Independent Contractor or Employee? The 100-Year War

By Robert W. Wood


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Independent contractor versus employee classification controversies are a staple of tax and employment practice. They often involve a push-me-pull-you negotiation in which a major goal of the IRS is to secure employee treatment in the future, even if not in the past. A recent case aptly illustrates this point.

History is littered with long wars, including the Peloponnesian War of ancient Greece (27 years), the Vietnam War (18 years), and many others. One 13-year conflict was actually called the "Long War," lasting from 1593 to 1606 between the Habsburgs and the Ottoman Empire. Longer still were the Thirty Years' War, from 1618 to 1648, and the Hundred Years' War, from 1337 to 1453.

Against such protracted suffering, the classic battle over the status of workers as employees or independent contractors seems trifling. Although the financial stakes can be high, it may seem to be a mere tactical game. But to outsiders, the rules of engagement doubtlessly seem arbitrary, if not downright rigged.

If your business is involved in one of these re-characterization battles, it may seem like a life or death struggle. This is especially so if it is punctuated by the domino effect of one dispute devolving into another and another and another. The free exchange of information among state and federal taxing and labor authorities can seem like sharks swarming to blood in the water, coming from miles away to take a bite out of your business.

Yet the great leveler of the field of battle — a kind of overarching and merciful medic — is section 530 relief. It is a worker status get-out-of-jail-free card. When it applies, it tells employers that even though they may be wrong in treating their workers as independent contractors, they can still defeat the IRS.

In fact, they are not only forgiven for the past, but immunized for the future. For employers who insist they will not enslave workers with the yoke of employee status, section 530 relief says: Let your people go. OK, I admit this is colorful hyperbole, if not downright blather. But shorn of metaphors and emotional fervor, the topic is still serious — maybe not as serious as a heart attack or a war — but plenty troubling all the same.

As Fundamental as It Gets

Of all the lines drawn in the tax law, few are more consequential than that between independent contractor and employee. Payments to employees are subject to income and employment tax withholding, as well as state income tax withholding. The employer must even pay part of the employment tax burden.[1] By contrast, payments to independent contractors are done via a gross check with no withholding. They simply report the payment (to the independent contractor and to the IRS) on Form 1099.

Of course, the differences do not stop with tax law. Payments to employees are subject to elaborate pension, benefit, and nondiscrimination rules. Employee-employer relationships are regulated by several state and federal employment and workplace laws. By contrast, with few exceptions, relationships with independent contractors are entirely unregulated.

As if those differences were not enough, there are enormous implications in terms of third-party liabilities. Businesses generally have vicarious liability for the acts of its employees as long as they are pursued

[1]Section 3101 provides that the employer must pay half of the employee's Social Security and Medicare taxes.

within the course and scope of employment — even if those acts were unauthorized or expressly forbidden by the employer.

The ramifications can be enormous. An employee getting into an auto accident — even if drunk — can trigger liability to the employer.[2] By contrast, independent contractors are generally on their own. They are fully liable for their own actions, and typically do not impute liability to someone who hires them as an independent contractor.

Given those (and many other) sharp distinctions between independent contractors and employees, it is no wonder that many companies make liberal use of the independent contractor construct. It is also not surprising that some companies push the envelope when it comes to worker classification.

Taxing and other agencies have strong incentives to police the line between the two groups; classically, none has done so more assiduously than the IRS. Many tax disputes with the IRS involve bet-the-company stakes. For that reason and others, businesses may dread independent contractor versus employee disputes more than any other tax controversy.

In part, that may be a testament to how widely used independent contractors are in American business. There is a degree of self-consciousness in many businesses, an awareness that many putative independent contractors may not be quite so independent after all. Independent contractors are cheaper, but the tax liabilities can be enormous.

Anatomy of a Dispute

A recent Tax Court decision sheds light on the system and how an employer can mount an appropriate defense. It also puts a gloss on the limited circumstances in which attorney fees may be recoverable, even from the IRS.

In *RI Unlimited Inc. v. Commissioner*,[3] the Tax Court considered the status of medical transcribers as employees or independent contractors. RI offered services to doctors and other medical providers, using home-based medical transcriptionists to type medical documents from dictation files. One key question was the extent of the transcriptionists' independence. Precisely how and when did they carry out their work? Was it under or outside the tutelage of RI?

As is often the case, there were good facts and bad. The medical transcriptionists decided when and how often to work. They paid all their own expenses, including the costs of maintaining a home office, personal computer equipment, medical reference texts, and Internet service.

