Employment Taxes - Advantage Exotic Dancers

By Robert W. Wood[1]

I. INTRODUCTION

In the stiffly starched world of the Internal Revenue Service, it may seem surprising that there have been a number of disputes between the IRS and companies that operate exotic dance theaters, fantasy booths and other venues for adult entertainment. IRS fights with the clubs aside, some cases actually pit the IRS with the dancers themselves. Whether the club or dancers are the targets, the grounds for dispute are the employment tax status of the dancers, the dichotomy between club employees and those who hold themselves out as independent contractors.

II. WHAT IS THE FIGHT ABOUT?

In a whole bevy of these suits, nightclub dancers have asserted independent contractor status, arguing that they control the manner and means of providing their services to their clients. In most cases, the dancers themselves are not the litigants. The club typically is being chased for withholding and employment taxes, something that would be proper if the dancers were employees, but not if they are independent contractors. For examples, see *Taylor Blvd. Theatre, Inc. v. U.S.*[2] and *Deja Vu Entertainment Enterprises of Minnesota*.[3]

Generally, the dancer pays "rent" for the stage under a contract requiring the dancer/contractor to pay her own taxes. The dancers solicit their own customers, often circulating in the club. Unlike many independent contractor relationships in other lines of business, however, the club typically can impose rules and regulations, even levying fines for prohibited conduct. Still, such powers have not been ruled to be strong enough by the courts to result in the kind of control that usually spells employment status. See *JJR, Inc. v. U.S.*[4]

Surprisingly, the case law has evolved to favor the independent status of exotic dancers. Indeed, since providing one's own tools often spells true independent contractor status, panties and pasties may be a worker's own tools. Some nightclubs, after a successful run against the IRS, want to rub the IRS' nose in the clubs' victory. There is only one way to do that effectively: the clubs want attorneys' fees.

Under a little-known portion of the tax law, the government can be forced to fork over attorneys' fees if the IRS' position on a matter is "substantially unjustified." Up until a few years ago, meeting this high legal standard (and so getting the attorneys' fees) was virtually impossible. But all that has changed.

III. SOMETIMES IRS SUBJECT TO ATTORNEY FEE AWARDS

In *Marlar Inc. v. U.S.*,[5] a U.S. District Court awarded attorneys fees to a nightclub, finding that the club reasonably relied on industry practice in treating its nude dancers as "lessees." The court found the government was not substantially justified in pursuing employment tax claims against the club, so the club won attorneys' fees. According to sex-club industry practice, the club received daily rental fees from dancers. The dancers got to keep money given to them, providing an opportunity to either make a profit or incur a loss. Risk of loss (and ability to make a profit) is a hallmark of independent contractor status.

Despite the appearance of measures of independence, the IRS found other indices of control by Club Marlar. Faced with classic do-what-you're-told evidence, the IRS reclassified the nude dancers as employees. Club Marlar paid the taxes and sued for a refund. The District Court found Marlar qualified for the safe harbor classification provision for independent contractors (Section 530 of the Revenue Act of 1978) because the club relied on industry practice. The IRS then appealed to the U.S. Court of Appeals for the Ninth Circuit. In the Ninth Circuit, the IRS argued that Marlar's reliance on industry practice was not "reasonable" and that Marlar had failed to file all required tax forms, one of the conditions for so-called Section 530 relief.

The Ninth Circuit agreed that safe harbor relief was appropriate, but the appeals court had to remand to the District Court for a determination whether the government's position was "substantially justified," the latter question impacting attorneys' fees.

Fortunately for Club Marlar (and for aggressive taxpayers everywhere) the District Court on remand found the government's position was not justified. Indeed, the court said: "A reasonable person could think that treating dancers as lessees was permissible under the tax code." (For another case involving the rental model in which a club was held not liable for employment taxes on its nude dancers see *Deja Vu Entertainment Enterprises of Minnesota, Inc. v. U.S.*[6]

IV. SAFE HARBOR

Even if a company loses a tax case about workers' status, the employer can normally find an escape valve by showing, among other things, that it was the industry's "uniform practice" to treat these workers as independent contractors. Recent Appellate Court cases arguably extend the sex clubs' protection even farther, suggesting the "industry practice" does not have to be "uniform." In *303 West 42nd Street Enterprises, Inc v. IRS, et al.*,[7] the Second Circuit Court of

Appeals reversed a summary judgment motion won by the IRS, where the IRS had determined that "fantasy performers" were employees.

This New York club operated an adult entertainment facility with fantasy booths, pornographic movies, live stage shows, etc. Customers in fantasy booths communicated with performers via telephone. When the customer deposited a coin, the telephone was activated and the performer became visible. At the end of each shift, performers retained all of their tips, but transferred the coins deposited by customers to the company. Performers signed a lease agreement which authorized the company to withhold forty percent of the coins as a security deposit to reserve a booth for each performer. The club treated the performers as tenants and not as employees.

