# PILLA TALKS TAXES

**DAN PILLA'S MONTHLY TAX AND FINANCIAL BULLETIN**

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## LOOKING FORWARD TO MY NEW BOOK

### *Dan Pilla's Small Business Tax Guide*

### The Complete Guide to Organizing and Operating Your Small Business

Featuring How-to Information You Can't Get Anywhere Else

Over the past two months, I made substantial progress on completing my ***Small Business Tax Guide.*** The manuscript will be going to the typesetter for design and layout very soon.

The book is pointed directly at small businesses. I address the important questions that new and existing small business owners need to know to stay in compliance with the morass of tax laws and the endless list of reporting burdens they face. I guarantee you that the information you learn in this book is not taught in even the best business schools in the country. This material is indispensible for any small business and for tax pros working with small businesses.

In the ***Small Business Tax Guide***, I cover important topics, including:

- Identifying the 15 most common mistakes small business make, and how to avoid them –
- Whether an LLC, Subchapter S corporation or partnership is best for you –
- Everything you need to know about hiring employees and using independent contractors –
- How to properly set up and use an office in your home –
- How to avoid the IRS's costly "hobby loss" rules –
- How to avoid tax penalties that can kill your business –
- How to properly deduct business travel and mileage expenses –
- Understanding the complex new rules for business meals and entertainment expenses –
- My fool-proof recordkeeping system to keep you out of trouble with the IRS –
- Plus much, much more!

## In this issue



**"Dan Pilla probably knows more about the IRS than the commissioner of the IRS." Associated Press.**

Chapter 8 explains how the Trust Fund Recovery Penalty works and I offer seven ways to avoid a Trust Fund Recovery Penalty assessment. This information is very important because small corporations are among the fastest growing business entities in the country, yet virtually none of their owners know anything about the Trust Fund Recovery Penalty.

What follows here is an excerpt from Chapter 8.

**How to Avoid an Assessment of the TFRP**

Now that you know your corporate or LLC status cannot protect you from unpaid trust taxes, let's discuss how such an assessment might be avoided. Here are some ideas, some of which are easier said than done.

1. *Avoid the net payroll debacle at all costs*. You are simply asking for trouble if you start down the path of net payroll. This is especially true if you have substantial employees because employment tax liabilities grow very quickly. This is why you have to keep your eye on the ball when it comes to your actual cash flow and cash flow projections. You also have stay on top of your receivables so you do not become an unwilling lender to your customers at the cost of the ability to pay your own taxes. Re-read chapter 2 and see how many of the common business problems lead to employment tax assessments because of the lack of attention paid to one's own financial condition.

If you see a downturn in profits or cash flow on the horizon, you have to make hard choices very quickly. Such choices include: a) borrowing money to get you through the downturn, b) raising prices on existing activities to raise cash, c) cutting staff or staff hours to reduce payroll, or d) selling business or personal assets to infuse cash. Maybe you have to consider a combination of all of the above, and perhaps other steps not on this list. Regardless, you have to avoid the net payroll catastrophe.

2. *Keep your eye on the ball*. Speaking of keeping your eye on the ball, as the owner of your company, you are supposed to know what is going on with your finances. I had a client years ago who owned three electronic stores in Maryland. He sold a wide variety of products and was reasonably successful. One day, seemingly out of the blue, an RO showed up at the door and wanted to know what my client was going to do about the corporation's outstanding employment tax debt, which was said to be north of $100,000.

Stunned, my client said, "What debt? What are you talking about?" The RO served a Final Notice of Intent to Levy on my client which claimed outstanding debt for the past four quarters.

This put my client in scramble mode. The first thing he did was talk with his trusted bookkeeper to whom he delegated not just common bookkeeping functions, but the handling of all bank deposits, check writing duties, account reconciliation, and employment tax return preparation, filing and payments. As it turned out, this trusted employee was embezzling tens of thousands of dollars, money that should have been paid to the IRS.

"How did you not see it?" I asked. The answer was that my client never looked at anything other than the monthly reports presented to him by the bookkeeper. Unfortunately, she was dummying up the reports to show that various bills were paid.

"Okay," I said. "But bank statements don't lie. Didn't you see that there were no regular electronic withdrawals from the bank going to the IRS?" His response to me was, "I never looked at the bank statements."

