



## Tax Reduction Letter

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### CCA 201723020

Subject: Effect of Tax Court Decision on Employment Tax Audits and the Disclosure of Tax Return Information for Purposes of Abatement under Code Section 3402(d) -----,

You asked whether the decision in *Mescalero v. Commissioner*, 148 T.C. No. 11 (Apr. 5, 2017), may be properly relied upon by taxpayers or their representatives to require the Service to provide worker return information during the conduct of employment tax audits, either during the examination process or during Appeals consideration. As set forth more fully below, *Mescalero* does not require the Service to provide such third party tax return information during either the examination or appeals process. The opinion in *Mescalero* is limited to worker return information requested during the discovery process in a Tax Court proceeding, when the Tax Court has: 1) determined that the requested information is disclosable in the judicial proceeding; 2) determined that the requested information is relevant to an issue in the Tax Court proceeding; AND

3) balanced the relevancy of the requested information against the burden placed on the government in producing the information in accordance with Tax Court Rules 70(b) and 70(c).

In worker classification employment tax examinations where examiners have concluded that the use of a mandatory reduced rate provided in Code section 3509(a) or 3509(b) is not applicable because intentional disregard has occurred, and thus abatement of income tax withholding under Code section 3402(d) may be available, and in employment tax examinations where worker classification is not at issue, the Service should continue to follow the procedures outlined in Internal Revenue Manual section 4.23.8.4.3, Procedures for Relief Under IRC 3402(d) and/or IRC 3102(f)(3) in Examination. These procedures authorize examiners to accept original Forms 4669 (Statement of Payments Received) before an examination is closed and to consider such forms "prima facie" evidence of the reporting and payment of tax. These procedures do not authorize examiners to disclose worker return information to the taxpayer or its representative during an examination.

The *Mescalero* Tax Court Decision During the 2009 through 2011 tax years, the *Mescalero* Tribe ("the Tribe") either employed or contracted with several hundred workers. During each of these years, the Tribe timely issued Forms W-2 to its employees, and Forms 1099 to workers it considered its contractors. The Service determined that some of the contractors who received Forms 1099 should have been classified as employees and subject to FICA and income tax withholding.

In connection with the Tax Court proceeding, the Tribe served a discovery request asking that the Service search the records of 70 workers to determine whether they reported their Form 1099 income on Form 1040 and paid their income tax liabilities. The Tribe requested this information during the discovery process after it claimed to have attempted to obtain Forms 4669 for each of the workers at issue, but did not receive Forms 4669 back from the 70 workers. The Tribe argued that this information was relevant and necessary to determine whether the Tribe is entitled to an abatement of withholding pursuant to Code section 3402(d).

Section 3402(d) provides that if the employer fails to deduct and withhold income tax, and thereafter the tax against which such tax may be credited is paid, the tax so required to be deducted and withheld shall not be collected from the employer. Regulation § 31.3402(d)-1 provides that the employer will not be relieved of his liability for payment of the tax required to be withheld unless he can show that the tax against which the tax under section 3402 may be credited has been paid. Section 3402(d) does not relieve the employer from liability for any penalties or additions to tax otherwise applicable in respect of the failure to deduct and withhold.

The Service opposed the discovery request on the basis that the information was barred from disclosure pursuant to Code section 6103, that the burden of proof with respect to section 3402(d) remains entirely on the taxpayer, and that the production of the requested information would place a burden on the Service.

The Court analyzed whether the information requested by the Tribe was directly related to a transactional relationship between the Tribe and the workers and whether the workers' return information directly related to the resolution of an issue in the Tax Court proceeding, as required by section 6103(h)(4)(C). The Court found that the requested return information directly relates to a transactional relationship between the Tribe and the workers, and that the return information showing whether the workers paid the taxes is directly related to the resolution of the Tribe's income tax withholding liabilities.

With respect to whether the information was subject to discovery under the Tax Court Rules, the Court first looked to whether the requested information was relevant to the subject matter in the case under Tax Court Rule 70(b), and then looked at Tax Court Rule 70(c) to determine whether the production of the requested information was unduly burdensome on the Service. In noting the Tribe's indication that it had already exhausted its own ability to find its workers, and return information regarding only 70 workers was not particularly voluminous, the Court found the information requested was discoverable.

It is important to note that the court's determination that the workers' return information was discoverable was based largely on the representation by the Tribe that it has already made a significant effort to locate the workers and that it had failed only with respect to a relatively small number. It is also important to note that IRC 6103(h)(4) authorizes disclosure, but does not require it; thus the court's determination that the workers' return information "is disclosable under section 6103(h)(4)(C)" does not create a requirement that the Service disclose the information.

Thus, Mescalero does not stand for the proposition that taxpayers and/or their representatives are entitled to workers' return information during the conduct of an employment tax audit or at the Appeals consideration level. Instead, the Mescalero decision is limited to discovery requests made by a taxpayer during the pendency of a Tax Court proceeding, where the Tax Court has the ability to determine whether the requested information is disclosable pursuant to IRC 6103(h)(4), AND has balanced the relevancy of the requested information against the burden placed on the Service pursuant to Tax Court Rules 70(b) and 70(c).

We suggest that you encourage Exam and Appeals to contact their local TEGEDC Area Counsel when presented with arguments from a taxpayer invoking the Mescalero opinion.