Is the IRS Raising the Worker Status Relief Bar?

By Robert W. Wood


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Worker status issues are much in the news these days, with recent cooperation agreements between the IRS and other agencies, plus the newly announced IRS voluntary classification settlement program (VCSP). Wood looks at section 530 relief, focusing on the nature and timing of the taxpayer's requisite reliance. His next column will address the VCSP.

Editor's note: This article was written before the September 21 announcement of the IRS voluntary classification settlement program (VCSP) and focuses on section 530 relief. The next Woodcraft column, to be published in the October 24 issue of *Tax Notes*, will address the VCSP.

Just about everyone knows that the IRS does not favor independent contractor treatment and believes — sometimes correctly — that the independent contractor classification is subject to abuse. The IRS is inclined to presume that most workers are employees even if they may be called independent contractors. That makes sense.

A person who is paid as an independent contractor does not pay tax until tax return filing time the following year. In contrast, payments to employees are subject to Social Security and Medicare taxes, which are collected on wages immediately. The counterpart to Social Security taxes is the self-employment tax for independent contractors. Yet the self-employment tax is one of the most notoriously under-collected taxes. Even if collected, it is paid only at tax return filing time, not immediately.

There are thus both timing and revenue differences between employee and independent contractor treatment. Moreover, the IRS sees a system in which some employers claim independent contractor treatment for their workers either without credible arguments or based on gerrymandered facts and documents. For those reasons, in addition to more analytical ones, the IRS greatly prefers having workers treated as employees and subject to withholding.

Despite the good financial reasons for the government to prefer treating everyone as an employee, it is clear that not all workers are actually employees. There are unequivocal cases in which independent contractor treatment alone makes sense. An independent plumber whom you pay one time to come to your home to fix your toilet is not your employee. Apart from obvious cases, however, it can be difficult to tell who can properly be treated as an independent contractor.

Because of the crippling liabilities some businesses were facing when the IRS retroactively classified their "independent contractors" as employees, Congress enacted a relief provision in 1978. Section 530 of the Revenue Act of 1978 was expressly designed to provide relief from IRS re-characterization when an employer misclassified workers. It was extended indefinitely in 1982 (P.L. 95-600) and amended in 1996 (P.L. 104-188). The provision was meant to be temporary and has never been integrated into the code. Yet more than 30 years later, it remains with us.

It continues to provide protection when an employer has treated a worker as an independent contractor, but the worker is reclassified on audit. Despite its tenure, section 530 relief has long been controversial. Before moving on to much bigger problems, President Obama targeted section 530 for reform.[1] Yet no reform has passed.

For companies embattled in bitter worker re-characterization wars and the lawyers representing

[1]*See* Treasury, "General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals" (Feb. 2011), at 105, *Doc 2011-3155*, or *2011 TNT 31-21*.

them, it is an incredibly valuable provision. It is powerful, and under the appropriate circumstances, not even difficult to satisfy. The IRS and some courts have suggested that if you fail to satisfy the criteria at the appropriate time, it can be too late.

In fact, timing has become an important element of the equation. PMTA 2011-015[2] addresses the timing issue represented by the provision's reasonable reliance requirement. It deals with the question whether the taxpayer seeking section 530 relief must show it was relying on one of the permitted bases when it made the worker classification decision. It also touches on what proof of that reliance should be required.

Section 530 Basics

Under section 530, a business may treat an individual as an independent contractor if:

1. the taxpayer does not treat the individual as an employee for any period;

2. the taxpayer does not treat any other individual holding a substantially similar position as an employee for purposes of employment taxes for any period;

3. all required federal tax returns are filed by the taxpayer on a basis consistent with its treatment of the individual as a non-employee; and

4. the taxpayer has a reasonable basis for not treating the individual as an employee.

Reasonable Basis

As those criteria reveal, the bedrock of section 530 relief is consistency of treatment and a focus on the conduct of the employer. Each requirement has its nuances and has caused controversy. The most amorphous and difficult to discern, however, is the reasonable basis the employer must have to support consistent treatment. One may satisfy it by reasonably relying on:

1. judicial precedent or IRS rulings;

2. a past IRS audit;

3. a long-standing practice of a significant segment of the relevant industry; or

4. other reasonable basis.

A taxpayer who cannot meet any of those safe harbors may nevertheless be entitled to relief by demonstrating a reasonable basis for not treating the individual as an employee in some other way. There are technically four ways of getting over the reasonable basis hurdle.

Demonstrating that the employer relied on a court case or previous IRS ruling is self-explanatory. Often, it is coupled with a legal opinion issued by a lawyer who relies on those authorities. The second way of showing reasonable basis — a prior audit — is a kind of estoppel notion.

The taxpayer has a reasonable basis for its classification if it can show that the business was audited and that the IRS did not reclassify similar workers. Audits commencing after 1996, however, must have specifically addressed the worker status issue for the same type of workers. The reliance cannot be based on a regular corporate or business tax audit during which the employee status issue is not raised.