As the owner of your business, you have an affirmative duty to know what is going on in your own company. My client should have looked at the bank statements. He should have reviewed the tax returns and employment tax deposit confirmations. He should have double-checked to see that essential operating expenses of the company were being paid. If he did those things, even just sporadically, he would have known: a) the taxes were not getting paid, b) other essential bills were not getting paid, and c) his trusted booker was making one heck of a lot more money than he agreed to pay her.

"I trusted her," he said.

Believe me, I understand that. We all have people we trust. But trusting somebody is not a good reason to completely turn your back on them. As the late President Ronald Reagan liked to say, "Trust but verify."

Never allow somebody in a position of control over the finances of your company to have *carte blanch* over primary source financial documents. Monthly reports are fine, but you must also periodically review bank statements, deposit information, and other primary source material to be sure that the reports are reporting the truth and not some fantasy cooked up by a clever bookkeeper or (unfortunately) even a business partner.

3. *Stop the bleeding*. If you are already on the net payroll path, you need to stop the bleeding, and stop it now. Do not wait for this "big sale," or the "angel investor" to show up with a bag of cash. Usually, such things do not materialize, or at least they do not materialize in

time to save the company from a huge debt, along with the TFRP that follows.

To the extent that you already amassed an employment tax debt, the IRS will not even consider installment agreement terms or other settlement possibilities unless you get and remain current with your employment tax return filings and payments going forward. All available resources must be used to pay the taxes for the current quarter to avoid making the problem worse. When delinquencies continue period after period, the IRS refers to that as "cascading liabilities." In that case, the RO believes that putting you out of business actually does you a favor since it stops the cascading.

There are only three ways I know of to stop the bleeding. While the answer is simple, implementing it is not. Very simply, you must reduce the number of employees to a level that allows you to timely pay all employment taxes. If you cannot afford to pay any employment taxes in a timely manner, then all employees must go and they must go now. Naturally, the problem of making timely payments disappears if the employees disappear. If you cannot operate without help, find a way to do it without employees. That might mean working longer hours yourself or using legitimate independent contractors to help. So be it. You have no choice.

I once worked with a man who operated a small business with about a dozen employees. He was tens of thousands of dollars behind on employment taxes and the IRS was threatening to liquidate his business equipment. My first suggestion was he cut the employees to a level that would allow him to pay current taxes on time. He said, "I can't do that. I need these people to operate my business."

I said, "Bob, if you don't immediately stop the net payroll game, you will not have any business to operate. They will shut you down." I explained that he would have to find a way to turn out the work with fewer employees or none at all.

Next, Bob protested that if he did not have employees, he could not operate profitably. Knowing the answer, I asked, "Are you earning a profit now?" Obviously, he said "no." After all, if he were he would not have employment tax problems. I then asked, "If you aren't making a profit *with* the employees, how can matters get any worse *without* them?" Bob had no answer.

Finally, I said, "Look Bob, you are the captain of a sinking ship. You must either plug the hole or get the heck out because as it stands now, the ship is going down. You don't have any other choices. The longer you continue with this pattern, the worse it gets—you take on more water."

I know this is very difficult but the business owner must recognize the point of no return. In all of my experience with employment tax disputes, I very seldom see companies work themselves out of the problem. It can be done, but it takes firm managerial resolve and the ability to make hard choices fast and stick with them. And it takes strong and consistent cash flow.

So the first of the three hard choices is to cut employees—*now*. If the number of employees remains constant, your problem only grows. The second challenge is to generate more cash flow—*now*. Without cash flow, you cannot pay the trust liabilities when due. And the third challenge is to make your company more profitable—*now*. Without profit, the non-trust taxes cannot be paid.

If you cannot do those three things in the ratios needed to stop the bleeding, then you must move to the fourth step. That is to shut down the business—*now*. You have no choice. Do not allow your emotions and wishful thinking to stand in the way of the cold reality that the IRS *will* shut down the business for you—without hesitation or remorse—and in a fashion that serves the government's best interests, not yours.

Only after you prove that your company can remain current on its employment taxes going forward does an RO entertain the idea of an installment agreement. I discuss the installment agreement process in detail in ***How to Get Tax Amnesty***.

4. *Designate partial payments.* It is critical to understand that when collecting delinquent taxes, ROs never disclose a significant reality. The reality is that when receiving partial payments, they apply those payments in the best interests of the government, not the company. More specifically, ROs always apply partial payments first to non-trust taxes. Only after the company pays the non-trust taxes in full for all delinquent quarters does the IRS apply further payments to the trust taxes. Why do you suppose that is? I promise—they will *never* tell you what you are about to read.

