Current Federal Tax Developments

Week of April 29, 2019

Edward K. Zollars, CPA
(Licensed in Arizona)

ACCOUNTING
CONTINUING EDUCATION

KAPLAN

CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF APRIL 29, 2019
© 2019 Kaplan, Inc.
Published in 2019 by Kaplan Financial Education.

Printed in the United States of America.

All rights reserved. The text of this publication, or any part thereof, may not be translated, reprinted or reproduced in any manner whatsoever, including photocopying and recording, or in any information storage and retrieval system without written permission from the publisher.

Current Federal Tax Developments

Kaplan Financial Education

Table of Contents

Section: 162 Settlement Related to Taxpayer's Corporations, Resulting in a Portion Being Deemed an Employee Business Expense 1

Citation: Ferguson v. Commissioner, TC Memo 2019-40, 4/23/19 1

Section: 199A IRS Greatly Expands Frequently Asked Questions for §199A on Website - And S Corporation Owners Aren't Going to Like the Final Answer 3

Citation: Tax Cuts and Jobs Act, Provision 11011 Section 199A - Qualified Business Income Deduction FAQs, IRS website, 4/11/19 3

Section: 401 IRS Releases Revisions to EPCRS Program, Expanding Issues That Can Be Corrected Via SCP 8

Citation: Revenue Procedure 2019-19, 4/19/19 8

Section: 6041 Emailed Memo Holds That Using a CPEO Does Not Allow a Partner to Be Treated as the Employee of a Partnership 9

Citation: ECC 201916004, 4/19/19 9

Section: 162
Settlement Related to Taxpayer's Corporations, Resulting in a Portion Being Deemed an Employee Business Expense

Citation: Ferguson v. Commissioner, TC Memo 2019-40, 4/23/19

The Tax Court determined a taxpayer would be allowed a deduction for a portion of a settlement he paid to a customer that had filed a legal claim for problems with work performed by two corporations he controlled only as an employee business expense in [Ferguson v. Commissioner](), TC Memo 2019-40, rather than as an above the line business loss. However, the portion of the loss allocable to the other corporation, which was an S corporation, would be treated as a contribution of capital giving rise to a deduction that would flow through to the taxpayer.

The opinion summarized the complaint of the customer as follows:

> *The homeowners alleged that Mr. Ferguson had misrepresented RFI's and Pinnacle's expertise in manufacturing and installing cast stone. The homeowners also alleged that Mr. Ferguson, in concert with Pinnacle and RFI, elected to use construction methods and materials that reasonable persons would not have employed.*

The opinion goes on to describe the ultimate settlement:

> *In 2011 the lawsuit was settled. The homeowners, Mr. Ferguson, RFI, Pinnacle, and VFE were parties to the settlement agreement, which Mr. Ferguson signed in his individual capacity. As a part of the settlement, Mr. Ferguson transferred nine parcels of real estate to the homeowners. Mr. Ferguson also gave the homeowners a check, which was drawn on his personal bank account. In turn the homeowners agreed to release Mr. Ferguson, RFI, Pinnacle, and VFE from their claims.*

RFI was a C corporation in which Mr. Ferguson held a majority interest that operated as the general contractor on custom homes that Mr. Ferguson built. Mr. Ferguson was an employee of RFI. Pinnacle was an S corporation of which Mr. Ferguson was also the majority shareholder which manufactured, supplied and installed cast stone. VFE was another S corporation owned by Mr. Ferguson that sold the lots on which the homes were constructed. He also operated a commercial construction business and a home remodeling business as sole proprietorships.

The taxpayer recorded the transactions as follows.