The transcribers were paid by RI based on the number of lines of completed and typed transcription. RI required transcriptionists to complete each assignment within 10 hours. In fact, any transcriptionist submitting work after the 10-hour deadline would be paid only one-half of the agreed rate. Further, transcripts containing spelling errors were considered incomplete. That meant transcribers would receive no pay at all for those transcripts. All of that seemed contractor-like, involving risk of loss to the worker and a degree of independence.

Moreover, the company had a track record of treating its medical transcriptionists as independent contractors from 2000 to 2003. In 2004, however, the IRS examined the company's relationship with its workers and concluded they were employees. Although the IRS determined that the medical transcriptionists did not fall within the common law definition of employees, they constituted statutory home workers under section 3121(d)(3)(C).

Given the fact-sensitive mishmash of factors that go into the employee versus independent contractor conundrum, people can be surprised to find that some workers are employees irrespective of whether they meet the common law definition of an employee. For over 50 years, the code has contained a codified class of workers, colloquially known as statutory employees, who are employees for employment tax purposes.[4] They include:

- drivers who distribute beverages (other than milk) or meat, vegetable, fruit, or bakery products; or who pick up and deliver laundry or dry cleaning;
- full-time life insurance salespersons whose principal business activity is selling life insurance or annuity contracts;
- individuals who work at home on materials or goods supplied by an employer that must be returned to the employer or his designate and for which the employer furnishes specifications regarding the work to be done; and
- full-time traveling salespersons who solicit and transmit orders to an employer from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments.

Interestingly, these statutory employees are not employees for all tax purposes. An employer must withhold Social Security and Medicare taxes from the wages of statutory employees only if all three of the following conditions are met:

[2]*See Carroll Air Sys. v. Greenbaum*, 629 So.2d 914 (Fla. Dist. Ct. App. 4th Dist. 1993).

[3]T.C. Memo. 2010-205, *Doc 2010-20737, 2010 TNT 184-14*.

[4]*See* section 3121(d)(3).

1. the contract of service contemplates that substantially all the services are to be performed personally by that individual;

2. the worker has no substantial investment in the facilities used in connection with the performance of those services; and

3. the services are part of a continuing relationship with the person for whom the services are performed and are not in the nature of a single transaction.[5]

Section 530 Relief

RI disputed the characterization of the medical transcriptionists as statutory home workers under section 3121(d)(3)(C) and asserted that it could rely on section 530. Employers who are determined to misclassify workers often attempt to qualify for penalty protection known as section 530 relief. Confusingly, section 530 was never added to the code; it is a section in the Revenue Act of 1978.[6]

Section 530 was enacted because many believed that the IRS was too harsh in imposing crippling tax liabilities and penalties when it reclassified workers. Congress responded with section 530 to provide a veritable get-out-of-jail-free card that forgives many instances of worker misclassification. Most thought the provision would be temporary, lasting only a few years. Yet more than 30 years after it was implemented, it remains with us.

To qualify, the employer must have had one of several good reasons to treat the worker as an independent contractor. Because of the cost of worker misclassification, many bills have attempted to either modify the relief provision or repeal it entirely.[7] President Obama himself seems personally invested in this campaign. It seems inevitable that at least curtailments of section 530 relief will eventually be enacted.

Currently, however, a business can seek to be relieved of a misclassification if it:

- had a reasonable basis for not treating workers as employees;
- was consistent in its treatment of any similar workers as contractors; and
- consistently filed required information returns with the IRS.

Each of these requirements has a body of law that has grown up around it, and each can be problematic for a business seeking to claim it.

Disputes are common. Indeed, perhaps because of the existence of section 530 relief, the IRS must change its game plan in many reclassification disputes. Often, it is interested in getting an employer to agree to *prospectively* treat its workers as employees, even if it is not able to collect back taxes and penalties from a retroactive reclassification.

Uneasy Compromise?

Eventually, *RI Unlimited* made its way to IRS Appeals. Under the IRS's Classification Settlement Program, the IRS Appeals officer offered to concede all the proposed tax for 2000, 2001, and 2002, and to concede 75 percent of the tax proposed for 2003. To an impartial observer, that sounds like an incredibly good deal. In exchange, the IRS only wanted RI to *begin* treating its medical transcriptionists as employees commencing July 1, 2007.

Sticking to its guns, RI refused. The IRS issued a notice of determination declaring the transcriptionists to be employees, denying section 530 relief, and seeking to collect employment taxes of $477,617.74.

Undaunted, RI went to the Tax Court. However, by January 2009, the IRS conceded that section 530 relief *did* apply. RI had reasonably relied on the advice of an attorney in treating its medical transcriptionists as independent contractors. Reasonable reliance on a professional adviser is one of the grounds on which section 530 relief may be based.[8]

Getting Attorney Fees From the IRS

Getting attorney fees from the IRS is unusual. It may not be as hard as getting blood from a stone, but close. Yet RI chose to push for its attorney fees under section 7430, seeking fees for the delays and (in its view, inappropriate) expenses the government caused RI to incur.

