Current Federal Tax Developments

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SECTION: SCAMS
BOGUS COLLECTION PHONE CALLS BEING MADE BY SCAMMERS DEMANDING PAYMENT OF "FEDERAL STUDENT TAX"

Citation: News Release `IR-2016-81, 5/27/16

One thing you can say for scammers—they react quickly as people become aware of one form of scam and move on to vary their approach so the mark is now confused that this call might be a real issue. In News Release `IR-2016-81 the IRS noted that scammers have now moved on to making dunning calls for a non-existent tax, not just a non-existent tax bill.

In the latest scam to be described by the IRS, the caller claims the taxpayer has an unpaid "student tax" for which payment must be made immediately. In one sense this sort of attack is a stroke of genius, since there are individuals that owe taxes, student loans or both, so this sort of confused combination likely dupes people who now are no longer sure what is being asked for. As well, actual students often are used to interacting with the tax system, and so won't as quickly recognize that the IRS simply doesn't function in that manner.

As always, the demand is for immediate payment via odd means, such as the purchase of prepaid debit cards.

As the news release notes:

> In this newest twist, they try to convince people to wire money immediately to the scammer. If the victim does not fall quickly enough for this fake "federal student tax", the scammer threatens to report the student to the police.

This almost certainly will not be the end of the variations that scammers will use to convince people that the call they are receiving is not the type of scam call that has gotten widespread press coverage.

The release goes on to give the following advice that advisers may want to forward on all clients:

> Scam artists frequently masquerade as being from the IRS, a tax company and sometimes even a state revenue department. Many scammers use threats to intimidate and bully people into paying a tax bill. They may even threaten to arrest, deport or revoke the driver's license of their victim if they don't get the money.
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> Some examples of the varied tactics seen this year are:
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> - Demanding immediate tax payment for taxes owed on an iTunes gift card.
> - Soliciting W-2 information from payroll and human resources professionals (IR-2016-34)
> - "Verifying" tax return information over the phone (IR-2016-40)
> - Pretending to be from the tax preparation industry (IR-2016-28)
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> The IRS urges taxpayers to stay vigilant against these calls and to know the telltale signs of a scam demanding payment.
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> **The IRS Will Never:**
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> - Call to demand immediate payment over the phone, nor will the agency call about taxes owed without first having mailed you a bill.
> - Threaten to immediately bring in local police or other law-enforcement groups to have you arrested for not paying.

- Demand that you pay taxes without giving you the opportunity to question or appeal the amount they say you owe.
- Require you to use a specific payment method for your taxes, such as a prepaid debit card.
- Ask for credit or debit card numbers over the phone.

If you get a phone call from someone claiming to be from the IRS and asking for money and you don't owe taxes, here's what you should do:

- Do not give out any information. Hang up immediately.
- Contact TIGTA to report the call. Use their IRS Impersonation Scam Reporting web page or call 800-366-4484.
- Report it to the Federal Trade Commission by visiting FTC.gov and clicking on "File a Consumer Complaint." Please add "IRS Telephone Scam" in the notes.
- If you think you might owe taxes, call the IRS directly at 1-800-829-1040.

More information on how to report phishing or phone scams is available on IRS.gov.

SECTION: SCAMS
POLICY CHANGE MEANS IRS WILL NO LONGER INITIATE AUDIT CONTACT WITH TAXPAYERS VIA PHONE

Citation: IRS Announcement on Policy Change, 5/6/16

After practitioners in Iowa complained in a meeting with Taxpayer Advocate Nina Olsen about the IRS initiating audits in that state via phone contact with taxpayers that was reported by *Tax Notes*, the IRS has decided to change that policy.

Practitioners had complained that such IRS contacts via phone were confusing to clients whom they had warned about fraudulent calls from people claiming to be with the IRS demanding payment, citing IRS statements that the "IRS doesn't call first" with regard to such collection cases.

The IRS, it appears, didn't see that while it might be very clear to those in the agency that collection and audit were totally different functions, for those not deep into the culture and structure of the agency that distinction is not clear—as this author can attest from my own clients' understanding of what the IRS has said and that I've found when discussing the issues in course sessions with CPAs.

In reality, the Internal Revenue Manual does contain language that suggests the "preferable" way to initiate an in-person filed audit to schedule the initial meeting. While in many states offices had not been taking step (likely due to management that realized the potential for confusion with scam calls), in some locations the agency's exam function appeared to be strictly following this preference.