When the IRS disagreed and the matter wound up in court, both sides moved for summary judgment on the industry standard (Section 530 relief) question. The court said the safe harbor relief applied only where the industry *uniformly* classified its workers as a single type of worker (and where the taxpayer relied in good faith on that classification). Because the court found the adult entertainment industry was ambivalent about worker classification, the court found there was no long-standing industry practice, one of the requisite bases for Section 530 relief. The Second Circuit Court of Appeals disagreed, siding with the club. According to the Appeals Court, a taxpayer seeking safe harbor relief can rely on the classification practice of a "significant segment" of the industry. It is not necessary to show uniformity of practice. See further discussion in *303 West 42nd Street Enterprises, Inc v. IRS, et al.*[8]

Even more recently, the Ninth Circuit has awarded litigation costs to another club that treated dancers as independent contractors. In *Deja Vu-Lynnwood, Inc. v. U.S.*,[9] the club treated dancers as tenants who rented space. The IRS said they were employees, and the matter went to district court. The IRS saw the writing on the wall from other cases, and actually *conceded* its case. The club moved for litigation costs, and the district court said "no."

But the club did not give up here. It went to the Ninth Circuit, where the court did award attorneys' fees, holding the government's reasons for pursuing the assessments weren't substantially justified. Part of the underlying dispute involved the club offering free legal services to the dancers after they were charged with criminal violations for their work at the clubs! The Ninth Circuit said these free legal services weren't reportable payments because the services were provided only at the club's discretion. Plus, the Ninth Circuit concluded that the government was not substantially justified in arguing that the club did not qualify for safe harbor independent contractor relief.

V. CONCLUSION

Some have argued that good social policy requires singling out the adult entertainment industry for tough tax treatment. See Soled, "Nude Dancing: A Guide to Industry Wide Noncompliance," *Tax Notes*, September 21, 1998, p. 1509. Nevertheless, the complex web of factors for determining who is an employee vs. an independent contractor—that the IRS itself has devised—has simply been more successfully manipulated by the adult entertainment industry than by many other lines of business. Perhaps that's an embarrassment to the IRS.

Even so, for virtually all industries, simplification of the contractor vs. employee standards is long overdue. Perhaps the latest wave of case law will cause the IRS or Congress to fix the confusing law. In the meantime, tax lawyers may find it amusing that nude dancers, generally heavily regulated by their clubs, are being found to be truly "independent." On top of that, the IRS is being slapped with attorneys' fees for arguing to the contrary.

ENDNOTES

1. Robert W. Wood practices law with Robert W. Wood, P.C., 477 Pacific Avenue, Suite 300, San Francisco, California 94113,(415) 834-1800 (telephone), (415) 834-1888 (facsimile), www.robertwwood.com (website). He is a Certified Specialist in Taxation, and is the author of 28 books, including *Taxation of Damage Awards and Settlement Payments* (2d Ed. © 1998, with 2001 Supplement), published by Tax Institute at 800/852-5515; e-mail info@taxinstitute.com).

2. *Taylor Blvd. Theatre, Inc. v. U.S.*, 1998 U.S. Dist. LEXIS 9355 (W.D.Ky., May 13, 1998)

3. *Deja Vu Entertainment Enterprises of Minnesota, Inc. v. U.S.*, 1 F.Supp.2d 964 (D. Minn. Feb. 17, 1998).

4. *JJR, Inc. v. U.S.*, 950 F.Supp. 1037 (W.D. Wash. 1999), *aff'd without opinion*, 156 F.3d 1237 (9th Cir. 1998)

5. *Marlar Inc. v. U.S.*, 934 F.Supp. 1204 (W.Dist. Wash. 1996), *aff'd in part, remanded in part*, 151 F.3d 962 (9th Cir. 1998), fees proceeding at 1999 U.S. Dist. LEXIS 8187, Tax Notes Doc. No. 1999-1983

6. *Deja Vu Entertainment Enterprises of Minnesota, Inc. v. U.S.*, 1 F.Supp.2d 964 (D. Minn. Feb. 17, 1998).

7. *303 West 42nd Street Enterprises, Inc v. IRS, et al.*, 181 F.3d 272 (2nd. Cir. 1999).

8. *Id.*

9. *Deja Vu-Lynnwood, Inc. v. U.S.*, 2001 U.S. App. LEXIS 23545 (9th Cir., Oct. 26, 2001), Tax Analysts Doc. No. 2001-28992, 2001 TNT 225-9.