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RECENT DEVELOPMENTS AFFECTING WORKER CLASSIFICATION DISPUTES WITH THE INTERNAL REVENUE SERVICE

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RECENT DEVELOPMENTS AFFECTING WORKER CLASSIFICATION DISPUTES WITH THE INTERNAL REVENUE SERVICE

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I. INTRODUCTION

A. The Issue

1. The Internal Revenue Code (hereinafter "the Code" or "IRC") imposes certain tax obligations on an "employer" of an "employee."

   a. An employer must withhold income tax, FICA tax, and Medicare tax from the wages of employees and pay over those withheld amounts to the Internal Revenue Service (hereinafter "the Service"). IRC § 3402, (Income Tax); IRC § 3101, et seq. (FICA and Medicare).

   b. An employer must also pay the employee's share of FICA and Medicare tax. IRC § 3111.

   c. An employer must also pay FUTA tax on the wages paid to employees. IRC § 3301.

2. However, if an employer's workers are independent contractors, no employment taxes must be withheld from the workers' compensation and the employer is not required to pay the employee's share of FICA or Medicare tax, or to report the compensation for federal unemployment tax purposes.

3. The tax obligations imposed on the employment relationship are the source of tension between business taxpayers and the Service. Because of the perceived tax and other advantages which flow from treating a worker as an independent contractor, the employer and/or the worker may want to classify the worker as an independent contractor. Some of the advantages of independent contractor status are as follows:

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a. The employer-payor avoids withholding and payment obligations and is not required to contribute the employee’s share of FICA and Medicare tax.

b. The employer may save in administrative costs attributable to compliance with the employment tax laws.

c. The employer’s costs attributable to supervising and managing its workers are reduced.

d. Independent contractor status gives an employee greater flexibility in meeting its labor needs.

e. The employer saves on health insurance coverage and on other benefit costs since independent contractors are excluded from employee benefit programs.

f. Independent contractor status excludes a worker from the protection of other statutes like the Fair Labor Standards Act (FLSA), Americans with Disabilities Act (ADA), and the Age Discrimination in Employment Act (ADEA).

g. The independent contractor can claim and deduct business expenses attributable to his or her business on the appropriate federal and state tax returns.

h. Having some or all of its workers classified as independent contractors can make an employer more competitive in its industry.

4. Classifying workers as independent contractors has disadvantages, however.

a. The Service and/or state tax authorities can challenge the workers’ classification and reclassify in appropriate cases resulting in substantial tax deficiencies and other adverse consequences.

b. The employer may subject its qualified plans to disqualification in some cases.

c. The employer may have difficulty in attracting qualified workers in some cases.
d. The independent contractor is more likely to "game" the tax system than a "W-2" employee, particularly where a Form 1099 is not filed for the worker.

e. As evidenced by the recent decision in Vizcaino v. Microsoft Corporation, __F.3d__(9th Cir. October 3, 1996), reprinted in 198 Daily Tax Report K-8 (October 11, 1996), workers incorrectly classified as independent contractors are suing for benefits and stock options offered to employees and receiving favorable decisions on their claims.

B. The Compliance Environment

1. The Internal Revenue Service has struggled for many years to determine when a worker should be treated as an employee for tax purposes.

   a. In July 1984, the Service began its Special Compliance Employment Tax Examination Program in an effort to increase its enforcement efforts in the employment tax area.

      (1) In 1988, the Service reported that, in the first year of the program, 92% of the taxpayers examined on worker classification issues were found to owe additional employment taxes.

      (2) The estimate of revenue loss attributable to improper worker classifications is approximately $2 billion. See, H.Rept. No. 103-861 at 5-6. Note: The annual tax gap attributable to underreporting by independent contractors has been estimated at $20 billion. Id.

   b. In 1988, the Service implemented an audit program, the Employment Tax Examination Program ("ETEP"), to address worker misclassification and other issues. This program has targeted businesses with $3 million or less in assets and is designed to ferret out worker misclassification problems.