> *Pinnacle recorded the aggregate value of the check payment and the fair market value of the real estate transfer (collectively, settlement payment) on its books for 2011 as a loan from Mr. Ferguson. No written loan documents were prepared, and no interest was accrued on the loan. Mr. Ferguson believed he could treat these amounts as a loan to Pinnacle because he believed that the settlement was attributable to the defective cast stone. Pinnacle had no sales or gross receipts in 2012, and Mr. Ferguson shut it down later that year; he assumed Pinnacle's liabilities regarding the recorded loan, essentially relieving Pinnacle of the obligation to repay him.*

The taxpayer claimed these amounts as a deduction on Pinnacle's S corporation tax return, with the losses flowing through to Mr. Ferguson's individual income tax return. The IRS contends that Pinnacle could not deduct the losses because it did not pay or incur them. Rather, the IRS

found that they were actually the liability of the C corporation and, as such, could only be deducted as an unreimbursed employee business expense.

The Tax Court opinion summarized the eventual positions of the parties as follows:

> *Respondent asserts that the settlement payment was RFI's expense because RFI was responsible for the work that gave rise to the homeowners' lawsuit. Respondent argues that as a statutory employee of RFI under section 3121(d)(1), Mr. Ferguson may deduct the settlement payment only as an unreimbursed employee business expense. Petitioners counter that RFI was not Mr. Ferguson's only trade or business. According to petitioners, they may deduct the settlement payment on a Schedule C because Mr. Ferguson paid it to protect his business reputation and, by extension, his other businesses.*

The Tax Court notes that the origin of the claim doctrine controls the deductibility of legal fees. The key question was whether the loss arose from a business activity of Mr. Ferguson other than his employment by RFI. That is important because employee business expenses are not deductible in arriving at adjusted income.[1]

The Court found that the claim clearly related to RFI and Pinnacle, not any Schedule C business of Mr. Ferguson:

> *The record establishes that the origin of the homeowners' lawsuit stems from work performed by RFI and Pinnacle rather than a separate trade or business of Mr. Ferguson. While the homeowners' complaint, amended complaint, and second amended complaint alleged various problems with the construction of the dwelling, the parties agree that the claims regarding the cast stone were the homeowners' primary grievance. The cast stone work was performed and/or supervised by RFI and Pinnacle. RFI was the general contractor for the construction project and agreed to perform "all work necessary to complete the dwelling". Pinnacle was subcontracted to produce, supply, and install cast stone for use in the construction.*
>
> *While the homeowners also sued Mr. Ferguson in his individual capacity, he was not a party to the construction contract with the homeowners. Furthermore, the homeowners did not allege that Mr. Ferguson took any action in the construction of the dwelling other than as the face and controlling shareholder of RFI and Pinnacle.*

The Court also found that there was no loan to Pinnacle:

> *Petitioners' argument that Mr. Ferguson's payment of the settlement was actually a loan to Pinnacle is not supported by the record. Petitioners cite Pinnacle's treating the settlement payment as a loan on its books as evidence of a bona fide loan. However, no loan documents were prepared, and the record is devoid of any evidence of a fixed repayment date or repayment schedule. No interest or principal was paid or accrued on the purported loan, which Mr. Ferguson effectively canceled when he ended Pinnacle's operations in 2012. Furthermore, Mr. Ferguson testified that Pinnacle had little chance of obtaining third-party financing on its own when he paid the settlement. This view was shared by Mr. Ferguson's accountant, who acknowledged at trial that Pinnacle's poor cash position made repayment unlikely.*

---

[1] For the years in question, if the item is an unreimbursed employee business expense it would be a miscellaneous itemized deduction subject to a 2% of adjusted income limitation and not deductible in computing adjusted minimum taxable income. For tax years 2018-2025 such an employee business would be wholly barred from deduction.

> *On the basis of these facts, we find that Mr. Ferguson knew that Pinnacle would be unable to repay him when he funded the settlement. Accordingly, Mr. Ferguson did not intend to establish a creditor-debtor relationship with Pinnacle, and his payment of the settlement was not a loan to the S corporation.*

Rather, the Tax Court found that Mr. Ferguson had made a capital contribution to Pinnacle. The Court found both Pinnacle and RFI were responsible for the legal matter and thus decided to allocate the settlement between the two parties:

> *Because Mr. Ferguson personally funded the settlement payment, 50% of which was an expense of Pinnacle, we will deem 50% of the payment a capital contribution to Pinnacle. See Rink v. Commissioner, 51 T.C. at 751-752; Koree v. Commissioner, 40 T.C. at 966. Accordingly, Pinnacle may deduct 50% of the settlement payment for 2011, and petitioners are entitled to their pro rata share of any loss this deduction produces.*
>
> *Because the remaining 50% was an expense of RFI, we would normally hold that this portion of the payment is not a deductible expense to petitioners but rather a capital contribution to the C corporation. See Rink v. Commissioner, 51 T.C. at 751-752; Koree v. Commissioner, 40 T.C. at 966. However, respondent has conceded that petitioners can deduct amounts paid on behalf of RFI as unreimbursed employee business expenses. On the basis of this concession, petitioners may deduct the remaining 50% of the settlement payment as an unreimbursed employee business expense.*

Section: 199A
IRS Greatly Expands Frequently Asked Questions for §199A on Website - And S Corporation Owners Aren't Going to Like the Final Answer

Citation: Tax Cuts and Jobs Act, Provision 11011 Section 199A - Qualified Business Income Deduction FAQs, IRS website, 4/11/19

The IRS for the second year in a row snuck a nasty surprise into a frequently asked question section of their website just before the tax filing deadline. In 2017 the nasty surprise related to the denial of refunds to taxpayers who overpaid taxes but were eligible for the installment payment of the §965 transition tax.

This year's "April surprise" arrived in the form of a massive expansion of the IRS's set of frequently asked questions on their website related to the §199A qualified business income deduction (Tax Cuts and Jobs Act, Provision 11011 Section 199A - Qualified Business Income Deduction FAQs).[2] The April 11 update expanded the FAQ from 12 questions to 33, and saved what many will see as the bombshell for the last question.

The page as it existed prior to the April 11 revision can be accessed at the Internet Archive Wayback machine, looking at the April 7 snapshot.[3]

---

[2] https://www.irs.gov/newsroom/tax-cuts-and-jobs-act-provision-11011-section-199a-qualified-business-income-deduction-faqs, April 11, 2019 update, page visited April 20, 2019.

[3] https://web.archive.org/web/20190407035039/https://www.irs.gov/newsroom/tax-cuts-and-jobs-act-provision-11011-section-199a-qualified-business-income-deduction-faqs, April 20, 2019

Many of the answers will not be surprising at all to most practitioners. One will likely cause some who had elected to use the proposed regulations to question whether that accomplished what they though it did, but the IRS position is one that many commentators had already suggested might be the position. And one result will likely shock a much larger number of observers, as the author of the FAQ has somehow decided that the language of §199A(c)(3)(A) allows the IRS to force a double deduction for an S corporation shareholder's self-employed health insurance deduction.

The most surprising answer for many is found in question and answer 33, which provides:

> ***Q33. Health insurance premiums paid by an S-Corporation for greater than 2% shareholders reduce qualified business income (QBI) at the entity level by reducing the ordinary income used to compute allocable QBI. If I take the self-employed health insurance deduction for these premiums on my individual tax return, do I have to also include this deduction when calculating my QBI from the S-Corporation?***
>
> *A33. Generally, the self-employed health insurance deduction under section 162(l) is considered attributable to a trade or business for purposes of section 199A and will be a deduction in determining QBI. This may result in QBI being reduced at both the entity and the shareholder level. (emphasis added)*

The IRS had not provided for the treatment of self-employed health insurance in the original proposed regulations, adding the provision specifically including them as a deduction in computing qualified business income only in the final regulations.[4] The final provision provides:

> *(vi) Other deductions. Generally, deductions attributable to a trade or business are taken into account for purposes of computing QBI to the extent that the requirements of section 199A and this section are otherwise satisfied. For purposes of section 199A only, deductions such as the deductible portion of the tax on self-employment income under section 164(f), the self-employed health insurance deduction under section 162(l), and the deduction for contributions to qualified retirement plans under section 404 are considered attributable to a trade or business to the extent that the individual's gross income from the trade or business is taken into account in calculating the allowable deduction, on a proportionate basis to the gross income received from the trade or business.*

Given the impact of that provision as interpreted by the FAQ, some might argue that the IRS should have issued the above in proposed form first where it seems likely commentators would have objected to a doubling up of the deduction. But that was not the route the IRS decided to take.