The third way of satisfying the reasonable basis rule is to show that the taxpayer treated the workers as independent contractors because that is how a significant segment of the industry treats similar workers. That rule is clear and widely used, but it has become controversial. In fact, Congress has several times entertained legislation to outlaw that particular brand of reasonable basis reliance, but so far, the law remains intact.

Finally, and perhaps most importantly, one can satisfy the reasonable basis portion of the three-part relief test with the catchall "other reasonable basis" category. That catchall could include a legal opinion or less formal advice from a knowledgeable lawyer or an accountant who had advised the independent contractor treatment for the workers in question.

Timing Concerns

It should be no surprise that *when* the taxpayer must have relied on one of those items might itself become controversial. On its face, section 530 relief would seem to be available only if the business established that it had *in fact* relied on one of the safe harbors. The precise timing of that reliance, however, is not so clear. A *basis* for reliance and reliance *in fact* are different standards, and the temporal aspects could be debated.

For example, what if at the time the company classified its workers it had little money and knew it could not afford to pay payroll taxes? What if it made an economic decision, paying its workers as contractors, but all the while fearing that the workers were entirely subject to its control and therefore might be employees? Alternatively, suppose the employer simply didn't consider the worker status question. In either case, it might later turn out that judicial precedents, an industry practice, or some other basis could conceivably bring the company within section 530 relief.

Is the taxpayer's reliance too late? Perhaps there should be no relief in the first scenario, but what about the second? A key question is whether the taxpayer should be required to demonstrate that he

[2]*See Doc 2011-17084* or *2011 TNT 152-59*.

reasonably relied on a safe harbor *before* engaging the worker to perform services. Cases have held that to fall within any of the three safe harbors (judicial precedent or IRS rulings, a past IRS audit, or a long-standing practice of a significant segment of the relevant industry), the required reliance must have been present when the employment decisions were being made. It will not be sufficient if the reliance occurs after the fact.[3]

Precisely what kind of burden the taxpayer must carry, and how explicit that timely reliance must be, is less clear than one might think. One of the more important cases to discuss that is *Peno Trucking v. Commissioner*,[4] which addresses both the timing of reliance and the substantial basis for it.

The IRS determined that Peno Trucking drivers were employees even though they were denominated as independent contractors. Peno Trucking claimed that the IRS's re-characterization was inappropriate because the Ohio Industrial Commission and the Ohio Court of Common Pleas had previously found two of its drivers to be independent contractors. Those decisions allowed the company to claim section 530 relief, the company argued.

The IRS nevertheless considered the drivers to be employees and found the Ohio authority unpersuasive. The IRS also considered section 530 relief to be unavailable, primarily based on the timing of the company's putative reliance. The Tax Court agreed with the IRS, holding that the company's reliance was too late.

Apart from mere timing, there was also the appropriateness of the substantive law involved. The Tax Court announced that for a taxpayer to rely on judicial precedent as a reasonable basis, that precedent must have used the federal common law test for determining employee status. That test generally relies on the company's overall control of the worker and 20 factors enunciated by the IRS.[5]

The Tax Court found no evidence that either of the Ohio entities had used the federal common law test for distinguishing employees from independent contractors. Moreover, the Tax Court found no indication that those Ohio decisions had *actually* been relied on by Peno Trucking when it decided to classify its drivers as independent contractors. The latter point was temporal, but it raised questions of proof.

Ultimately, on both substantive and temporal grounds, the Tax Court denied section 530 relief and sided with the IRS. Peno Trucking appealed and found more sympathetic ears in the U.S. Court of Appeals for the Sixth Circuit.[6] Reversing the Tax Court on the section 530 relief issue, the appellate court found that the trucking company could in fact have relied on the Ohio authority when it made its employee-versus-contractor decision. The Ohio decisions were rendered *before* the tax years in question, which was enough for the Sixth Circuit.

The timing issue satisfied, the Sixth Circuit pointed out that the Ohio Commission appeared to have used a 20-factor test for determining the status of the drivers that was virtually identical to the 20-factor test outlined by IRS. Thus, the Sixth Circuit found that Peno Trucking's reliance on the official state determinations satisfied the reasonable basis requirement for section 530 purposes.

Despite being reversed by the Sixth Circuit, the Tax Court in *Peno Trucking* is not the only court to construe the reasonable basis standard as requiring reliance in fact. For example, in *303 West 42nd St. Enterprises v. Commissioner*,[7] the Second Circuit questioned whether the taxpayer had in fact relied on any specific industry practice in deciding to treat its workers as non-employees.

At least in the Tax Court, specific details of the reliance are likely to be examined. In *Nu-Look Design*,[8] the court admonished that section 530 "does not countenance *ex post facto* justification." Although it reversed the Tax Court, even the Sixth Circuit in *Peno Trucking* quoted authorities restricting section 530 relief, saying it should apply only when the taxpayer "relied on the alleged authority . . . at the time the employment decisions were being made."[9]

Yet exactly what the taxpayer must prove it relied on, and exactly when the taxpayer must prove it did so can be debated. Peno Trucking had two official determinations about the specific workers in question, although the IRS claimed they were not sufficiently akin to IRS determinations to qualify. In contrast, the taxpayer in *Nu-Look Design* raised section 530 relief only several months before trial. These purely retroactive justifications seem doomed.