2. The efforts by the Clinton Administration and by Congress to reform the health care system brought renewed attention to the problems involved in classifying workers for tax purposes. The
concept of an employer mandate embodied in several of the reform proposals would have put additional pressure on the employee/independent contractor distinction.

3. The Service, in 1994 approximately, announced that it intends to include a review of an employer’s worker classifications as part of its corporate income tax examinations. Most recently, in 1996, Acting Assistant Secretary for Tax Policy, Donald Lubick, has emphasized the need to grapple with the pervasive problem of worker misclassification.

4. Although employment tax audits have generated relatively little commentary when compared to income tax audits, businesses subject to an employment tax audit and to proposed adjustments for failure to properly classify their workers realize very quickly how serious a worker classification dispute can be. If a business employs a significant number of independent contractors and those workers are reclassified as employees for federal employment tax purposes, the resulting tax liability can bankrupt a business and/or place the business at a distinct competitive disadvantage if its competitors are also treating workers as independent contractors.

5. Moreover, if a business has a qualified plan covering its employees, a reclassification of independent contractors as employees may cause the benefit plan to be in violation of the minimum participation requirements of Sections 401(a)(26) and 410(b).1 See, e.g., Kenney v. Commissioner, 70, TCM 614 (1995); Jim’s Window Service v. Commissioner, 33 TCM 563 (1974); Cooley v. United States, 75-2 USTC ¶13,085 (E.D.Tenn. 1985).

   a. If a benefit plan fails to satisfy the minimum participation requirements, income received by the plan’s trust will cease to be exempt. The employer also may lose its deduction for payments made into the plan.

   b. Highly compensated employees may be taxed on any nonforfeitable benefits.

   c. A worker reclassified as an employee may lose his or her ability to establish and maintain a Keogh Plan. Herman v. Commissioner, 52 TCM 1194 (1986); Bilenas v. Commissioner, 47 TCM 217 (1983).

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1/ All statutory references are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.
C. **The Federal Tax Laws - An Overview**

1. The tax obligations imposed on an "employer" of an "employee" under the Code include the following:

   a. An employer must withhold income tax, FICA tax, and Medicare tax from employees' wages and pay over those withheld amounts to the Internal Revenue Service ("the Service"). IRC § 3402 (Income Tax); IRC § 3101 et seq. (FICA and Medicare).

   b. An employer must pay the employer's share of FICA and Medicare tax calculated as a percentage of the wages paid with respect to employment. IRC § 3111.

   c. An employer must also pay FUTA tax on wages paid to employees in an amount equal to a specified percentage of the total wages paid. IRC § 3301.

2. The terms "employer," "employee," and "wages" are critical terms in determining whether there is an obligation to pay the taxes outlined above.

   a. For income tax withholding purposes, the terms are defined by IRC § 3401.

      (1) As a general rule, an "employer" is the person for whom an individual performs or performed any service, of whatever nature, as the person's employee. IRC § 3401(a). However, if the person for whom the service was performed does not control the payment of wages for the services, then the employer is the person having control of the payment. IRC § 3401(d)(1). See also, Reg. § 31.3401(d)(1).

      (2) Under Section 3401(c), an "employee" includes certain people such as an officer of a corporation but is otherwise not defined by statute. However, Reg. § 31.3401(c)-1 provides more detailed guidance concerning who is an employee for withholding tax purposes.
(3) Reg. § 31.3401(c)-1(b) provides, in pertinent part, as follows:

(b) Generally the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is an employer. Other factors characteristic of an employer, but not necessarily present in every case, are the furnishing of tools and the furnishing of a place to work to the individual who performs the services. In general, if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he is not an employee.

(4) The term “wages” is defined by Section 3401(a) to mean all remuneration for services performed by an employee for an employer including the cash value of all remuneration paid other than in cash unless excluded by Section 3401(a)(1)-(20). See also, Reg. § 31.3401(a)-1.

b. For FICA purposes, the terms are defined by Section 3121.

(1) “Employee” means an officer of a corporation, any individual who, under the common law rules applicable in determining whether an employer-
employee relationship exists, has the status of an employee, certain enumerated statutory employees, and any individual who performs services included under an agreement covered by Section 218 of the Social Security Act. IRC § 3121(d).