Some practitioners had suggested that the use of the proposed regulations, where none of the issues of the deduction for self-employment taxes, qualified plan contributions for a self-employed person or the self-employed health insurance deduction were directly addressed, would allow for ignoring those deductions on 2018 returns in computing QBI. In question 32 the IRS took the position many had suspected they would—the final regulations represented

---

[4] Reg. §1.199A-3(b)(1)(vi)

only a clarification and not a change in treatment for those items. Even if the 2018 proposed regulations were used, QBI is still reduced for those items.

Question and Answer 32 provides:

> ***Q32. I was told that I can rely on the rules in the proposed regulations under § 1.199A-1 through 1.199A-6 to calculate qualified business income (QBI) for my 2018 tax return. Does this mean I do not have to include adjustments for items such as the deductible portion of self-employment tax, self-employed health insurance deduction, or the self-employed retirement deduction when calculating my QBI in 2018?***
>
> *A32. Section 199A(c)(1) defines qualified business income as the net amount of qualified items of income, gain, deduction, and loss with respect to any qualified trade or business of the taxpayer. Proposed regulation § 1.199A-1(b)(4) followed this definition, providing that QBI is the net amount of qualified items of income, gain, deduction, and loss with respect to any trade or business as determined under the rules of 1.199A-3(b). Section 1.199A-1(b)(5) of the final regulations retains this rule, also providing that QBI means the net amount of qualified items of income, gain, deduction, and loss with respect to any trade or business (or aggregated trade or business) as determined under the rules of 1.199A-3(b).*
>
> *Section 1.199A-3(b)(2) defines the term "qualified items of income, gain, deduction, and loss" as items of gross income, gain, deduction, and loss to the extent such items are effectively connected with the conduct of a trade or business within the United States (with certain modifications) and included or allowed in determining taxable income for the taxable year. The final regulations add additional clarity in § 1.199A-3(b)(1)(vi), which provides that generally deductions attributable to a trade or business are taken into account for purposes of computing QBI to the extent that the requirements of section 199A and § 1.199A-3 are satisfied. For purposes of section 199A only, deductions such as the deductible portion of the tax on self-employment income under section 164(f), the self-employed health insurance deduction under section 162(l), and the deduction for contributions to qualified retirement plans under section 404 are considered attributable to a trade or business to the extent that the individual's gross income from the trade or business to the extent that the individual's gross income from the trade or business is taken into account in calculating the allowable deduction, on a proportionate basis to the gross income received from the trade or business.*
>
> *The above the line adjustments for self-employment tax, self-employed health insurance deduction, and the self-employed retirement deduction are examples of deductions attributable to a trade or business for purposes of section 199A. There is no inconsistency between the proposed and final regulations on this issue. QBI must be adjusted for these items in 2018. (emphasis added)*

The passthrough entity portion of the FAQ is more taxpayer friendly and clarifies some key points.

One key question many had asked was how partnerships and S corporations should handle items that are subject to limitation or special treatment that can only be determined at the shareholder level. Q&A 28 indicates that the passthrough entity must provide detailed

information to the equity holder to allow them to make the appropriate adjustments to QBI that can only be computed at that level:

> ***Q28. If a pass-through entity has one business, is it only required to provide one dollar amount for the QBI?***
>
> *A28. The pass-through entity is required to provide the owners QBI information necessary for the owner to compute the deduction. If the entity only has ordinary income from a single trade or business, tit may be appropriate to reflect one QBI amount. Items from a pass-through entity are required to be separately stated due to the potential of unique treatment on one or more owners' returns. Items not included in current year taxable income are not included in QBI. Therefore, additional details will also need to be provided for the owners. If for example, in addition to ordinary income the owner is allocated a section 179 deduction, since the 179 deduction may be limited, the detail would be required in order for the owner properly to determine the current year QBI. (emphasis added)*
>
> *Also note that the rules to separately state items from each activity for the application of the at-risk rules and passive activity loss limitation rules still apply even when a pass-through entity chooses to aggregate a trade or business for the purposes of section 199A.*

Note that practitioners have reported that tax software generally is not making such adjustments to any amounts reported by the passthrough entity. Practitioners will need to make manual calculations for these items, including the impact of passive loss, basis and at-risk limitations on QBI for each trade or business.