The Sixth Circuit found very different facts in *Peno Trucking*. By presenting evidence that it never treated the drivers as employees and consistently issued to them Forms 1099-MISC, Peno Trucking

[3]*See, e.g.*, *Nu-Look Design Inc. v. Commissioner*, T.C. Memo. 2003-52, *Doc 2003-5282*, *2003 TNT 39-7*.

[4]T.C. Memo. 2007-66, *Doc 2007-7174*, *2007 TNT 56-12*, *rev'd*, 296 Fed. Appx. 449 (6th Cir. 2008), *Doc 2008-21241*, *2008 TNT 194-75*.

[5]*See* Rev. Rul. 87-41, 1987-1 C.B. 296.

[6]*See Peno Trucking*, 296 Fed. Appx. 449.

[7]181 F.3d 272, 277 (2d Cir. 1999), *Doc 1999-21668*, *1999 TNT 120-16*.

[8]T.C. Memo. 2003-52.

[9]*See Peno Trucking* (quoting from *Veterinary Surgical Consultants PC v. Commissioner*, T.C. Memo. 2003-48, *Doc 2003-5286*, *2003 TNT 39-11*).

shifted the burden to the IRS to prove that section 530 relief did not apply. That shifting of the burden of proof turned out to be critical. The IRS was unable to show that Peno Trucking did not in fact reasonably rely on the state law authority regarding its decision to treat the truckers as independent contractors.

Refined Standard

The ''could have'' approach used by the Sixth Circuit in *Peno Trucking* appears to be too laissez faire for the IRS. PMTA 2011-015 stated that an employer must demonstrate actual and reasonable reliance *before* the period for which employment decisions are made. However, the IRS did not specify what could be considered sufficient proof.

It would be clearest to show that the taxpayer reasonably relied before making the *initial* employment decision. However, an employer may be able to satisfy the reasonable basis requirement by establishing that it actually and reasonably relied on the asserted basis before making the employment decision regarding the workers' status for *later* periods. That appears to treat the decision to pay workers on an independent contractor basis as a continuing decision. In effect, worker status can involve repeated decisions. Reliance on one of the permitted items could come long after the initial hiring decision.

For example, suppose one makes a knee-jerk decision to treat a worker as an independent contractor in 1995. The reasonable reliance in fact must not *necessarily* be established in 1995. If the worker's status for tax years 2005, 2006, and 2007 are in question, then it should suffice to show that the company reasonably relied in fact on one of the permitted bases at some time *before* 2005.

The standard of proof appears to be another matter. The latest IRS pronouncement concludes that employers must demonstrate reliance in fact. To rely on an industry practice, for example, the taxpayer would have to show it was aware of the putative industry practice before making the decision to treat the workers as independent contractors for the pertinent periods. Moreover, the taxpayer would apparently need to show that the industry practice was in fact the basis of the decision.

Further, the taxpayer would also need to show that relying on that basis was reasonable. Some taxpayers will not be able to meet that heavy temporal and factual burden. After all, rightly or wrongly, for many businesses, the employee-versus-independent contractor decision is made in haste and with little regard for the long term. Facts, practices, and sensitivities vary.

A worker may start out as an independent contractor — there may even be good justification for it. Later, the same worker may morph into what looks and sounds like an employee. Despite having an extended tenure, he may continue to be treated as an independent contractor and to receive a Form 1099. Or he might be in an industry such as trucking that is often characterized by an aggressive use of the independent contractor norm. As in *Peno Trucking*, there may be a past legal determination on which the taxpayer may claim to rely.

In those cases, a good lawyer may be able to successfully assert section 530 relief, because the employer reasonably relied on the appropriate basis at the appropriate time. The result of section 530 relief is not merely that the taxpayer is relieved of penalties. In the IRS's view, an application of section 530 relief results in an incorrect classification being allowed to continue indefinitely; its frustration is palpable.

Whether workers are employees or independent contractors arguably ought to depend on the facts and the actual relationship between the worker and the company. The essence of section 530 relief is that some misclassifications not only will be forgiven, but also ignored. If erroneous treatment is supported by a good reason, even flatly incorrect classifications are allowed to remain as continuing exceptions to the rules.

Conclusion

We have had section 530 relief for a long time. Congress's inability to tackle the provision suggests that we may continue to have it, perhaps perpetually. As long as we do, taxpayers and their advisers will continue to assert it. Taxpayers will attempt to show that they relied in fact on one of the enumerated good items at the time of their initial or continuing worker classification decision. They may so argue even if they didn't know at the time precisely what they were relying on. Equally understandably, the IRS can be expected to push back.