When "Independent Contractors" Are Ruled Employees

Robert W. Wood

Among the most frightening liabilities in business are those relating to employees. One can fear products liability for manufacturing, liability to third parties for goods or services, and liabilities to the government. But liabilities for wage and hour laws, discrimination, wrongful termination, and similar rules seem particularly frightening.

One assumed way of minimizing such exposure is simply not to have employees or to keep their ranks to a minimum. Increasingly, though, it is not clear whether one avoids such liabilities with independent contractors. It is usually possible to have some workers operate as independent contractors, thus sidestepping a panoply of tax and other liabilities. The critical questions are:

- In what circumstance can one have them?
- What rules govern the relationship? and
- Above all, when can "independent contractors" be re–characterized?

The stakes can be huge. They certainly were for the building contractor in the recent Fifth Circuit case, *Bruecher Foundation Services Inc. v. U.S.* Bruecher performed residential foundation repair and grading work for customers. To do that, it needed workers for manual labor whom it treated as independent contractors. But when the IRS audited Bruecher for 1999 and 2000, it ruled this treatment was inappropriate.

This was a regular corporate tax audit, not an employment tax audit. The employee v. contractor issue was flagged when the IRS discovered Bruecher had claimed deductions for its contract labor, yet had not filed Forms 1099 for all its independent contractors. The corporate auditor referred the issue to the IRS employment tax group which started an audit without telling the company.

Because of the behind the scenes nature of this audit, the IRS did not provide Bruecher with notice it could qualify for the Section 530 safe harbor. (More about the safe harbor below.) The audit summary concluded that Bruecher was not entitled to Section 530 relief because it failed to file Forms 1099. Various administrative scuffles ensued.

The IRS issued a tax lien in 2005 and then levied on Bruecher's bank account in 2006. Bruecher belatedly (in 2006!) filed its 1999 and 2000 Forms 1099, and then sued in U.S. district court. Agreeing with the IRS, the district court ruled the workers to be employees. Bruecher appealed to the Fifth Circuit, arguing that:

- The district court was wrong in finding that Bruecher was not entitled to Section 530 relief;
- Even if Bruecher was not entitled to Section 530 relief, the district court should have assigned the burden of proof at trial to the government because the IRS failed to comply with the advanced notice procedures of Section 530; and
- On the merits, the workers were independent contractors not employees.

Each one of these contentions has implications for the future of worker status disputes.

Section 530 Relief

Section 530 of the Revenue Act of 1978 provides relief from re–characterization liabilities when an employer misclassifies workers. It was enacted in 1978, extended indefinitely in 1982, and amended again in 1996. More than 30 years after this "temporary" provision was enacted, it continues to be interpreted liberally, providing protection when an employer has classified a worker as an independent contractor and the worker is reclassified on audit.

The employer is relieved of liability if the tax returns including Forms 1099 show that all similar workers were consistently treated as independent contractors, and that there was a reasonable basis for that classification. Employers must satisfy three requirements: a reasonable basis for treating the workers as independent contractors, a substan-

tive consistency requirement, and a reporting consistency requirement.

1. Reasonable Basis

Having a "reasonable basis" may sound difficult, but in practice is rarely a problem. There are several ways of getting over this reasonable basis hurdle. One way is to show that the employer relied upon a court case or ruling issued by the IRS. Another is to rely on a prior audit, if the IRS didn't reclassify the workers in the past.

You have a reasonable basis for your classification if you can show that your business was audited by the IRS and that the IRS did not reclassify similar workers. This is a kind of estoppel notion. However, for audits commencing after 1996, the audit must have included employment tax issues and must specifically have considered the worker status issue for the same type of workers. It cannot be a regular corporate or business tax audit where employee status issues aren't raised.

Third, you can satisfy the reasonable basis rule if you treated workers as independent contractors because you knew that was how a significant segment of your industry treated similar workers. This rule is clear and widely used, but has become controversial. Congress has several times entertained legislation to outlaw this brand of reasonable basis reliance.

Finally, and perhaps most important, you can satisfy the reasonable basis part of the three–part relief test with a catchall "other reasonable basis" category. This catchall could include a legal opinion or less formal advice of a knowledgeable lawyer or accountant who advised you that independent contractor treatment was appropriate for your workers. There are sometimes debatable points in this area, as where a general business lawyer is assisting in setting up the business and drafting contracts, but isn't specifically asked to deal with the worker status question for these particular workers.

2. Substantive Consistency

In addition to having a reasonable basis for your classification decision based on any one of the four established means noted above, the company must have consistently treated the workers (and any similar workers) as independent contractors. The idea is to catch inconsistencies. If you have two process servers on your law firm staff and treat one as an independent contractor and the other as an employee for the same work, your independent contractor treatment is inherently suspect. There are some special rules and interpretations of this substantive consistency requirement, but it is generally straightforward.

3. Reporting Consistency

Finally, you must have reporting consistency, requiring that you must have filed all appropriate tax returns and forms. For most companies, the critical question is whether all appropriate Forms 1099 were filed for independent contractors. As we shall see, this requirement was problematic for Bruecher. Significantly, the IRS must provide taxpayers with written notice of the provisions of Section 530 on or before the commencement of any employment tax audit.

However, this type of due process notice requirement is modified where an audit morphs from a regular personal or corporate tax audit into an audit of employment taxes. Where the portion of an audit involving worker classification issues does not arise until after the examination of the taxpayer has begun, the IRS notice of Section 530 is not required until the worker classification issue is first raised with the taxpayer.