(2) The term "employer" is not defined by the FICA provisions (chapter 21). However, "employment" is defined. See, IRC § 3121(b) and related regulations.

(3) The term "wages" is defined as all remuneration for employment, including the cash value of all remuneration paid other than in cash unless excluded by Section 3121(a)(1)-(21). IRC § 3121(a).

c. For FUTA purposes, the terms are defined by Section 3306.

(1) The term "employee" has the same meaning as that used for FICA purposes under Section 3121(d) with certain exceptions. IRC § 3306(i).

(2) The term "employer" means any person who during any calendar quarter in the calendar year or the preceding calendar year paid wages of $1,500 or more, or on each of some 20 days during the calendar year or during the preceding calendar year (each day being in a different calendar week, employed at least one individual in employment for some portion of the day. IRC § 3306(a). However, wages paid for domestic services as defined in Section 3306(a)(3) are not taken into account.

(3) The term "wages" is defined by Section 3306(b) in a manner similar to the FICA definition.

3. If a person is an "employee" of an employer, the employer must file timely employment and unemployment tax returns and must pay over withheld income and FICA tax as and when required. If the employer fails to do so, the employer is liable for the tax and interest as well as penalties. See, e.g., IRC §§ 6651, 6656.
4. If an employer fails to deduct and withhold income tax as required by chapter 24 of the Code, and thereafter the tax against which the withheld taxes may be credited is paid, the amount of income tax which should have been withheld will not be collected from the employer (unless Section 3509 applies). IRC §§ 3402(d) and 3509(d)(1).

5. If an employer fails to deduct and withhold income tax as required by chapter 24 (withholding at source) or subchapter A of chapter 21 (employee’s share of FICA) because the worker was treated as independent contractor, the employer’s liability for withholding taxes and the employee’s share of FICA tax is ordinarily determined in accordance with Section 3509(a).

a. Withholding tax is deemed to be equal to 1.5% of wages paid. IRC § 3509(a)(1).

b. FICA tax is deemed to be equal to 20% of the amount imposed under subchapter A of chapter 21. IRC § 3509(a)(2).

c. However, if the employer fails to satisfy the reporting requirements of Sections 6041(a), 6041A, or 6051 with respect to the employee, the amount of tax that the employer is deemed to be liable for doubles unless the failure is due to reasonable cause. IRC § 3509(b).

d. Moreover, if the employer has intentionally disregarded its obligation to withhold, Section 3509 (which is a damage control provision) does not apply.

e. If an employer’s liability for employment taxes is determined under Section 3509,

(1) the employee’s liability for tax is not affected by the assessment or collection of the tax from the employer;

(2) the employer may not recover the tax from the employee;

(3) Sections 3402(d) (credit against required withholding for income tax paid by employee) and 6521 (mitigation of effect of limitations period on
employment tax disputes) do not apply. IRC § 3509(d)(1).

f. Section 3509 does not apply to certain statutory employees described in Section 3121(d)(3) or to an employer who has withheld income tax but not FICA tax. IRC § 3509(d)(2) and (3).

D. Other Federal Laws

1. In addition to the Code, other federal laws impact on the determination of the employment relationship. They include the following:

a. The Fair Labor Standards Act ("FLSA") [Codified at 29 USC § 201 et. seq.];

b. The National Labor Relations Act ("NLRA") [Codified at 29 USC § 151 et. seq.];

c. Title VII of the Civil Rights Act of 1964, as amended ("Title VII") [Codified at 42 USC § 2000(e) et. seq.;

d. The Age Discrimination in Employment Act ("ADEA") [Codified at 29 USC § 621 et. seq.];

e. The Americans with Disabilities Act ("ADA") [Codified at 42 USC § 12101 et. seq.];

f. The Employee Retirement and Income Security Act of 1974 ("ERISA"); and

g. The Immigration Reform and Control Act of 1986 ("IRCA").

2. The existence of an employer-employee relationship is critical to a claimant’s right to assert legal remedies afforded under these statutes.