First, as explained above, the non-trust taxes of a corporation cannot be assessed against an individual. Only trust taxes are subject to the TFRP. Therefore, as long as the IRS milks funds from an active corporation, it applies them to the tax that cannot be passed on to an individual. The agency theorizes that if the corporation goes south, the IRS will never be able to collect the non-trust taxes. However, the trust taxes may potentially be

collected from the personal income and assets of the responsible officers. Consequently, ROs make every effort to apply as much money as possible to the non-trust taxes before enforcement actions or other factors potentially crush the corporation. That's why you have to designate all partial payments to the trust taxes.

Whenever you make voluntary payments to the IRS, you have the absolute right to "designate" that payment to apply in the manner which best suits you, not the IRS. This is expressed in the case of *O'Dell v. United States*, 326 F.2d 451 (10th Cir. 1964). It is enforced by the courts, and the IRS knows it. See also: *Amos v. Commissioner*, 47 T.C. 65 (1966). In fact, in the case of *Dixon v. Commissioner*, 141 T.C. 173 (2013), the IRS expressly acknowledged in court that it has a policy of "honoring an employer's designation of voluntary payments" between trust and non-trust taxes. It must follow that policy. See: Revenue Procedure 84-58 (1984); Revenue Ruling 73-305; and Revenue Ruling 79-284, the latter of which provides that the right of designation applies to "withheld employment taxes and collected excise taxes where the taxpayer provides specific written instructions" regarding the application of the payment.

The key to enjoying this right is to make a "voluntary payment." A payment is voluntary when not procured by a levy, a refund offset, or a court proceeding in which the government seeks collection. Under this definition, payments made by the taxpayer to an RO or through the IRS's online payment system are considered voluntary payments. When properly designated, they must be applied per the election of the taxpayer.

To constitute a proper designation, the designation must:

a. Be made by the taxpayer; in the case of a corporation, the corporate president or other responsible officer must make it,

b. Be made at or before the time of submitting the payment,

c. Be specific; funds designated only to a specific quarter but not directed to trust taxes for that quarter may be applied to non-trust taxes for that quarter, and

d. Be in writing. I recommend making the designation on both the payment device itself and with an accompanying cover letter. The statement should read, "Apply to trust fund taxes for _____ quarter (i.e., 2nd quarter, 2017). Apply any excess to trust fund taxes for _____ quarter." Include the company EIN on both the payment device and the cover letter. Keep copies of both the letter and the payment device for your records. Mail the payment using certified mail with return receipt requested.

Be as aggressive as you possibly can with payments to the trust taxes. The faster you work to pay it, the more likely the IRS will not assess a TFRP. Moreover, if you pay your total employment tax liability down to under $25,000, the IRS will considered entering into an installment agreement with the company without assessing the TFRP at all. In the worst case scenario, if all available resources are used pay off the trust funds, and yet the corporation fails, the IRS cannot collect remaining non-trust taxes at all. (Note that this is not true for sole-proprietorships, partnerships and LLCs taxed as sole-proprietorships.)

To follow the progression of your payments, obtain statements from the RO reflecting the outstanding trust and non-trust assessments as payments continue. Monitor the balances to ensure the payments are applied in the manner you designate.

Be aware of the fact that if you intend to work the corporation out of the tax problem, you must eventually pay the non-trust taxes. The IRS does not look favorably upon an operating corporation with outstanding employment tax debts, even if they do represent non-trust amounts.

5. *Correct misapplied payments*. While it is absolutely true that you have the right to designate voluntary payments, it is also true that the IRS often ignores such designations and applies the payments as it sees fit regardless. In the case of *In Re Frank*, 322 B.R. 745 (Bankr. M.D.N.C. 2005), the court considered the question of a corporate officer's trust fund liability after a corporation failed. The IRS assessed about $120,000 against the corporate officer.

During the proceedings, the officer provided proof to show that various payments were in fact designated to trust taxes and the revenue officer to whom the payments were sent failed to apply them properly. The taxpayer argued that he could not be "willful" as that term is used in the context of the TFRP because, based on his best efforts and to his knowledge, the trust taxes were being paid. The IRS argued that the taxpayer should have followed up to determine whether the RO was doing his job properly. And because the taxpayer did not, they argued that he was indeed "willful."