That aspect of the case was not substantive. The independent contractor vs. employee debate had already been resolved in RI's favor. Yet the standard for evaluating claims for attorney fees necessarily involves a review of the underlying legal issues in the case. In that sense, evaluating the appropriateness of legal fees turns out to be about who is and is not an independent contractor.

Seeking to support its claims that it should be awarded attorney fees, RI argued that the IRS's position was not substantially justified. After all, RI's medical transcriptionists could not have been statutory home workers within the meaning of the statute. Predictably, the IRS argued that this position was reasonable on the facts and under the law.

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[5]*See* IRS Publication 15-A, *Employers Supplemental Tax Guide* 5 (2009), *Doc 2009-128*, *2009 TNT 5-26*.

[6]P.L. 95-600.

[7]*See* The Taxpayer Responsibility, Accountability, and Consistency Act of 2009, H.R. 3408 (2009); The Fair Playing Field Act of 2010, S. 3786 (2010), H.R. 6128 (2010).

[8]*See In re McAtee*, 115 B.R. 180, 183 (N.D. Iowa 1990); *Smoky Mt. Secrets v. United States*, 910 F. Supp. 1316, 1323 (E.D. Tenn. 1995).

RI argued that even if that were true, it was clearly entitled to section 530 relief. That should have been verifiable early on, making (in RI's view) the protracted nature of the proceedings inexcusable. In response, the IRS argued that it was RI's responsibility to bring the section 530 relief issue to a head.

With a kind of he-said-she-said verbosity, the IRS claimed it was RI that unreasonably protracted the tenure and handling of the case. The Tax Court concluded that it did not need to answer the substantive question whether the medical transcriptionists could have been statutory home workers. It was a close question, said the court. Yet the court found it enough to note that the IRS had a reasonable basis in fact to make the arguments it made.

Turning to section 530 relief, the Tax Court engaged in an exhaustive discussion of the nature of section 530 relief, looking at the various independent bases. But at its root, said the court, the taxpayer has the burden of *establishing* its entitlement to section 530 relief.

Did RI do that? Despite the longevity of the dispute, no, it didn't, at least not until the end. By July 17, 2003, it was still unclear whether the taxpayer was entitled to section 530 relief. That was RI's burden, not the government's.

In the court's view, it was only on August 4, 2008, that RI finally established the applicability of section 530 relief. At that point, the burden shifted to the IRS to establish that RI was not entitled to section 530 relief. In essence, then, most of the delays and costs were the taxpayer's and not the fault of the IRS.

As this demonstrates, getting attorney fees from the IRS is not easy. Under section 7430(b)(3), no award for reasonable litigation costs may be made for any portion of the court proceedings during which the prevailing party unreasonably protracted those proceedings. The taxpayer bears the burden of proving that it did not unreasonably protract the court proceedings.[9]

The Tax Court had already held that the taxpayer could be entitled to fees only after August 4, 2008. Having divvied up the costs into discrete time periods, the parties agreed that RI had incurred $22,547 in litigation costs after August 4, 2008. The court considered them reasonable and awarded them to RI.

Larger Lessons

Like the Seven Years' War (also called the French and Indian War), RI's tribulations brewed slowly. It is difficult to enunciate the biggest lesson of RI's seven-year case. Most companies might have taken the offer made by IRS Appeals.

Indeed, viewed against a normative IRS compromise, the taxpayer in such a deal is lucky. It would have wiped away all the proposed tax for 2000, 2001, and 2002, and 75 percent of the tax for 2003. The downside was that the deal would have required RI to agree to prospectively treat the transcriptionists as employees.

From the IRS's perspective, section 530 relief is the fly in the ointment. A company that has a good case that section 530 relief applies has a far smaller incentive to bargain in this fashion. I would wager that the IRS would probably have even agreed to give up the 25 percent of the 2003 tax it sought. Indeed, in my experience, it is often possible in a worker status dispute to have the sins of the past completely washed away in exchange for an agreement never to sin again.

Of course, I use "sin" here as the IRS would. Some taxpayers may view the dynamic as a form of government-sanctioned (but still reprehensible) extortion. As taxpayers might see it, the IRS reclassifies independent contractors retroactively to gin up a huge bill of back taxes, interest, and penalties that virtually no business could withstand. Then the IRS offers to wipe the slate clean. But to wipe the slate clean and forgive the past, says the IRS, there's just one more thing. . . .

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[9]*See Swanson v. Commissioner*, 106 T.C. 76 (1996), *Doc 96-4781*, *96 TNT 33-14*.