The FAQ goes on to discuss additional complexities involved with flow through entities in Q&A 29:

> ***Q29.My income is under the threshold amount and I only have income from W-2 wages and a partnership interest. Does my QBI equal the amount of partnership income reported on Schedule K-1?***
>
> *A29. Maybe. As discussed in Q&A 4, QBI is the net amount of qualified items of income, gain, deduction and loss from any qualified trade or business. To determine the total amount of QBI, the taxpayer must consider deductions not reported on Schedule K-1 that are related to the trade or business. (emphasis added) This could include unreimbursed partnership expenses, business interest expense, the deductible part of self-employment tax, the self-employment health insurance deduction, and self-employed SEP, SIMPLE, and qualified plan deductions in addition to other adjustments. Amounts received as guaranteed payments and payments received by a partner for services under section 707(a) are not QBI and are not eligible for the deduction.*

In Q&A 23 the IRS discusses how to apply the loss limitation and carryover rules to §199A issues:

> ***Q23. Can you explain in more detail how losses that are limited by basis, at-risk, or passive activity rules affect the deduction?***
>
> *A23. Items not included in taxable income are not qualified items of income, gain, deduction, or loss and are not current year QBI. If a taxpayer has a suspended loss that is allowed against current year taxable income, whether the loss reduces QBI depends on whether the loss was limited before or after January 1, 2018.*

If the loss was disallowed before 2018, the loss is never taken into account for purposes of computing QBI. This means the taxpayer must keep track of pre-2018 disallowed losses, so that they can be excluded them from QBI in the year the loss is allowed.

If the loss was generated after 2018, it is included in QBI if it is a qualified item deduction or otherwise loss that would otherwise be included in QBI, but not until the year it is included/allowed in taxable income.

Disallowed, limited, or suspended losses must be used in order from the oldest to the most recent on a first-in, first-out (FIFO) basis.

The FAQ also clarifies that the passive loss limitation issue also "spills over" into publicly traded partnership QBI calculations:

Q31. In 2018, I receive a Schedule K-1 allocating a PTP loss. The loss is not currently allowable due to the passive activity rules. Is it used in computing the REIT/PTP component?

A31. No. Since the loss is not included in taxable income for 2018, it is not used in computing the QBI deduction in 2018. In a later taxable year, when the loss is allowable, the loss generated in 2018 will be used in computing the REIT/PTP component.

Some questions had been asked regarding whether real estate professionals get a "pass" on having to analyze their rentals for qualification as a trade or business for §199A purposes. Q&A 17 gives a clear "no" answer to that question.

Q17. If someone is a real estate professional, will their rental real estate qualify for the deduction?

A17. The deduction is not based on whether the taxpayer qualifies as a real estate professional under section 469. Rental real estate may constitute a trade or business for purposes of the QBI deduction if the rental real estate:

- *Rises to the level of a trade or business under section 162,*
- *Satisfies the requirements for the safe harbor provided by Notice 2019-07, or*
- *Meets the self-rental exception (i.e., the rental or licensing of property to a commonly controlled trade or business conducted by an individual or RPE).*

Whether rental real estate rises to the level of a trade or business under section 162 depends on all the facts and circumstances. To be engaged in a trade or business under section 162, the taxpayer must be actively involved in the activity with continuity and regularity and the primary purpose for engaging in the activity must be for income or profit.

Throughout the past filing season, a number of practitioners asking questions in online discussion groups have seemed to want to apply "material participation" requirements to obtain

the §199A deduction. Q&A20 clearly states that the concept of material participation is not applicable to qualification for the §199A deduction.