The court ruled that while it might have been prudent for the taxpayer to follow up (that is, babysit the RO), his failure to do so was not willful. The court stated:

The court, however, also finds that the [taxpayer] operated on a subjective good faith belief that [the corpora-

tion] could and had effectively designated $76,043.73 in checks, and $40,064.95 in electronic transfers in May and June of 2000 as voluntary partial payments on its trust fund tax obligations. Because the court is convinced that the [taxpayer] had a good faith belief that [the corporation] was paying on its trust fund taxes in that amount, the court finds that there was no "willful" failure by the [taxpayer] to make payments to the extent of $116,108.68 of the unpaid trust fund taxes Ibid, 322 B.R. at 760-61.

See also: *Watson v. United States*, 86-1 USTC Para. 9122 (E.D. Ky. 1986). There the court held that "willfulness" is generally not found where a responsible person causes a corporation to pay a sufficient sum to the IRS to cover trust fund tax obligations notwithstanding the fact that the IRS applied a portion of that payment to other tax deficiencies.

A word of warning is critical. You need to know that when making electronic payments to the IRS online, there is no way to designate payments made on a particular quarter to trust taxes only for that quarter. You can designate to a particular quarter, but not to either trust or non-trust taxes within that quarter. Therefore, do not make payments to a delinquent quarter online unless you intend to full pay the entire liability for that quarter. To pay trust fund taxes only, you simply must send a check with a written designation both on the check itself and in an accompanying cover letter.

*6. No funds to pay the tax*. Keep in mind that to sustain a TFRP assessment, the responsible officer must have acted "willfully." In this context, that means favoring other creditors at a time when the trust taxes were owed. But what if the corporation had *no funds* available at the time the employment taxes were due? A broke company does not favor other creditors necessarily. It simply has no ability to pay anybody. This has been held to vitiate willfulness. See: *Campbell v. Nixon*, 207 F. Supp. 826 (E.D. Mich. 1962). However, you cannot prevail on this position if the corporation continues to operate and revenue collected after the tax became delinquent was used to pay employees or other creditors.

In addition, failure to pay was held not to be willful when, through no fault of its own, the debts due a corporation by its customer went unpaid, leaving the corporation unable to meet its obligations. Under the circumstances, the court determined that since the corporation exercised ordinary and necessary business care and prudence and was nevertheless unable to meet its obligations, willfulness did not exist. *Glenwal Schmidt Joint Venture v. United States*, 78-2 USTC Para. 6910 (D.D.C. 1978).

7. *Make your position known*. If you are just one of two or more shareholders in a struggling corporation, you have to start thinking about your potential TFRP liability the minute the corporate shows signs of financial stress. If you participate in management meetings in which decisions are jointly made to pay other creditors or employees when the tax is owed, you will likely be held liable for the TFRP. Knowing that, you have to be clear with your fellow shareholders that you do not approve of or condone any decision to pay anybody other than the IRS until the company stops the bleeding and gets into a reasonable installment agreement. Your position should be put in writing so that later, there is no confusion as to where you stood. If there are debates and votes on these issues, you must be able to prove that you were outvoted or otherwise overruled. In the worst case scenario, you must consider resigning your position and leaving the company. This can help you avoid being assessed with the TFRP. You cannot be liable for a TFRP for taxes that arise after you left the company. See: *George v. United States*, 819 F.2d 1008 (11th Cir. 1987).

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# DEMOCRAT CANDIDATES TARGET TRUMP'S TAX LAW
## Result? Middle Class Tax Hikes!

Two things became abundantly clear from the recent debates by the Democratic presidential candidates when it comes to tax policy. First, they want to trash President Trump's 2017 Tax Cuts and Jobs Act, which is responsible for tax cuts for all but the top 20% of income earners. That is, only the richest 20% saw either no cut tax or a tax increase under the Jobs Act. Second, Democrats would institute new taxes to pay for a wide range of social programs, allegedly to benefit the middle class. Make no mistake about it. Those tax hikes would include hikes on the middle class, as evidenced by the candidates' own statements, discussed below.

So get your arms around this picture. Democrats

intend to take more of your money to provide you with benefits you can no longer afford to buy because the government is taking more of your money. The irony is that some Democrats no longer even try to mask the idea of a middle class tax hike behind some Alice in Wonderland economic theory.

During the debate in Miami at the end of June, Senator Bernie Sanders bluntly admitted that middle class Americans will see their tax bills go up if he is president. But he promised an increase in the level of "government services" they would receive. For example, he is promising—among other things—programs of universal health care and free college for all. Sanders said, "Yes, they will pay more in taxes, but less in health care for what they get."

