the statute)
- Innocent spouse (extends the statute)
- Taxpayer assistance order (extends the statute)
- Currently not collectible status (does not extend the statute)

These items are beyond the scope of this article; remember we are doing scoping and analysis for the client at this point, not actually interacting with the IRS on behalf of the client.

The Collection Appeal Program (CAP) is a process you should know about. This program provides taxpayers or third parties an administrative appeal for certain collection actions including liens, levies, installment agreements, seizures and third-party claims to property.

A collection group manager conference is required prior to appeal. Submit Form 9423, *Collection Appeal Request*, to request a CAP appeal. Enforcement is generally withheld pending appeal if timely received.

Another option is the Fast Track Settlement (FTS) program, which offers small businesses, the self-employed and individual taxpayers a way to resolve audit issues during the examination process in 120 days or less. Working with the Large Business and International Division and Appeals, taxpayers can shorten the amount of time spent in appeals.

This process is available for most factual and legal issues, listed transactions, appeals and compliance coordinated issues, and issues requiring hazards of litigation settlement.

Following are some advantages of the FTS program:

- Quicker resolution of audit issues
- No need for a formal protest to request
- A one-page application
- Delegation order

- Consideration of hazard of litigation
- Withdrawal from the process at any time
- Retention of all traditional appeal rights
- One tax computation
- Case closes

Conclusion

As you can see, a lot is involved in our scoping and analysis before we even decide if we'll represent the client. Once you have a better understanding of where your client is in the IRS process and have identified other possible issues they didn't know about, you can put together a tentative game plan for a future engagement to help this client "get right" with the IRS. After presenting the plan to the client and discussing options and recommendations for a continuing engagement, you can decide where to go from there.

About the author

Kathy Morgan, EA, USTCP recently retired after 25 years as a tax professional with H&R Block and started her own practice, Puzzled by Taxes LLC. Her prior careers as a USAF military police officer and as a police communications officer for the Bossier City Police give her a wide variety of experience that translates into tax issues. Kathy is also an accomplished speaker and instructs continuing education for many local, state and national organizations. Kathy lives and practices in the Shreveport, La. area. When not in "tax mode," she enjoys reading, writing and spending time with her grandchildren and family.

Engagement Letter for a Consultation to Discuss Representation

Please be advised, any information, verbal or written, used or disclosed while in the preparation of your business income tax return(s) is NOT PRIVILEGED [§7525].

_____________________ (firm) agrees to perform the following services for which ______________ [Client(s)] agree to pay our firm for the performance of those services. Services are billed at our hourly rate of $195.00 per hour. For consultation services, we require a retainer of __________.

Obtain a Form 2848, *Power of Attorney and Declaration of Representative*, from client(s). This will allow us to discuss your case with the appropriate tax agencies.

Investigate your case by requesting your account transcripts.

Ascertain and determine viability of your case.

Client(s) shall, in addition to our hourly fees, reimburse our firm for the following: Coping costs, postage and auto mileage (at the applicable federal rate).

Client(s) are responsible for and must pay for all services performed regardless of any further engagement between the firm and the clients.

After our firm has investigated your case and it has been determined that we will represent _____________________, this agreement shall terminate and a representation engagement letter will be offered to the client(s).

Any litigation initiated by you and arising out of this engagement must be filed within one year from the execution date of this engagement. In the event of litigation brought against us, any judgment you may obtain shall be limited in amount and shall not exceed under any circumstances the amount of fee charged by this firm and paid by you for the services rendered as set forth in this engagement letter. Your signature(s) on this engagement letter indicates your full acceptance of this clause in this engagement letter.

By signing this agreement, you have read all the terms and conditions set forth in this letter and those terms and conditions are fully acceptable to you. As proof thereof, your signature(s) below is hereby attesting to your acceptance of the agreement. If you are married, both spouses must sign this engagement letter.

Taxpayer's Signature _________________________________ Date ____________________________________

Spouse's Signature ___________________________________ Date ____________________________________

Engagement Letter for Representation

Please be advised, any information, verbal or written, used or disclosed while in the preparation of your representation paperwork is NOT PRIVILEGED [IRC §7525].