After a furor developed over the Iowa complaints, the IRS has now decided that, out of "an abundance of caution" (agency-speak for "we aren't admitting we did anything wrong") the policy should be changed.

The IRS's statement of a change in their position follows:

> Phone scams from con artists are one of the biggest challenges facing taxpayers. Generally, phone scam callers are focused on masquerading as an IRS collection agent and demanding immediate payment of money.

While the vast majority of initial audit contacts are handled by sending a letter first, in some of our in-person field audits, a small percentage of our overall audits, the IRS may contact the taxpayer or their representative by phone to schedule an appointment to begin the audit. This phone contact is followed up with an appointment letter confirming the appointment. This has been a longstanding policy at the IRS and we have no indication that criminals claiming to represent the IRS on the phone have said they were calling to set up an appointment for a meeting.

However, in an abundance of caution and in light of pervasive phone scams seeking to extort money from taxpayers, the IRS has decided to adjust this policy for in-person field exams. The IRS will implement a policy to notify taxpayers in this smaller exam category first via mail that their return has been selected for audit and then contact them to schedule an appointment.

The protection of taxpayers and their rights remains a top priority for the IRS. We are committed to working with our partners across government and the private sector to stop these scammers from preying on taxpayers.

On May 20, IRS Deputy Commissioner for Services and Enforcement John Dalrymple issued a memo to the commissioners of all four divisions of the IRS outlining this policy change. That memo, first published in the National Association of Enrolled Agents weekly newsletter and later reported by *Tax Notes Today*, provides the following which implements the policy change noted above:

May 20, 2016

MEMORANDUM FOR COMMISSIONER, LARGE BUSINESS & INTERNATIONAL
COMMISSIONER, SMALL BUSINESS & SELF-EMPLOYED
COMMISSIONER, TAX-EXEMPT & GOVERNMENTAL ENTITIES
COMMISSIONER, WAGE & INVESTMENT

FROM:
John Dalrymple
Deputy Commissioner for Services and Enforcement

SUBJECT:
Change in Policy on Initial Taxpayer Contact in
Examination Cases

Effective immediately, <u>all initial</u> contacts with taxpayers to commence an examination must be made by mail, instead of the telephone, using the appropriate initial contact letters. Although we recognize making initial contact by telephone to schedule an appointment in some of our examination operations has been a long-standing policy, we are changing our practice in response to the continuing threat of phone scams, phishing, and identity theft.

Employees will use the appropriate initial contact letters listed in the Internal Revenue Manual (IRM) to notify a taxpayer when a return is selected for examination, and **<u>will not</u>** make **<u>initial</u>** contact by telephone. When a valid Form 2848, *Power of Attorney and Declaration of Representative*, or Form 8821, *Tax Information Authorization*, is on file for the taxpayer, the appropriate initial contact letter will be mailed to the taxpayer and a copy of the letter will be mailed to the representative with Letter 937, *Transmittal Letter for Power of Attorney*. After mailing the contact letter, and sufficient time has lapsed for the taxpayer to respond (allow 14 calendar days from mailing the letter), employees can then initiate contact by telephone with the taxpayer as needed. We are evaluating our other contacts with taxpayers, outside of the examination context, to determine whether they present risks with respect to phone scams and other such threats.

Please ensure this guidance is distributed to all affected employees within your organization. Interim guidance specific to the respective functional IRMs reflecting this policy change should be issued in the near future, as needed.

Similarly, the IRS noted in the past year they plan to start contacting taxpayers who fall behind in 941 payments proactively. Not a bad idea, but the agency then notes that it will include making such contacts by phone—so, once again, a taxpayer could see contact initiated by a phone call.

Of course, the IRS isn't the only governmental body that doesn't seem to "get" that phone calls and tax matters are now "tainted" and a potential problem. Let's not forget that our Congress has mandated that the IRS begin contracting with outside collection agencies to pursue delinquent tax bills.

While in that case it should be the IRS will not initiate contact, it likely won't take the scammers long to start claiming they represent the new collection agencies and start attempting to scare marks into turning over funds. But that is a problem for another day.