Thanks to the level of government intervention in health care under Obamacare, the cost of health insurance went up by as much as 300 to 400%. If the government usurps a monopoly over health care payments, imagine what the cost will be. Then imagine what your tax hike might be in order to pay for it.

Both Sanders and Senator Elizabeth Warren intend to propose new taxes on all securities trades and on high income individuals to fund more government benefits. According to Sanders and his twisted view of economics, even with higher taxes, including higher taxes on the middle class, "people would still come out ahead."

But people never come out ahead when taxes go up. The reason is that for every dollar you pay in taxes, that's one less dollar you have available to save for your own retirement, pay for your own health care, provide for your family's daily living expenses, including food and clothing, or build your own business. Said another way, taxes make you poorer. Make no mistake about it.

And even if higher taxes didn't make you poorer by reducing your capacity to spend, save or invest your own money, the government programs that higher taxes fund reduce your liberty. If the government controls health care, you have fewer (if any) choices in how your health care is delivered, or what that care might consist of. Likewise, if government controls the payment of higher education expenses, what level of control do you believe the government will assert over the curriculum of higher education institutions?

The answer is simple, and it is based on a basic legal doctrine that was asserted by the Supreme Court in the 1950s, and which is binding law. The doctrine is, "What the federal government subsides, it shall control." That is the Court's way of saying, "He who pays the fiddler calls the tunes."

Are you prepared to surrender your liberty to the federal government in exchange for so-called "benefits?" Even if you are prepared to surrender your liberty, you have no right to surrender mine, or that of any other citizen who wishes to preserve the blessings of liberty which our republican constitutional model of government guarantees.

And while all the Democrat candidates are pushing to repeal the tax cuts brought about by the Jobs Act, they would still fall far short of the revenue needed to fund their expensive socialist proposals. Providing universal health care and free college tuition for everybody will cost tens of trillions of dollars. Even if a Democrat president were successful in repealing every element of the Jobs Act, it would mean just $1.5 trillion in new taxes (mostly on the middle class). Where will the difference come from?

It's quite easy to talk about providing "free" benefits to the public. It's quite another to explain how such benefits will be paid for. Most candidates cannot be specific about how they would be raise the trillions needed to pay for universal health care, more child care benefits, paying down existing student loan debt and providing free college to all.

Senator Kamala Harris and Former Vice President Joe Biden Biden, while touting more programs, fall way short of explaining any specifics of their tax plans. Former Texas Congressman Beto O'Rourke also is vague about how he would pay for his plans, including his $5 trillion proposal to achieve net-zero carbon emissions in the U.S. by 2050. All O'Rourke can say, and indeed all most Democrats ever say, is he intends to make corporations and high income citizens "pay their fair share." As a student of tax policy and administration for over forty years, I can tell you unequivocally that that phrase has absolutely no meaning to anyone other than completely ignorant voters and Leftist media members.

Biden insists that the Jobs Act must be repealed. But then in the same breath, says he wants to give an "economic boost to the middle class." First, the Jobs Act was an economic boost to the middle class. It cut taxes for all but the bottom 80% of income earners and is responsible for creating the best job market we've had in the country since the 1960s. Beyond that, Biden provides no specifics on how he would do what he claims he wants to do.

That is simply because he would not do it. If he were president and were successful in repealing critical elements of the Jobs Act, the taxes of most middle income Americans will go up. The same can be said for any of the Democrats in the race.

# STATE WORKER RECLASSIFICATIONS CAN BE APPLIED RETROACTIVELY

## Ninth Circuit Opens the Doors for Massive Liabilities

By Scott B. MacPherson

My best advice is simple. **Stop voting for Democrats!** On May 2, 2019, the Ninth Circuit issued a profound decision that will affect state employment tax audits going forward. Indeed, some say that this decision will open the floodgates to nationwide liability for multiple years of back wages and overtime pay for workers. The case is question is *Vazquez v. Jan-Pro Franchising International, Inc.*, 923 F.3d 575 (9th Cir. 2019). There the court said that the earlier decision of *Dynamex Ops. W. Inc. v. Superior Court*, 416 P.3d 1 (Cal. 2018) can be retroactively applied. The court remanded for *Dynamex* expressly to be retroactively applied in this instance.

Does this case "sound the death knell for franchising in California" and elsewhere in the country as some suggest? After all, it means that workers who were previously classified as independent contractors can sue for a reclassification of their past work and thus get back pay.