Even that was not done in Bruecher's case. Yet to make Section 530 even arguably applicable, Bruecher needed to prove it filed all Forms 1099. To make that colorable, Bruecher argued there was no time limit on when it could file the Forms 1099. When it filed the Forms 1099 five or six years late, it contended, that satisfied the second Section 530 relief requirement!

In fact, Bruecher had conceded that it was not entitled to Section 530 relief until it had filed the Forms 1099. At the time the tax was assessed, Bruecher had not yet done so, and that made the assessment correct when made. The Court of Appeals declined to address whether Section 530 requires the timely filing of relevant Forms 1099, yet it seemed to have done the equivalent. The fact that Bruecher filed the Forms 1099 after the conclusion of the IRS administrative process (and after the assessment of the tax) prevented Bruecher from successfully raising Section 530 as a defense.

Burden Of Proof

Bruecher also argued that the IRS' failure to comply with Section 530's notice procedures meant that the

usual burden of proof had to be reversed, putting the burden on the government. This was a creative argument, but appeared to have no authority to support it. Besides, Bruecher received the IRS determination as to the non–applicability of Section 530 relief at the conclusion of the audit, and that allowed Bruecher ample time to seek administrative relief. Thus, the court rejected Bruecher's burden of proof argument.

Classifying Workers

The most fundamental part of the *Bruecher* case is whether these construction workers were independent contractors or employees. That, after all, is the substantive issue. Historically, this is determined under common law rules that go back generations. The IRS interpreted the common law criteria and formulated its own 20 factor version in 1987.

There have been suggestions that new and more streamlined tests are necessary. Yet these 20 factors are in some ways intuitive, requiring a facts and circumstances analysis that cannot be shortcut:

1) *Instructions*
The more instructions that are given, the more likely it is that the worker is an employee.
2) *Training*
The more training that is given, the more likely it is that the worker is an employee.
3) *Integration*
The more closely integrated the work is with the employer's business, the more likely it is that the worker is an employee.
4) *Services Rendered Personally*
If the worker must personally do the work, employee status is likely.
5) *Hiring, Supervising & Paying Assistants*
A person who does these things will often be an independent contractor.
6) *Continuing Relationship*
The longer the arrangement's term, the more likely it is that the worker is an employee.
7) *Set Hours Of Work*
Set hours tend to indicate employee status.
8) *Full–time Required*
Working full–time tends to indicate employee status.
9) *Doing Work On Employer's Premises*
Working on the employer's premises tends to suggest employee status.
10) *Order Or Sequence Set*
Performing services in a particular order or sequence set suggests employee status.
11) *Oral Or Written Reports*
Reports to an employer tend to suggest employee status.
12) *Payment By Hour, Week, Or Month*
Payment by the hour, week, or month tends to suggest employee status.
13) *Payment Of Business & Traveling Expenses*
Payment of business and traveling expenses suggests employee status.
14) *Furnishing Of Tools & Materials*
Furnishing significant tools, materials, and other equipment suggests employee status.
15) *Significant Investment*
A worker's significant investment tends to indicate independent contractor status.
16) *Realization Of Profit Or Loss*
A worker's potential to realize a profit or suffer a loss suggests independent contractor status.
17) *Working For More Than One Firm At A Time*
Working for more than one firm at the same time suggests independent contractor status.
18) *Making Service Available To The General Public*
Making services available to the general public on a regular and consistent basis suggests independent contractor status.
19) *Right To Discharge*
The right to discharge a worker suggests employee status.
20) *Right To Terminate*
A worker's right to terminate the relationship without incurring a liability suggests employee status.

How did these construction workers stack up? The Fifth Circuit noted that they had no risk of loss, were not in business for themselves, and had virtually no investment in their facilities or tools. In fact, all indications were that this was simply employment, pure and simple. True, Bruecher maintained only a moderate degree of control over them. Yet they were relatively unskilled and appeared not to require much supervision.

The Fifth Circuit noted that the longevity of the relationship varied from worker to worker, and this factor seemed to be neutral based on the facts. Viewing all the factors together, though, the Fifth Circuit upheld the district court's conclusion that these workers were employees.

Heightened Scrutiny

The potential liability for mischaracterization of workers is already frightening, and it may become even more expensive. There are now proposals to make misclassification

penalties more severe and to give additional procedural advantages in cases of misclassification to the government. There are increased audit programs designed to ferret out problems, and more employers of all sizes are destined to face such battles. Although the pace of change may seem slow, there is substantial impetus to toughen employer liabilities and enforcement.

Drafting worker contracts is difficult, and evaluating which points are more important than others is not easy. In a dispute, it is often not easy to sort out precisely what happened when in the actual operation of the relationship, no matter what the contract may say. There may be no easy way to resolve the inherently factual maelstrom that independent contractor v. employee controversies can become.

Short of treating everyone as an employee, there is no easy solution to this problem. It is clear, though, that many companies do not routinely examine their worker relationships before they are confronted with an outside (IRS or other agency) audit. They should. This is an area in which a little prevention can be better than a cure. ■

Robert W. Wood
Attorney at Law
Wood & Porter, PC
333 Sacramento Street
San Francisco, CA 94111-3601
phone - (415) 834-1800
fax - (415) 834-1888
wood@rwwpc.com
www.woodporter.com