This letter is to confirm our understanding of the terms and objectives of your engagement of this firm and to clarify the nature and limitations of the services that will be provided for by our representation for you with respect to the Internal Revenue Service examination or collection activities of your tax year _______ federal income tax return(s). As part of this engagement, we require that you sign the attached IRS Form 2848, *Power of Attorney and Declaration of Representative*, which will be sent to the IRS notifying them that we are your authorized representatives pursuant to 31 CFR Part 10: Regulations Governing Practice Before the Internal Revenue Service. Important Note: Once this matter is resolved with the IRS, amendments may be required for each state in which you filed a tax return during the tax year(s) of the examination.

We will not start working on your tax representation matter until you have signed and returned the IRS Form 2848, *Power of Attorney and Declaration of Representative*, this engagement letter and your retainer.

This firm will represent you before the Internal Revenue Service during this examination or collection action. Our firm will use our best judgment in resolving questions where the tax law is unclear, or where there may be conflicts between the taxing authorities' interpretation of the law and what seems to be a supportable position [§6694]. Unless otherwise instructed by you, we will try to resolve all such questions in your favor, whenever possible. If research of the Internal Revenue Code, Internal Revenue Manual or other tax law repositories is required to resolve questions of procedure or tax law, the billing rate for such work is________________________________. Furthermore, in the event we cannot resolve all the issues at the examination level, we will be available to appeal any proposed deficiency to the Appeals Division of the Internal Revenue Service, although that appeal is not part of this engagement.

The fees for services are based upon the amount of time/work required. They are billed at our standard billing rate of ______________, plus our out-of-pocket expenses. We will bill you on that basis: all invoices will be due and payable upon presentation. We require a retainer of_________ (for about _____ to _____ hours work), payable upon your acceptance of this agreement. Fees and expense reimbursements are due and payable upon presentation of our invoices.

For examination representation, we will carefully review but not audit, or otherwise verify, any information provided by you for us to use in our presentation during the examination to the Internal Revenue Service. We will carefully review all your supporting documentation. However, unless we deem it necessary or you specifically request us (in writing) to do so, we will not audit your supporting documents. If you ask us, or we need to do a detailed review of your documentation, there will be additional hourly fees for these services.

If, during our work, we discover information that affects prior-year tax returns, we are required, by law, to advise you of this and discuss possible solutions. However, we cannot be responsible for identifying all items that may affect prior-year returns. If you become aware of such information during the year, please contact us to discuss the best possible solution.

It is very important for you to know that federal law imposes strict penalties if a taxpayer makes a substantial understatement of their tax liability. For individual taxpayers, a substantial understatement is when the understatement for the year exceeds the greater of 10% of the tax required to be shown on the tax return, or $5,000. The penalty is 20% of the tax underpayment. You should also know the IRS audit procedures will include questions on bartering transactions and on deductions that require strict documentation such as travel and entertainment expenses, business usage of autos and cell telephones [§274-d]. Automobile logs are mandatory [§274-d] and will be required for your examination or Collection Due Process Hearing.

The Internal Revenue Service has recently begun employing several procedures during examinations to ascertain that taxpayers have reported all their income. These procedures have led to a growing number of requests by examining agents to interview the taxpayer directly and/or to "tour" the taxpayers' home or business premise. However, you do have a statutory right to be represented [§7521] and not to meet with the examining agent (unless you are served with an enforceable administrative summons). We believe that it is in your best interest to refer any questions or other contact

–continued on page 38

from the agent to us without discussing the case with the agent. By signing this engagement letter, you acknowledge that any direct contact by the IRS will be referred to us as your authorized representative. If, on the other hand, they do call you, you are to tell them you are legally represented by this firm and that they are to contact us for any information or documents they may need. If they tell you they have tried to contact us and have had no response, tell them you will contact us and have us return their call. Then ask them, "At what telephone number can they reach you?" They do not like to give out their telephone number and might say they'll try us again. (It's not likely they never tried us the first time.) Just be very careful! Today's IRS agents are skillful at extracting information. If during our engagement, you contact the Internal Revenue Service or any state tax agency and do not contact us immediately (before calling or responding to the tax agency), you may have alienated this agreement and this firm may immediately terminate the agreement. Fees for all services performed will become immediately billable and payable upon receipt of our invoice. If you have advanced us a retainer, all costs for our services will be deducted from that retainer and any excess will be returned to you by Certified U.S. Mail within fifteen business days.