Regardless of whether that prediction proves true or not, TFI members should take note because the obvious implication of this holding is that the California FTB can retroactively audit employers (that is, our potential clients) for past years as well.

The case arose when a group of janitors (plaintiffs) working for a franchise cleaning business sued the master franchisors (defendants). Defendants classified the plaintiffs as independent contractors to avoid paying them the hourly minimum wage and overtime pay required by statute for "employees." Plaintiffs sued to be classified as employees so as to get that extra pay. Thus, the legal issue was whether to classify these workers as employees or to maintain their independent contractor status.

The district court in California held for defendants. The Ninth Circuit overturned that decision as a matter of law, but the factual record was insufficient for a decision as to the workers' status, so the circuit court remanded for a finding as to whether plaintiffs were employees or independent contractors.

Of note—and to repeat the cause for concern by the *amicus* parties—the Ninth Circuit's narrow legal holding was that *Dynamex* applies retroactively.

Before *Dynamex*, California case law supplied three alternative definitions of "employee" status in the context of employee/independent contractor classifications. One of them was that a putative employer "suffers or permits" a putative employee to work. This term was understood to mean that a putative employer had "knowledge of and failed to prevent the work from occurring." *Vazquez* at 593.

But in *Dynamex*, the California Supreme Court clarified that

a "hiring entity" (the putative employer) "suffers or permits" a putative employee to work if it cannot overcome the "ABC test." 232 Cal.Rptr.3d 1, 416 P.3d at 35. In particular, *Dynamex* embraced the Massachusetts version of the test. [citations omitted] As in Massachusetts, the test requires the hiring entity to establish three elements to disprove employment status: (A) that the worker is free from the control and direction of the hiring entity in connection with the performance of the work, both under the contract for the performance of the work and in fact; (B) that the worker performs work that is outside the usual course of the hiring entity's business; and (C) that the worker is customarily engaged in an independently established trade, occupation, or business of the same nature as the work performed. *Dynamex*, 232 Cal.Rptr.3d 1, 416 P.3d at 35. And, as in Massachusetts, all three elements must be established to disprove employment status. *Id. Vazquez* at 593.

Notice that under the "ABC test," all workers are presumed to be employees. The employer/company has to prove that they are not. And as the Ninth Circuit phrased it, "[B]y judicial fiat, California incorporated Massachusetts's employment classification statute into its labor laws." *Id.*

On its face the ABC test is broad, and expressly, the California Supreme Court meant for it to be "exceptionally broad" because "wage orders are the type of remedial legislation that must be liberally construed in a manner that serves their remedial purposes." *Id.* (Internal citation omitted.) Thus, it is understandable why the *amicus* parties predicted, in their *amicus* briefs, that the liability floodgates will now be opened.

In support of its holding of retroactive application, the Ninth Circuit explained that statutes are prospective (they

apply only to future behavior) but court holdings are both retroactive and prospective:

As the Supreme Court of California has explained, it "is basic in our legal tradition" that "judicial decisions are given retroactive effect." *Newman v. Emerson Radio Corp.*, 48 Cal.3d 973, 258 Cal.Rptr. 592, 772 P.2d 1059, 1062 (1989). This is true even for decisions that overrule precedent. *See Sierra Club v. San Joaquin Local Agency Formation Comm'n*, 21 Cal.4th 489, 87 Cal.Rptr.2d 702, 981 P.2d 543, 556 (1999). As in the federal system, appellate courts in California apply intervening state supreme court rules retroactively when reviewing cases, even if the judgment in the trial court was entered prior to the ruling from the California Supreme Court. *See*, e.g., *Penn v. Prestige Stations, Inc.*, 83 Cal. App. 4th 336, 339, 99 Cal.Rptr.2d 602 (2000). The California Supreme Court has repeatedly quoted then-Justice Rehnquist in explaining that "[t]he principle that statutes operate only prospectively, while judicial decisions operate retrospectively, is familiar to every law student." *Evangelatos v. Superior Court*, 44 Cal.3d 1188, 246 Cal.Rptr. 629, 753 P.2d 585, 596 (1988) (emphasis omitted) (quoting *United States v. Sec. Indus. Bank*, 459 U.S. 70, 79, 103 S.Ct. 407, 74 L.Ed.2d 235 (1982)). *Vazquez* at 586. (Emphasis added to note that this is a rule of federal law also.)