> ***Q20. Do I have to materially participate in a business to qualify for the deduction?***
>
> *A20. No. Material participation under section 469 is not required for the QBI deduction. Eligible taxpayers with income from a trade or business may be entitled to the QBI deduction (if they otherwise satisfy the requirements of section 199A) regardless of their involvement in the trade or business.*

Advisers should remember that IRS website FAQs are not authority, nor are they subjected to the level of review that would face a more formal IRS document. But it is reasonable to expect that, unless the provisions are revised by the IRS, that agents are likely to turn to these FAQs for use in interpreting the regulations and law.

Advisers who face an agent attempting to use the FAQ to support a position on exam may want to direct the agent to SBSE Memo SBSE-04-0517-0030 where agents are specifically cautioned regarding the limitations of FAQs. See our article on this issue, IRS Warns Agents Against Using IRS Website FAQs to Sustain Positions in Exam, that was posted in May of 2017.

Section: 401
IRS Releases Revisions to EPCRS Program, Expanding Issues That Can Be Corrected Via SCP

Citation: Revenue Procedure 2019-19, 4/19/19

The IRS has released revisions to the Employee Plans Compliance Resolution System (EPCRS) in Revenue Procedure 2019-19. The revisions are effective as of April 19, 2019.

EPCRS constitutes three separate programs that are used to correct problems in the operations or documents of qualified retirement plans and certain other retirement arrangements (such as SEPs). The program generally treats sponsors more favorably who come forward voluntarily to correct their problems, and the system is meant to encourage sponsors to voluntarily fix the plan as opposed to "hoping" the issue will never be noticed.

The components of EPCRS are:

- Self-Correction Program (SCP) – for items eligible for correction under this program, the plan sponsor takes the specified corrective action without payment of any fee and without a sanction.
- Voluntary Correction Program (VCP) – For corrections eligible for this program, the sponsor pays a "limited fee" and receives the IRS's approval for correction of certain failures.
- Correction on Audit (Audit CAP) – Failures identified on audit may be eligible for correction via Audit CAP. Under Audit CAP the sponsor corrects the failure and pays a sanction.

The new IRS procedure modifies and supersedes Revenue Procedure 2018-52. The IRS summarizes the purpose of this update as follows:

> *This update to Rev. Proc. 2018-52 is a limited update and is published primarily to expand SCP eligibility to permit correction of certain Plan Document Failures and certain plan loan failures, and*

> *also to provide an additional method of correcting Operational Failures by plan amendment under SCP.*

Note that most (but not all) programs covered by EPCRS are also subject to the jurisdiction of the Department of Labor who may also impose penalties and sanctions. The DOL's program for corrections is the Voluntary Fiduciary Correction Program (VFC Program). Correction under EPCRS does not necessarily mean the correction will also satisfy the DOL unless DOL has specifically indicated that it will accept the correction. Plan sponsors may need to also take actions under the VFC program to fully eliminate the potential sanctions that could be imposed.

For instance, the new Revenue Procedure notes that the IRS will now allow sponsors to correct some plan loan failures under SCP, as well as correction methods previously available under VCP and Audit CAP. However, Section 2.02(4) of Revenue Procedure 2019-19 notes that the Department of Labor will only grant a no-action letter for such issues under that agency's VFC Program if the taxpayer submits a VCP letter. The Revenue Procedure goes on to note "[t]he Department of Labor has advised the IRS that it will not issue a no-action letter … unless such failures are corrected under VCP."

Section: 6041
Emailed Memo Holds That Using a CPEO Does Not Allow a Partner to Be Treated as the Employee of a Partnership

Citation: ECC 201916004, 4/19/19

The IRS issued emailed advice discussing Certified Professional Employer Organizations (CPEO) and self-employed individuals that has general information on the issue of a partner or proprietor being as an employee when such an organization is used. ECC 201916004 restates the IRS's view that such individuals generally cannot be treated as an employee of the unincorporated entity they hold an ownership interest in.