You may terminate this agreement, with or without cause, upon service to this firm of your written notice. Termination will not affect your responsibility to pay for all services rendered up to the date of termination, plus any costs associated with the actual termination of the agreement. This firm may terminate this agreement for any reason, upon service to you of our written notice. If the firm terminates this agreement, the firm will return to you all files and documents that you have provided this firm. (A major reason for client termination is the failure of the client(s) to provide accurate, complete and full documentation in a timely manner.)

If after we have reviewed and billed you for all or part of our tax representation services, and you seek out another tax professional to represent you, you are still liable for all the invoices and services we have provided. If you do not pay our invoice within thirty days, you will forfeit any discounts we may have afforded you and, after sixty days of non-payment, your account will be turned over to our collection agency.

Any litigation initiated by you and arising out of this engagement must be filed within one year from the execution date of this engagement. In the event of litigation brought against us, any judgment you may obtain shall be limited in amount and shall not exceed under any circumstances the amount of fee charged by this firm and paid by you for the services rendered as set forth in this engagement letter. Your signature(s) on this engagement letter indicate your full acceptance of this clause in this engagement letter.

In accordance with our firm's document retention policy, we will retain our work papers for seven (7) years. Physical deterioration or catastrophic events may shorten the term during which our records will be available. The working papers and files of our firm are not a substitute for your original records. The information we have gathered and/or assembled for your representation are the property of______________, and only his/her delegated successors or survivors.

In compliance with Federal and State regulations, the information you provided us and contained on your tax return(s) or representation documents are private, but not privileged [§7525]. As such we will not, nor can we, divulge the contents of your tax information to any individual, civil or governmental agency without your written permission, or by order of the U.S. Court, or as may be provided by federal and/or state law.

You hereby acknowledged that if you choose to appear before and/or discuss this case with any IRS agent, doing so is against our advice, and you do so at your own risk. We strongly admonish you not to discuss anything with the IRS.

The foregoing is in accordance with your understanding of this agreement with _________________ to provide you representation services. Please sign this letter in the space(s) provided and return it to us with your Form 2848, *Power of Attorney and Declaration of Representative*, and the retainer.

By signing this agreement, you have read all the terms and conditions set forth in this letter and those terms and conditions are fully acceptable to you. As proof thereof, your signature(s) below is hereby attesting to your acceptance of the agreement.

We appreciate this opportunity to serve your tax representation needs.

Taxpayer's Signature _________________________________ Date ____________________________________

Spouse's Signature ___________________________________ Date ____________________________________

Tax Court Appeals

A brief look at the process

By NATP Staff

This article is written primarily for the professional tax preparer who has little or no experience appealing an IRS audit, but needs to understand what happens between the conclusion of an examination and the day of trial in tax court in order to tell the client what to expect.

Imagine yourself in this situation: Your client's income tax return has been examined and the IRS has proposed changes with which you and your client strongly disagree. A meeting with the examiner's supervisor failed to resolve the issues. Your client wants to appeal, and you think he has a good chance of success. What happens next?

30- and 90-day letters

Under normal audit procedures, the IRS issues a 30-day letter, along with a copy of Pub. 5, *Your Appeal Rights and How to Prepare a Protest If You Don't Agree*, giving a taxpayer 30 days (in the absence of extenuating circumstances) to decide whether to accept their fate, file a protest and request an appeals hearing within the IRS, or to appeal directly to the courts. Most audited taxpayers choose not to appeal, despite the average appeal resulting in at least some decrease in the taxes, penalties and interest imposed by the auditor.

Upon the taxpayer's failure to request a hearing or following an unsuccessful appeals hearing, the IRS issues a 90-day letter (Notice of Deficiency), giving the taxpayer 90 days to file a tax court petition before collection proceedings begin.

Appeals within the IRS

Writing letters and contacting the Taxpayer Advocate Service through its hotline could resolve the dispute before the IRS issues the 90-day letter. However, it may be difficult for the IRS to resolve a dispute within that time frame.

Another option is the local IRS appeals office (Appeals). While it isn't necessary to have appealed within the IRS before going to tax court, it can be a good idea. The appeals officer's intent is to settle cases without litigation, and they may be more willing to compromise than the examiner was.