The court recognized an exception "when a judicial decision changes a settled rule on which the parties below have relied." *Id.* (Internal quotation omitted.) But after much discussion, the Ninth Circuit concluded that *Dynamex* was a clarification rather than a departure from established law, and it found nothing to indicate that California courts are likely to hold that it applies only prospectively. *Vazquez* at 588. The court then dismissed any constitutional "due process" concerns to retroactive application. *Id.* at 588-89.

That decided, the Ninth Circuit realized that,

The district court had no opportunity to consider whether Plaintiffs are employees of Jan-Pro under the *Dynamex* standard, and neither party had the opportunity to supplement the record with regard to the *Dynamex* criteria. Given the fact-intensive nature of the *Dynamex* inquiry, we leave it to the district court to consider the question in the first instance with the benefit of a more developed record. *Vazquez* at 593-94.

The Ninth Circuit added that the district court "should consider all three prongs of the ABC test and, in doing so, may wish to consider authorities from other jurisdictions that apply the test." *Id.* at 594.

In short, California businesses (that is, potential clients of TFI members) must conform to the ABC test not only going forward. Even if they did not conform in the past, they are at risk now of a retroactive imposition of the test.

You can read a detailed discussion of employee versus independent contractor classification in Dan's new book ***Dan Pilla's Small Business Tax Guide***. There are three chapters in the book that deal with employment tax issues.

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# VIRTUAL CURRENCY OWNERS CAN'T HIDE
## IRS Already Has Thousands of Names

For years I've been arguing with the owners of crypto-currency, such as Bitcoin, also known as virtual currency, over: 1) whether gains derived from trading in such a currency are taxable, and 2) whether, in any event, the IRS can find out whether one traded in virtual currency.

As to question 2, the IRS did find out because the agency served summons on various virtual currency clearing houses as part of their ongoing compliance initiative. As a result, starting the last week if July, the IRS will be sending letters to virtual currency owners who potentially failed to report income and pay the tax from virtual currency transactions or did not report their transactions properly.

According to the IRS, "By the end of August, more than 10,000 taxpayers will receive these letters." See: IRS News Release IR-2019-132 (July 26, 2019). IRS Commissioner Chuck Rettig warns that "Taxpayers should take these letters very seriously." A copy of IRS Letter 6173 is attached following this article.

As to question 1, as far as the IRS is concerned, virtual currency is property and is to be treated like any other property for tax purposes. That is, if you buy virtual currency for X dollars, and sell it for X-plus, the profit is taxable income. In 2014, the IRS issued Notice 2014-21, addressing the virtual current issue. Question 1 of the Frequently Asked Questions addressed in the notice reads:

Q-1: How is virtual currency treated for federal tax purposes? A-1: For federal tax purposes, virtual currency is treated as property. General tax principles applicable to property transactions apply to transactions using virtual currency.

I said repeatedly that the IRS would not look the other way on this issue. As far as the agency is concerned, any "accession to wealth" is taxable, and profit from trading in such currency is no exception. Now is the time to get help if you misreported for failed to report virtual currency trades.

**Department of the Treasury**
**Internal Revenue Service**
**[Operating Division / Program Name]**
[Street address]
[City, State ZIP]

**Date:**
07/16/2019
**Taxpayer ID number:**

**Hotline telephone number:**

**eFax number:**

**Respond by:**

[Recipient name]
[Address line 1]
[Address line 2]
[Address line 3]

## Reporting Virtual Currency Transactions

Dear [Name]:

**Why we're writing to you**
We have information that you have or had one or more accounts containing virtual currency and may not have met your U.S. tax filing and reporting requirements for transactions involving virtual currency, which include cryptocurrency and non-crypto virtual currencies.

Virtual currency is considered property for federal income tax purposes. Generally, U.S. taxpayers must report all sales, exchanges, and other dispositions of virtual currency. An exchange of a virtual currency (such as Bitcoin, Ether, etc.) includes the use of the virtual currency to pay for goods, services, or other property, including another virtual currency such as exchanging Bitcoin for Ether. This obligation applies regardless of whether the account is held in the U.S. or abroad. More information can be found on www.irs.gov and in Notice 2014-21, found at www.irs.gov/pub/irs-drop/n-14-21.pdf, which describes how general tax principles for property transactions apply to transactions using virtual currency.

For one or more of tax years 2013 through 2017, we haven't received either a federal income tax return or an applicable form or schedule reporting your virtual currency transactions.