These sorts of things do make it difficult to warn clients *in a way they can easily understand* about fraudulent calls that attempt to scare them into giving money, thinking that otherwise they are facing a problem with the IRS, something most taxpayers absolutely want to avoid. Unfortunately, until both the IRS and Congress grasp the difficulties in this area we are going to have problems communicating to our clients what does and does not represent legitimate contact by the IRS with the taxpayer.

SECTION: 501
IRS REDUCES USER FEE FOR SMALL ORGANIZATIONS FILING FORM 1023-EZ FOR §501(C)(3) STATUS FOR LAST SIX MONTHS OF 2016

Citation: Revenue Procedure 2016-32, 5/27/16

In Revenue Procedure 2016-32 the IRS announced a reduction in the 2016 user fee for certain exempt organization applications effective July 1, 2016.

The fee for organizations filing Form 1023-EZ, *Streamlined Application for Recognition of Exemption Under Section 501(c)(3) of the Internal Revenue Code* will be reduced from $400 to $275.

That form, which must be filed electronically on Pay.gov, is available to exempt organizations that:

- Have annual gross receipts that do not exceed $50,000;
- Assets are no more than $250,000 and
- Meets various other criteria described in the eligibility worksheet found at the end of the Instructions for Form 1023-EZ.

Organizations that do not meet the requirements to file the Form 1023-EZ must complete and file the longer Form 1023.

The original user fee for 2016 was found in Revenue Procedure 2016-8 which is modified by this Revenue Procedure.

SECTION: 1401
PAYMENTS MADE TO FORMER INDEPENDENT CONTRACTOR UNDER AGREEMENT FOUND TO BE SUBJECT TO SELF-EMPLOYMENT TAX

Citation: Petersen v. Commissioner, CA11, Nos. 14-15773, 14-15774, aff'd TC Memo 2013-271, 5/24/16

The Eleventh Circuit Court of Appeals found that payments received by a former independent Mary Kay beauty consultant under a nonqualified plan after her retirement was subject to self-employment tax (*Petersen v. Commissioner*, CA11, Nos. 14-15773, 14-15774, *aff'd* TC Memo 2013-271).

The Mary Kay plan in question had been modified in 2008 in response to the addition of IRC §409A by Congress. In doing so, the plan documents now clearly referred to the plan as being one granting nonqualified deferred compensation to the participants to be paid after they retired.

Nan Smoot, Mary Kay's Director of Taxes, in testimony in the original Tax Court case explained the reasons for the change as follows:

> Smoot testified she was involved in drafting the Mary Kay Amendments for the Family Program and Futures Program in 2008 to ensure they complied with IRS regulation 409A. She explained the IRS "did not want a receiver of income to be able to manipulate what year they received the income"; "if . . . deferred compensation plans were not compliant with the 409A rules, . . . the person who would be receiving the payments, would be subject to a 20 percent penalty on the plan amounts" plus "100 percent of all amounts under the plan to be paid in the future, that amount would be subject to tax up front." Trial Tr. 285, 286. Consequently, Smoot testified the 2008 Amendments to the Family and Futures Programs were favorable to a participating NSD, because, instead of the 20 percent penalty, the regular income tax rate would have applied "on all future payments covered under the contract." Id. at 286. As the Tax Court judge clarified with Smoot, this penalty tax would have been imposed "before receipt . . . , if the Program did "not comply with [the IRS] rules," which Smoot testified would be "pretty onerous" to the NSD participants. Id. at 286, 287 (emphasis added).
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> Through the 2008 Amendments, Smoot testified the intent of Mary Kay was to make "extremely clear to the IRS" that the 409A rules applied, which was to the benefit of the NSDs participating in the Family Program and Futures Program. Id. at 289.
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> In response to the judge's inquiry as to the significance of a nonqualified-deferred-compensation arrangement, Smoot responded the participant NSDs are "independent contractors," and "there's no way to have a qualified pension plan for a non-employee. So, it had to be a non-qualified plan. It's not a pension arrangement under 401." Id. at 288 (emphasis added). For tax purposes, Smoot explained Mary Kay treated payments to NSDs under the Family Program and Futures Program as deferred compensation based on past services, making them ordinary deductions for Mary Kay. She testified the 2008 Amendments did not change Mary Kay's tax reporting regarding these Programs: "We have always treated the [Program] payments as payments for past services" or deferred compensation. Id. at 293. This deferred-compensation treatment for payments under the Family Program and Futures Program is shown by Mary Kay on its books, tax returns, and reported to the IRS as nonemployee compensation on Form 1099-MISC.