If the taxpayer does file a protest with Appeals, the 90-day period for filing a tax court petition continues to run during the time Appeals is considering whether to take the case.

If the taxpayer does not request an appeals hearing and instead files a tax court petition, the case will likely be sent to Appeals anyway. The taxpayer will then probably be offered an appeals hearing, or can request one. If a settlement is not reached with Appeals, the file will be sent to an IRS lawyer and the tax court case will proceed. If Appeals refuses to consider the case, the taxpayer is notified and told that the denial does not extend the 90-day period [IRM 8.2.2.2].

Note: Only attorneys, certified public accountants or enrolled agents may represent a taxpayer before Appeals. An unenrolled preparer may be a witness at the conference, but not a representative.

If the taxpayer does not request an appeals hearing and instead files a tax court petition, the case will likely be sent to Appeals anyway.

Going to court

Let's assume you have gone to Appeals and your client is still unhappy. The next step is to appeal to the court system. About half of all taxpayers win at least partial victories in court. Should the client go to tax court, the Court of Federal Claims or district court? Only 5% of all tax disputes for regular cases go to a district court or the Court of Federal Claims. A big reason is that to appeal to these courts, the taxpayer must pay the tax first.

Historically, the federal courts had jurisdiction only over suits for the recovery of taxes wrongly assessed. As a matter of policy, Congress felt the public treasury could not await court review if the government was to operate. In later years, the U.S. Tax Court was given the power to remedy what could be a harsh result if the taxpayer had to pay the tax before any review.

There are other differences between the courts. The Court of Federal Claims cannot hear cases involving abusive tax shelters or the aiding and abetting of an understatement of a tax liability.

There is no right to trial by jury in the Court of Federal Claims.

Jury trials are allowed in district court, which has more relaxed rules of discovery, but the taxpayer must be represented by an attorney admitted to practice before the court. Both courts follow the Federal Rules of Civil Procedure.

In either the Court of Federal Claims or district court, the taxpayer must both prove that the IRS's action in assessing and collecting the tax was erroneous, and provide an explanation and documentation of the correct tax, and the amount owed to him that the IRS wrongfully holds. The taxpayer has the burden of proving the erroneous collection and correct amount of the refund by a preponderance of the evidence, which means sufficient evidence on which a reasonable trier of fact could reach a conclusion in the taxpayer's favor. The IRS's original determination is presumed to be correct, but no weight is given to the IRS's findings of fact.

The United States is represented by lawyers from the office of the Assistant Attorney General of the Justice Department's Tax Division. Appeals from the district courts and the Court of Federal Claims are handled by an attorney in the Appellate Section of the Justice Department's Tax Division.

Tax court

If the taxpayer does not want to pay the tax before going to court, the tax court still has jurisdiction to hear cases involving income tax, estate or gift tax or certain excise taxes, after a 90-day letter has been issued.

The process is begun by filing a petition using forms found on the tax court's website. Filing a tax court petition is simpler than filing a protest with the IRS Appeals Office. A tax practitioner who can prepare a protest can surely prepare a tax court petition. Non-lawyers may represent taxpayers as long as they are admitted to practice before the tax court, or taxpayers may represent themselves. In fact, taxpayers represent themselves in over half of all tax court cases and nearly all of "small tax cases" under §7463. The IRS is represented by lawyers from the Office of the Chief Counsel.

Note: The tax court refuses to recognize a holder of a power of attorney as the taxpayer's representative unless the holder is admitted to practice in tax court. Someone with tax court experience should be available for questions about strategy, evidence or procedures. If the case goes to trial, the client may require someone admitted to tax court practice, especially if calling witnesses or if knowledge of rules of evidence becomes critical. Practice in tax court, even in small cases, is much more adversarial than practice before Appeals. The government's lawyers will not hesitate to ask the court to dismiss a case for late filing of a petition, failing to state a complaint on which relief can be granted, lack of jurisdiction or other technical reasons.

Small tax case procedure

If less than $50,000 is in dispute (including penalties and other additions to tax, but excluding interest), the taxpayer qualifies for small tax case (also called "S" case) proceedings. If the audit bill for any single year is over the $50,000 threshold, a taxpayer may still be able to utilize the simplified "S" case procedures. The catch is that he must give up his right to contest amounts over $50,000 in taxes and penalties for any one tax year.

