



DEPARTMENT OF THE TREASURY  
INTERNAL REVENUE SERVICE  
WASHINGTON, D.C. 20224

OFFICE OF  
CHIEF COUNSEL

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MEMORANDUM FOR DISTRICT COUNSEL,

CC:EBEO:Br2:

FREV-100524-99

FROM: Jerry E. Holmes  
Branch Chief CC:EBEO:Br2

SUBJECT: Employment Taxes in Abusive Trusts

This responds to your memorandum dated December 31, 1998, in which you ask that our office pre-review your proposed response to an advisory request from the Appeals Office in the

The case you describe involves a taxpayer who operated a business as a sole-proprietorship before . Thereafter, the taxpayer implemented a strategy to avoid federal taxes by using trusts and a Limited Liability Company (LLC). During and part of , the taxpayer operated his business as a trust. During , the taxpayer began operating his business as an LLC. The LLC's two members were trusts in which the taxpayer was the sole beneficiary. Concurrent with implementing this scheme, the taxpayer reclassified all employees as independent contractors. You ask us to review your advice assuming the trusts and the LLC are shams for all years.

You explain that for income tax purposes, statutory notices of deficiency were issued to the taxpayer for , , and ; and whipsaw notices of deficiency were issued to trusts for and , and notices of final partnership administrative adjustment were issued to the LLC for and .

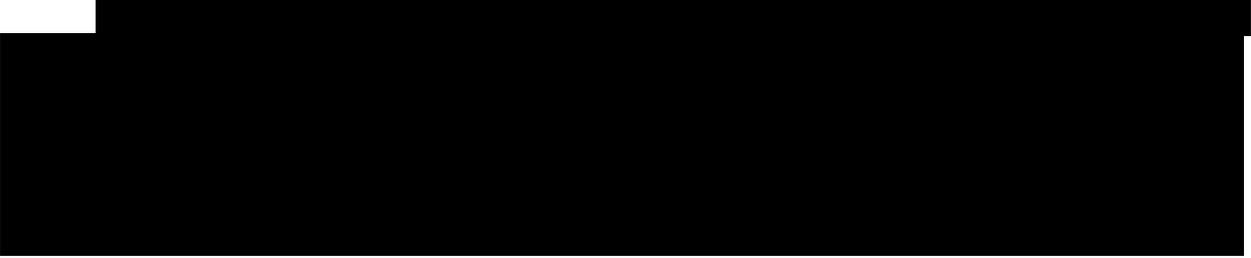




The Taxpayer Relief Act of 1997 created new § 7436 of the Code, which provides Tax Court review rights concerning certain employment tax determinations. Section 7436(a) provides the Tax Court with jurisdiction to review determinations by the Service that workers are employees for purposes of subtitle C of the Code, or that the taxpayer for whom the services are performed is not entitled to relief from employment taxes under § 530 of the Revenue Act of 1978. Section 7436 became effective with respect to assessments made on or after August 5, 1997.

The Notice of Determination procedures mirror the notice of deficiency procedures. Because a Notice of Determination constitutes the Service's determination as described in § 7436(a), the Notice of Determination is a jurisdictional prerequisite for seeking Tax Court review of the Service's determinations regarding worker-classification and § 530 issues. The Service will inform taxpayers of a determination described in § 7436(a) by sending the taxpayer a Notice of Determination by certified or registered mail. A copy of the current Notice of Determination is in Notice 98-43, 1998-33 I.R.B. 13.

Section 7436(d)(1) provides that the restrictions on assessment under § 6213 apply in the same manner as if a notice of deficiency had been issued. Thus, under § 6213(a), the Service may not assess taxes attributable to worker-classification and § 530 issues prior to expiration of the 90-day period during which the taxpayer may file a timely Tax Court petition. If the taxpayer does file a timely Tax Court petition, § 6213(a) generally precludes the Service from assessing taxes attributable to the worker-classification and § 530 issues until the decision of the Tax Court becomes final. Therefore, as in an income tax case, the taxpayer has the opportunity to have worker-classification and § 530 determinations reviewed by the Tax Court before assessment.



You also asked if there are any special concerns raised by the fact that the business was operated as an LLC for tax years        and        . As an initial matter, we note that because the years at issue are        and        , the Procedure and Administration Regulations in effect prior to January 1, 1997, control for purposes of determining how the entity will be classified for federal tax purposes.<sup>1</sup>

The answer to the issue of who is the employer for employment tax purposes would follow from a court's determination on whether the trusts, the LLC, or both, are shams for federal tax purposes. If the LLC and the lower tier trusts are determined to be shams, then the workers would be employees of the taxpayer.

If the trusts are determined to be shams, but the LLC is determined to not be a sham, then the LLC would be deemed an entity with a single owner and would therefore be taxable either as an association or as an entity disregarded for federal tax purposes depending on whether the entity had certain corporate characteristics as provided under former Treasury Regulations § 301.7701-2(a)(1) (1960). If the entity was taxable as a corporation, then the corporation would be liable for employment taxes on wages it paid to its employees. If the entity was not a corporation, then it would be disregarded for federal tax purposes; accordingly, the owner would be liable for employment taxes on wages paid.

If the lower tier trusts and the LLC are determined to not be shams, then the LLC, which has classified itself as a partnership, would be liable for employment taxes on wages it paid to its employees.<sup>2</sup> If the partnership were honored as an

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<sup>1</sup>Treas. Reg. § 301.7701-2, -3 (1960). The "check-the-box" regulations became effective January 1, 1997. See Regs. § 301.7701-2, et seq.

<sup>2</sup>Section 301.7701-3(f)(2) provides that in the case of an entity, such as an LLC, that was in existence prior to January 1, 1997, the entity's claimed classification will be honored with respect to all periods prior to January 1, 1997, if certain conditions are met, e.g., the entity had a reasonable basis for its claimed classification. We assume that the district is not asserting as an alternate position that the LLC was properly classified as a corporation for federal tax purposes.

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entity, then employment taxes could not be assessed against the members (the trusts); instead, as you state, whether the trusts or the taxpayer could be held liable for the debts of the partnership is a question of state law.

In addition to addressing the specific questions you raised, we would like to make you aware of certain issues surrounding the application of § 530 of the Revenue Act of 1978. Section 530(e)(3) provides that the availability of the safe harbors (e.g., industry practice) is not dependent upon the worker otherwise being an employee. Based upon this provision, the Service has taken the position that the first step in a worker-classification case is to determine whether the taxpayer is entitled to relief under § 530. Accordingly, before the Service issues a Notice of Determination, it must determine whether the taxpayer is allowed relief under § 530.

In determining whether § 530 treatment is available, § 530(a)(3) provides that relief from employment taxes will not be available if the taxpayer (or predecessor) has treated any worker in a substantially similar position as an employee. This is referred to as the “substantive consistency” test. Thus, even if the trusts and LLC are honored as entities for federal tax purposes, the substantive consistency test will not be met because the predecessor entity treated workers holding substantially similar positions as employees.

If we can provide further assistance, please call the branch telephone number.

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Jerry E. Holmes  
Branch Chief  
Office of the Assistant  
Chief Counsel  
(Employee Benefits & Exempt  
Organizations)