First, the ruling clarifies that IRC §3511, which generally provides protection for the taxes that end up not being deposited by a CPEO, does not apply to self-employed individuals:

> *The reporting of amounts paid to self-employed individuals is provided for in section 6041. CPEOs must report remuneration they pay to self-employed individuals (within the meaning of section 6041 and the regulations thereunder) in accordance with the rules under these and other applicable provisions. Section 3511(f) of the Code provides that a self-employed individual is not a work site employee with respect to remuneration paid by a CPEO to the self-employed individual. Section 3511(c) provides that a CPEO is not treated as an employer of a self-employed individual. Consistent with these two provisions, section 31.3511-1(f)(2) of the proposed regulations provides that section 3511 does not apply to any self-employed individual.*

More to the point, the email provides that any such payments made by the CPEO is not to be reported on a Form W-2, but rather on a Form 1099R:

> *Section 301.7705-1(b)(14) of the proposed regulations defines a "self-employed individual" as an individual with net earnings from self-employment (as defined in section 1402(a) and without regard to the exceptions thereunder) derived from providing services covered by a CPEO contract, whether such net earnings are derived from providing services as a non-employee to a customer of a CPEO, from the individual's own trade or business as a sole proprietor customer of the CPEO, or as a partner in a partnership that is a customer of the CPEO, but only with regard to such net earnings. Accordingly,*

> *any remuneration from the CPEO to such self-employed individuals, in their capacity as a non-employee providing services to a customer of the CPEO, a sole proprietor customer of the CPEO, or a partner in partnership that is a customer of the CPEO, is not wages and must not be treated as such for reporting purposes. Under the section 6041 regulations, payments to self-employed individuals are reported on information returns such as Form 1099-MISC, Miscellaneous Income, and not on Form W-2.*

The issue that gave rise to the email was a discussion in the preamble to the proposed regulations governing CPEOs. The email outlines this issue as follows:

> *The preamble discussion of the definition of "work site employee" under section 301.7705-1(b)(17) of the proposed regulations provides that "a self-employed individual, whether an independent contractor to the customer, a sole proprietor customer of the CPEO, or a partner in a partnership customer of the CPEO, is not considered to be a work site employee under section 3511(f) with regard to such earnings," but also provides that "in the limited case in which such an individual also is paid wages by a CPEO under a CPEO contract with the customer, the individual may nevertheless be a work site employee with respect to such wages."*

The email explains that this will not be a normal situation:

> *This latter language addresses the very uncommon situation in which one individual is receiving payments from the CPEO in two separate capacities. For instance, a common law employee of a marketing firm receives wages from a CPEO for services the employee performed for the marketing firm under a contract between the firm and a CPEO. This employee also owns a part-time cleaning business as a sole proprietor and this cleaning business is contracted by the marketing firm to clean its offices. Payments to the cleaning business for its cleaning services are also managed by the CPEO under its contract with the marketing firm. Payments made to the individual by the CPEO for the services the individual's sole proprietor cleaning business performs for the marketing firm are not wages and must be reported as payments to a self-employed individual under section 6041. However, the CPEO is treated as the employer of the individual for employment tax purposes with respect to the payments the CPEO makes to the individual for the services the individual performs as a common law employee of the marketing firm, these payments are reported as wages by the CPEO.*

The email concludes that this exception will never apply to the sole proprietor or a partner of the business:

> *In contrast to the situation described above, under the proposed regulations any payment made by a CPEO to a partner in a partnership under a contract between the partnership and the CPEO must always be treated as a payment to a self-employed individual and reported as such under section 6041. Under Revenue Ruling 69-184, "[b]ona fide members of a partnership are not employees of the partnership" for employment tax purposes. "Such a partner who devotes his time and energies in the conduct of the trade or business of the partnership, or in providing services to the partnership as an independent contractor, is, in either event, a self-employed individual rather than an individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee." Thus, "[r]emuneration received by a partner from the partnership is not 'wages' with respect to 'employment.'" So whether an individual partner in a partnership is receiving payments from the CPEO for services performed in the conduct of the trade or business of the partnership, or receiving payments from the CPEO for services performed as an independent contractor of the partnership, the payments are payments to a self-employed individual and should be treated as such for reporting purposes as provided by section 6041.*