Example: Sadie's audit report says she owes $62,000 for 2017 and $9,500 for 2018. Sadie can proceed as a small case in tax court if she contests only $50,000 for 2017, agreeing she owes the $12,000 overage. She can still contest the full $9,500 for 2018. The total amount contested is $59,500, and this is still an "S" case under tax court rules.

The advantage to "S" case proceedings is that they are less formal, and the rules of evidence are more relaxed, so the judge can consider any relevant evidence. Also, trials are held in more locations than are regular cases. The biggest disadvantage is that no appeals are allowed if the taxpayer loses at this level. Taxpayers tend to lose "S" cases more often than regular cases. This is due to the nature of cases brought, as well as the lack of solid support to overcome the "burden of persuasion" imposed on the taxpayer.

Paralegals from the IRS District Counsel's office usually handle "S" cases. The attorneys and paralegals in the District Counsel's office will assist the inexperienced non-admitted practitioner with procedural matters and will often prepare and file motions for matters agreed on.

Regular case procedure

If the taxpayer doesn't qualify for, or does not want, "S" case treatment, within 90 days of the deficiency notice's date (150 days, if the deficiency notice is addressed to a taxpayer outside the U.S.), the taxpayer must complete and hand deliver or mail a petition to the U.S. Tax Court in Washington, D.C. The petition can be filled out on the court's website, which also has helpful FAQs to guide the novice through the process.

The taxpayer must attach to the petition a complete copy of the notice of deficiency or the notice of determination, including the explanation of adjustments or the Appeals officer's report issued with the notice of deficiency or the notice of determination. A T.C. Form 4, *Statement of Taxpayer Identification Number,* and a T.C. Form 5, *Request for Place of Trial,* must also be submitted, which tells the tax court where the taxpayer would like to have the trial held. The trial location is selected from the list of cities in which the tax court holds trial sessions.

The taxpayer files the original plus four copies of each document (unlike small case proceedings where only the original plus two copies of each document is filed) and includes a $60 filing fee. The taxpayer will receive a notice of receipt of petition from the tax court acknowledging the filing, with the docket number for the case.

The taxpayer must be able to prove the deficiency determination is invalid, but (unlike in district court cases) need not prove the correct amount of tax. The tax court will generally make that calculation.

After the petition has been filed, the attorney for the IRS files an answer. The trial date will be scheduled after the answer is filed. Trials are usually scheduled six months or more in advance.

Prior to the trial date, the parties typically meet informally to exchange documents, try to settle and start the process of stipulating to facts and issues mutually agreed upon before filing discovery motions. Written interrogatories (questionnaires, which must be answered in writing), depositions (face-to-face questioning) and requests for admission (written statements a party is requested to admit or deny) are all allowed as part of the discovery process in which each side attempts to learn as much about the other side's case as possible before the trial date. The court strongly encourages this process because it causes the parties to arrive at trial well prepared, so they won't waste the court's time; it also promotes settlement when weaknesses in a case become apparent.

Over 90% of docketed cases are settled without going to trial. Though a trial date may be months away, the paperwork for any settlement is usually not completed until the eleventh hour.

The petitioner should file a pretrial memorandum with the court to assist in organizing the case and help the judge understand the taxpayer's position.

A final status report (FSR) is used to inform the court and the IRS of a settlement of a case not previously reported to the court, or to provide final estimates of the likelihood and/or length of the trial not previously reported to the court in the pretrial memorandum. The FSR may be submitted to the court and the IRS by mail, fax or electronic transmission as late as 3 p.m. Eastern time on the last business day before the trial session begins.

Win or lose

After trial, the judge may immediately issue a bench opinion or summary opinion (in a small case), or may take the time to write a memorandum decision (issued in a regular case that does not involve a novel legal issue, where the law is settled or factually driven) or a tax court opinion (issued in a regular case when the tax court believes it involves a sufficiently important legal issue or principle).

A losing taxpayer can file a motion for reconsideration within 30 days after the written opinion was mailed (although such a motion is heard by the judge who issued the opinion and thus is seldom granted). Within 90 days after a decision is entered, an unhappy taxpayer can file a notice of appeal with the clerk of the court along with a $450 filing fee and a bond for double the amount of the deficiency from which the appeal is taken. This will allow the taxpayer to go to the U.S. Court of Appeals for the circuit of the taxpayer's residence or business.