The panel explained the self-employment tax as follows:

> To be self-employment income, "there must be a nexus between the income received and a trade or business that is, *or was*, actually carried on." *Newberry*, 76 T.C. at 444 (emphasis added). In addition, the income "must arise from some *actual (whether present, past, or future) income-producing activity of the taxpayer before such income becomes subject to . . . self-employment taxes.*" Id. (emphasis added).

> "The self-employment tax provisions are broadly construed to favor treatment of income as earnings from self-employment." *Bot v. Comm'r,* 353 F.3d 595, 599 (8th Cir. 2003).

The Tax Court had found that this deferred compensation program represented amounts earned by the taxpayer in a prior year from her business which was being paid out in a later year and thus was subject to self-employment tax.

The taxpayers argued first that the structure, which included a non-compete agreement, was actually a sale of her business and thus should not be subject to self-employment tax. The court did not find any evidence that this was really a sale rather than deferred compensation. As was noted earlier, the plan now stated it was a deferred compensation arrangement.

Nowhere did it provide for a sale of the taxpayer's Mary Kay business and, as well, the taxpayer had actually violated the non-compete agreement yet payments continued to be made under the program.

The major argument of the taxpayers, and that was also endorsed in *amici* briefs filed with the Court, is that the case should be governed by prior cases in other circuit that dealt with payments to insurance salesmen. As the court noted:

> They primarily rely on two nonbinding circuit cases involving insurance salesmen, whose payments after terminating their relationships with their insurance companies were found not to be subject to self-employment tax. *Gump v. United States*, 86 F.3d 1126 (Fed. Cir. 1996); *Milligan v. Comm'r*, 38 F.3d 1094 (9th Cir.1994)42; but see *Schelble v. Comm'r*, 130 F.3d 1388 (10th Cir. 1997) (concluding insurance salesman's after-termination-of-employment payments were subject to self-employment tax). We distinguish these insurance cases on at least four bases. First, their products are different. Insurance policies, whether they are for life, automobiles, fire and casualty, or general coverage involve contracts with a customer for a specific time period; they have to be renewed, when that term expires. That is not the case with fungible cosmetic sales, which do not involve contracts with customers or renewals. Second, the calculation of after-termination-of-business payments for insurance salesmen is based on methods and concepts, such as renewals, adjustments, and deductions, which are germane to the insurance business. Third, while insurance salesmen and Mary Kay NSDs are independent contractors, their means of operation are entirely different. Insurance salesmen work singularly; the commissions they garner are the result of each salesman's individual work. In contrast, Mary Kay NSDs no longer are selling cosmetics but lead and train their ever increasing networks, whose sales generate the NSDs' commissions before and after their retirement, which meet the requirement under a nonqualified plan for deferred compensation, derived from previous work as an independent contractor. Fourth and most distinctive, the Mary Kay Family Program, for percentages of commissions from NSDs' domestic networks, and Futures Program, for percentages of commissions from their foreign networks, are one of a kind. As Jill Wedding, Mary Kay Director of Consultants, testified at the Tax Court trial, the Family Program and Futures Program are "unique" concerning after-retirement programs for direct-sales companies. For these reasons, we do not consider the after-termination payments of insurance salesmen to be comparable to the Mary Kay Family Program and Futures Program for the purpose of determining whether commission payments received by NSDs in retirement are subject to self-employment tax as deferred compensation under a nonqualified plan. The Petersons "failed to establish that [Peterson] qualified for an

> exemption to the [self-employment] tax" imposed on her 2009 deferred payments for the Family Program and Futures Program. Patterson, 740 F.2d at 929.

While the above describes the majority opinion, in this case the panel's decision was not unanimous. Judge Rosenbaum found that the 2008 changes, made unilaterally by Mary Kay, should not serve to automatically "brand" the payments as deferred compensation.

Neither does the dissent agree that the insurance cases are irrelevant, rather finding a more detailed analysis is required. After conducting such an analysis the dissent found some payments had sufficient nexus to the taxpayer's services for Mary Kay to be considered self-employment income but others, which depended on production of others, did not meet that test.