Exotic Dancers Win Tax Disputes

By Robert W. Wood

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

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 were independent contractors. For examples, see *Taylor Blvd. Theatre, Inc. v. United States,* 82 AFTR2d Par. 98-5020 (W.D.Ky. 1998), *Doc 98-21923 (9 pages), 98 TNT 131-8;* and *Deja Vu Entertainment Enterprises of Minnesota, Inc. v. United States,* 1 F.Supp.2d 964 (D. Minn. 1998), *Doc 98-21922 (10 pages), 98 TNT 131-7.*

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, this authority has 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. United States,* 950 F.Supp. 1037 (W.D. Wash. 1999), *Doc 1999-8758 (8 original pages), 1999 TNT 50-20, aff'd without opinion* 156 F.3d 1237 (9th Cir. 1998), *Doc 98-26187 (1 page), 98 TNT 166-6.*

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 government's nose in the clubs' victories. There is only one way to do that effectively — the clubs want attorney fees.

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

Pay Up, IRS

In *Marlar Inc. v. United States,* 934 F.Supp. 1204 (W.D. Wash. 1996), *Doc 96-23210 (15 pages), 96 TNT 162-63, aff'd in part, remanded in part* 151 F.3d 962 (9th Cir. 1998), *Doc 98-25330 (9 pages), 98 TNT 154-7,* fees proceeding

at 1999 U.S. Dist. LEXIS 8187 (W.D. Wash. 1999), *Doc 1999-19831 (7 original pages), 1999 TNT 121-14,* a U.S. district court awarded attorney 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 attorney fees. According to sex-club industry practice, the club received daily rental fees from dancers. The dancers kept 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 independence, the IRS found other indices of control by Club Marlar. So, the IRS reclassified the nude dancers as employees. The club paid the taxes and sued for a refund. The district court found the club qualified for the safe harbor classification provision for independent contractors (section 530 of the Revenue Act of 1978) because Club Marlar 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 Club Marlar's reliance on industry practice was not "reasonable" and that the club 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 remanded to the district court for a determination whether the government's position was "substantially justified," the latter question affecting attorney 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. United States,* 1 F.Supp.2d 964 (D. Minn. 1998).)

Uniform Practices

Even if a company loses a tax case about the classification of its employees, 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.,* 916 F.Supp. 349 (S.D. N.Y. 1996), *Doc 97-1506 (18 pages), 97 TNT 11-14, rev'd* 181 F.3d 272 (2d Cir. 1999), *Doc 1999-22305 (13 original pages), 1999 TNT 124-9,* the Second Circuit reversed a summary judgment motion won by the IRS that certain "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 authorizing the company to withhold 40 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 ended 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 district court found the adult entertainment industry was ambivalent about worker classification, it found there was no long-standing industry practice, one of the requisite bases for section 530 relief. The Second Circuit disagreed, siding with the club. According to the appellate 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.,* 181 F.3d 272 (2nd. Cir. 1999).

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. United States,* 88 AFTR2d Par. 2001-5554 (9th Cir., Oct. 26, 2001), *Doc 2001-28992 (15 original pages), 2001 TNT 225-9,* the club treated dancers as tenants who rented space. The IRS contended they were employees, and the matter went to district court. The IRS saw the writing on the wall from other cases, and 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 attorney fees, holding the government's reasons for pursuing the assessments were not 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 appeals court concluded that the government was not substantially justified in arguing that the club did not qualify for safe harbor independent contractor relief.

Last Dance

Some have argued that good social policy requires singling out the adult entertainment industry for tough tax treatment. See "Nude Dancing: A Guide to Industrywide Noncompliance," *Tax Notes,* Sept. 21, 1998, p. 1509, written by Rutgers University Professor Jay A. Soled. 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.

In any event, for virtually all industries, simplification of the contractor vs. employee standards is long overdue. Perhaps the latest cases 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 attorney fees for arguing to the contrary.

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