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IRS Narrows Independent Contractor Relief

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If you treat workers as independent contractors who are really employees and fail to withhold payroll taxes the IRS can reclassify them and assess potentially crippling retroactive penalties. For many, a key way out of this mess is Section 530, a tax relief provision that can let you keep even an erroneous classification. Under this provision, a business can treat an individual as an independent contractor if:

1. It never treats the person as an employee;
2. It does not treat any other person with a substantially similar position as an employee;
3. All required federal tax returns and Forms 1099 show the worker as an independent contractor; and
4. The business had a "reasonable basis" not to treat the person as an employee.

One can satisfy the fourth requirement by reasonably relying upon:

- Judicial precedent or IRS rulings;
- A past IRS audit; or

- A long-standing practice of a significant segment of the relevant industry.

Plus, if you cannot meet any of these three you can ***still*** show a reasonable basis some other way. It is no secret that the IRS finds this a frustrating provision that allows some businesses to go on misclassifying workers forever. Congress has several times considered repealing Section 530 altogether.

In the meantime, the IRS is considering timing and whether the business was ***actually*** relying on one of the permitted items at the time it made its worker status decision. In Program Manager's Technical Advice, "Section 530: Reasonable Reliance Safe Harbor," the IRS considers whether an employer must show it relied on the safe harbor ***before*** it engaged a worker to provide services.

Section 530 relief would seem to be available only if you established you had in fact relied, but when? At the time you classified your workers, suppose you had little money and knew you could not afford to pay payroll taxes so intentionally flaunted the rules, knowing all the time the workers were entirely subject to your control and therefore employees.

Later, it turns out that judicial precedents, an industry practice or some other basis arguably brings you within Section 530 relief. Must you show that you did not initiate your reliance too late? A key question is whether the taxpayer must demonstrate that it reasonably relied on a safe harbor ***before*** engaging the worker to perform services.

One case raising this issue is *Peno Trucking v. Commissioner*, where the Tax Court held that the company failed to show it actually relied on relevant judicial precedent. Reversing the Tax Court, the appellate court found the trucking company ***could have*** relied on an Ohio ruling when it made its employee versus contractor decision because the Ohio ruling was rendered before the tax years in question. The timing issue satisfied, the Sixth Circuit went on to rule that Ohio had used the same 20-factor common law test.

The IRS doesn't like this "could have" approach. In the recent Program Manager's Technical Advice, the IRS stated that an employer must

demonstrate actual and reasonable reliance ***before*** the employment decisions were made. Moreover, the IRS says that employers must demonstrate ***reliance in fact***.

In the case of an industry practice, the taxpayer would have to show it was aware of the practice ***before*** making the decision to treat the workers in question as independent contractors. In addition, the taxpayer would need to show the industry practice was ***in fact*** the basis of the decision and that relying upon it was ***reasonable***.

Bottom line? Some business won't meat these tough standards. Expect more worker status controversies.

For more, see:

Independent Contractor or Employee? The 100-Year War

Some Control Won't Convert Independent Contractors To Employees

Ten Mistakes to Avoid Over Independent Contractors

Independent Contractor Versus Employee Issues: Bad, Ugly, and Uglier

White House On Contractor vs. Employee: There Will Be Blood

Miranda-Like Warnings To Independent Contractors?

Publication 15-A, Employer's Supplemental Tax Guide

Publication 1779, Independent Contractor or Employee

Publication 1976, Do You Qualify for Relief under Section 530?

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