If the taxpayer elected to use the "S" case (under $50,000) procedure, the judge's ruling is final and cannot be appealed. All other regular cases heard in tax court, as well as cases brought in a district court, or the Court of Federal Claims, can be appealed to the Court of Appeals, which will let findings of fact stand unless they are clearly erroneous, but will review issues involving the interpretation of law. A lawyer is needed to handle this highly technical process, and you can expect legal fees starting at $10,000. If the taxpayer wins, however, they may be able to persuade the judge to order the IRS to pay the taxpayer's attorney fees.

A taxpayer's statistical chance of winning in the Court of Appeals is about 10%. If the taxpayer loses, they can ask the U.S. Supreme Court to hear the case, but the odds are better for winning their state lottery. ▸

Home Office Deduction

A review of the basics, including nexus implications during the pandemic

By Joseph L. LiPari, CPA, MBA

Due to the substantial increase in the number of employees working remotely from home and the startup of many small businesses due to staggering unemployment numbers during 2020 and into 2021, it would be wise to review the home office deduction rules. Most probably, many of our clients will be entitled to this deduction or may inquire about the possibility of taking it. Additionally, employees previously working in a state other than the one in which they reside will want guidance on which state they will be taxed in since they are now working from home.

This article will address a few of the income tax dilemmas created by the COVID-19 pandemic. Will taxpayers working remotely from home qualify to take the home office deduction and, if an employee, what state will they be taxed in if their employer's tax home is in a different state?

Home office

As you know, the *Tax Cuts and Jobs Act* (TCJA) eliminated the home office expense deduction for W-2 employees. Previously, this deduction was available as a miscellaneous itemized deduction subject to the 2% of AGI threshold — which was also repealed — to those employees who met the home office deduction requirements. Hence, the following information regarding the home office deduction is limited to self-employed individuals and partners only.

IRS Pub. 587, *Business Use of Your Home (Including Use by Daycare Providers)*, is a great source of information with respect to this deduction. To qualify to deduct expenses for the business use of your home, you must use part of your home exclusively and regularly as your principal place of business, and exclusively and regularly as a place where you meet or deal with patients, clients or customers in the normal course of business. To meet the exclusive use test, you must use a specific area of your home only for your trade or business. The area can be a room or other separately identifiable space, which doesn't need to be separated by a wall or permanent partition. To qualify under the regular use test, you must use a specific area of your home for business on a continuing basis.

You may have more than one business location. In this case, your home must be your principal place of business for that business. In other words, you must consider the relative importance of the activities performed at each place where you conduct business and the amount of time spent at each location.

Your home will qualify as your principal place of business if you use it exclusively and regularly for management or administrative activities and you have no other location where you conduct substantial administrative or management activities. Examples of administrative or management activities include billing, bookkeeping, scheduling of appointments, purchasing supplies, etc.

The same home office can be considered the principal place of business for two or more business activities. Also, you can deduct expenses for a separate free-standing structure, such as a studio, workshop, garage or barn, for example.

Once it has been determined that the taxpayer qualifies for the home office deduction, you must determine the amount you can deduct using either the simplified method or actual expenses. If you use the simplified option, just multiply the allowable square footage of home use for business (not to exceed 300 square feet) by $5 per square foot. If using the actual method, multiply the actual qualifying expenses of the home, including depreciation, by the percentage of the home used for business. If you rent instead of own the home you occupy, and meet the requirements for business use, you can deduct part of the rent you pay by multiplying your rent payments by the percentage of business use.

Deduct expenses for the business use of your home on Form 1040, *U.S. Individual Income Tax Return*, or Form 1040-SR, *U.S. Tax Return for Seniors*. Where you deduct these expenses on the form depends on whether you are a self-employed person or partner.

If you use your home in a self-employment activity, other than farming, report the deduction for business use on Schedule C (Form 1040), *Profit or Loss From Business*. If you use your home in your farming business, report your deduction for business use on Schedule F (Form 1040), *Profit or Loss From Farming*.