**What you need to do by the "respond by" date above**
Take one of the following actions:

- If you failed to file one or more income tax returns, file the delinquent returns and report your virtual currency transactions as soon as possible. For more information see www.irs.gov/filing
- If you made a mistake on your income tax return, such as not reporting your virtual currency transactions or incorrectly calculating your income, gain, or loss; you can file an amended return. For more information, visit www.irs.gov/forms-pubs/about-form-1040x
- If you believe you followed all tax and information reporting requirements relating to your virtual currency accounts, mail or eFax the following to the address or eFax number shown at the top of this letter.
  - A statement of facts explaining your position. Include a complete history of previously reported income from your virtual currency transactions. Explain the actions you took to become compliant with U.S. reporting requirements and provide copies of previously filed documents that confirm your compliance.
  - Your contact information, including your telephone number, complete address, and the address where you receive mail (if different).

**Letter 6173 (6-2019)**
Catalog Number 72154R

I, _____ , declare under penalties of perjury that I have examined this
(Name)
entire document, including all attachments and accompanying statements, and that the enclosed is true, correct, and complete.

I also understand with respect to any submission that the IRS reserves the right to make further contacts with me and my representatives to clarify any written explanation or any other documents. Statements and documents sent under this option will be checked against information received from banks, financial advisors, and other sources for accuracy.

_____ **Signature** _____ **Date**

Please note that there is a 10MB limit for data sent to the eFax number. If your electronic file exceeds this size, either mail your documents or fax the information in multiple, smaller transmissions to fit the size requirements.

**Do not send original returns or amended returns for processing via eFax**. Instead, send original returns to the address below and include a copy in your response to this letter. Write "Letter 6173" at the top of the first page of the amended or delinquent return. Mail the originals to:

Internal Revenue Service
2970 Market Street
Philadelphia, PA 19104

If you need more time, send a request for a 30-day extension to the address above by the "respond by" date shown at the top of this letter.

**If we don't hear from you by the "respond by" date**
We may refer your tax account for examination. Please be aware that underpayments of tax are subject to interest and penalties.

**Someone may represent you**
If you want someone to represent you in this matter, send a completed Form 2848, Power of Attorney and Declaration of Representative, with your response to the address above.

**Additional information**
You can find the forms and publications for reporting your virtual currency transactions by visiting our website at www.irs.gov/forms-pubs or by calling 800-TAX-FORMS (800-829-3676).

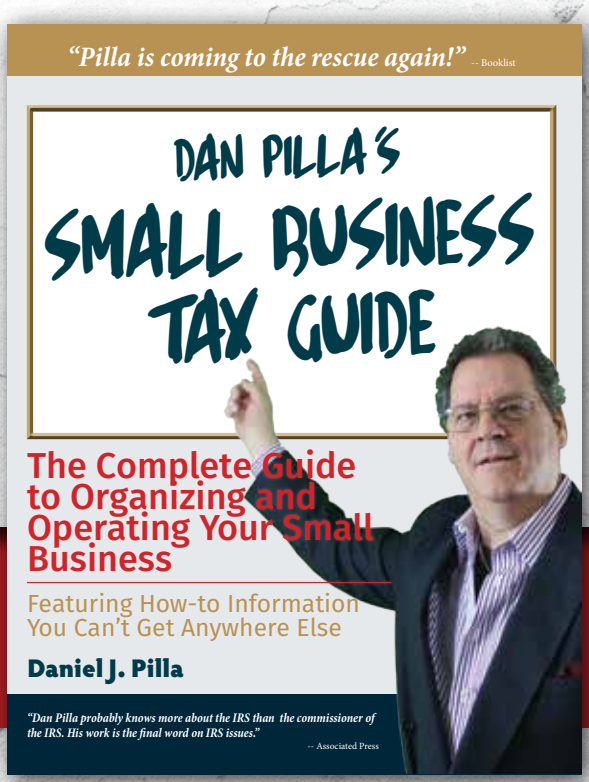
If you have questions, you can call the hotline telephone number shown at the top of this letter and leave a message. We'll respond to all messages within three business days.

Thank you for your cooperation.

Sincerely,

[Name]
Program Manager

**Letter 6173 (6-2019)**
Catalog Number 72154R




# Dan Pilla's Small Business Tax Guide

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## How You Can Ask Dan Pilla a Question

**If you have questions or problems you'd like Dan Pilla to address, please write to Dan at:**

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**or e-mail to: expert@taxhelponline.com**

**Write the word "newsletter" in the subject line.**