If you are a partner, you may be allowed to deduct unreimbursed ordinary and necessary expenses you paid on behalf of the partnership (including qualified expenses for the business use of your home) if you were required to pay these expenses under the partnership agreement and they are trade or business expenses under §162. The partner can deduct these expenses on Schedule E (Form 1040), *Supplemental Income and Loss*, as "unreimbursed partner expense" (UPE). As per the Schedule E instructions, UPE should be reported on a separate line of the section reporting partnership loss, and include the name of the partnership, a description of the amount and the notation "UPE." Form 8829, *Expenses for Business Use of Your Home*, does not have to be filed in this case.

Unlike the self-employed home office deduction, UPE can be deducted if it exceeds the income reported through the Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.* (subject to basis limitations). UPE is deductible against both federal income tax and self-employment tax. Keep in mind, however, the IRS takes the position that partnership expenses are not deductible on the individual partner's return unless the partnership agreement expressly states the partner is required to pay the expenses personally. Therefore, the partner should not only have adequate substantiation of the expenses but also ensure the partnership agreement includes language that each partner is required to pay for home office and other partnership expenses without reimbursement.

State nexus

The COVID-19 pandemic also created a situation whereby employees who have previously commuted across state lines for work are now working remotely from their homes. Employers withhold taxes on behalf of their employees, and usually they withhold for the state where the work was performed, even if the employee lives in a different state. The employee will then file a state income tax return in the state of employment, pay taxes there and take a credit for taxes paid to other jurisdictions when filing the tax return in their home state. Some neighboring states have reciprocity agreements that eliminate the need to file in two or more jurisdictions. For example, compensation paid to New Jersey residents employed in Pennsylvania is not subject to Pennsylvania income tax.

So, during this pandemic, for which state should the employer withhold state income taxes when employees live and remotely work from home in the same state, and it isn't the state where their employer has offices?

Technically, these businesses should be withholding taxes in the states where their employees work, even if just temporarily. Obviously, this can be an expensive and confusing cost of compliance for businesses not used to or familiar with having a workforce spread out over numerous states. This is why businesses are often hesitant about offering telework in a number of states since it could expose them to taxation or Nexus in those states. Nexus means "to be taxable." It is a relationship between a taxing authority, such as a state, and a business. A nexus must exist before a taxing authority can impose a tax on the enterprise, and it requires that there be a substantial link between the jurisdiction and the business.[1]

So again, it appears that during this pandemic, which is seeing a large number of employees working from home in a state that differs from their employer's offices, we have tax nexus. But, are the employers withholding state income taxes in the state from where the employee resides and is working remotely? The answer is probably not.

As of this writing, there has been no guidance from the federal government or any of the state governments regarding this issue. My home state of New Jersey has petitioned the United States Supreme Court to take this case. The governor of New Jersey, Phil Murphy, made the following statement: "In the course of this once-in-a-century pandemic, hundreds of thousands of New Jersey residents who typically commute to New York and pay New York taxes have been working from home for the last nine months. We are hopeful that the Supreme Court will hold that states do not have the constitutional authority to tax individuals who neither live nor work there."

Although the states from where the former commuters reside and now work remotely will have a lot of lost income tax revenue (New Jersey estimates upward of $1.2 billion in lost tax revenue), the enactment of any new law to address this would create enormous and complex tax implications. These implications would not only affect the employees' taxes and withholding but would also adversely affect the employers.

These employers would not only be required to withhold taxes and remit them to other states but, more importantly, they would now be scrutinized as to the level of sufficient presence and contacts in those states potentially creating nexus. It would expose them to taxation in states where they might otherwise have insufficient contacts to be subject to corporate taxation in those states.

So, as we await some sort of guidance, The Tax Foundation, among others, including the American Institute of Certified Public Accountants, is calling for states and the federal government to eliminate needless complexity and "treat temporary pandemic-related telework as if the employees' place of business had not changed." After all, the present crisis has created the necessity of working remotely for many people. ▸

Endnote

1. Jean Murray, MBA, Ph.D., What Is Tax Nexus? www.thebalancesmb.com.

About the author

Joseph L. LiPari, CPA, MBA is an associate professor at Montclair State University (Montclair, NJ) in the Department of Accounting and Finance. He maintains an accounting practice in Wayne, NJ.