3. Unfortunately, the determination of what constitutes an employer-employee relationship can differ depending on the statute being invoked and the standard which is applied under the statute to determine if a worker is an "employee."
4. The incorrect classification of a worker as an independent contractor can have financial consequences extending far beyond simply liability for the tax, interest and penalties resulting from the failure to collect and pay over the required employment taxes.

E. State Employment Laws

1. State law defines an employer’s liability for such items as unemployment insurance and workers’ compensation.

2. State law may also include civil rights legislation of various kinds and may impose tort liability on employers for the acts of employees under the doctrine of respondeat superior.

3. State law will often look to the common law test to determine if an employer-employee relationship exists.

II. WHO IS AN EMPLOYEE FOR FEDERAL EMPLOYMENT TAX PURPOSES?

A. The Common-Law Test

1. The federal employment tax laws utilize the common law test for determining when a worker is an employee. IRC § 3121(d)(2); Req. § 31.3121(d)-1(c); Reg. § 31.3306(i)-1; Reg. § 31.3401(c)(1).

2. In 1947, the United States Supreme Court decided two cases which addressed whether certain workers were employees within the meaning of the Social Security Act. The cases were United States v. Silk, 331 U.S. 704 (1947) and Bartels v. Birmingham, 332 U.S. 126 (1947). In Silk and Bartels, the Court articulated the "economic reality" test in determining who was an employee and rejected the idea that control alone dictated whether a worker was an employee. As the Court in Bartels noted,

   ... Obviously control is characteristically associated with the employer-employee relationship but in the application of social legislation employees are those who as a matter of economic reality are dependent upon the business to which they render service. 332 U.S. at 130.

3. The Service promptly moved to revise its employment tax regulations to incorporate the "economic reality" test, a standard
which was even broader than the traditional common law standard. However, Congress in 1948 passed a resolution which tied the definition of employee to the usual common law rules. See, H.J. Res. 296, P.L. 642, 80th Cong. 2d Sess., ch. 468, 62 Stat. 438 (1948). See also, United States v. Thorson, 282 F.2d 157, 159-160 (1st Cir. 1960).

4. The Service and the courts have continued to muddle their way through cases requiring a determination of whether a worker is an employee for employment tax purposes. The efforts have been disjointed and not necessarily consistent. However, the efforts have produced a great deal of verbiage concerning the factors which should be applied in determining if the common law test has been met.

5. The employment tax regulations focus on control. They provide that the relationship of employer-employee exists when the person for whom the service is performed has the right to control or direct the individual who performs the service, not only as to the result but also as to the details and means by which the result is accomplished. Reg. §§ 31.3121(d)-1(c); 31.3306(i)-1; and 31.3401(c)-1. See also, Breaux and Daigle, Inc. v. United States, 89-2 USTC 9536 (E.D.La. 1989), aff'd, 900 F.2d 49 (5th Cir. 1990), where the company who employed workers to pick crab meat was held to have the right to control the workers even though the company did not instruct the workers how to do their job; Rev. Rul. 69-225, 1969-1 CB 256 dealing with control required by regulatory agencies.

6. In Rev. Rul. 87-41, 1987-1 CB 296, the Service attempted to summarize the factors used to ascertain whether sufficient control is present to establish an employer-employee relationship. The factors were drawn from “an examination of cases and rulings considering whether an individual is an employee.” The factors are as follows:

a. Instructions. A worker who is required to comply with other persons’ instructions about when, where, and how he or she is to work is ordinarily an employee. This control factor is present if the person or persons for whom the services are performed have the right to require compliance with instructions. See, for example, Rev. Rul. 68-598, 1968-2 CB 464, and Rev. Rul. 66-381, 1966-2 CB 449.

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b. **Training.** Training a worker by requiring an experienced employee to work with the worker, by corresponding with the worker, by requiring the worker to attend meetings, or by using other methods, indicates that the person or persons for whom the services are performed want the services performed in a particular method or manner. See Rev. Rul. 70-630, 1970-2 CB 229.

c. **Integration.** Integration of the worker’s services into the business operations generally shows that the worker is subject to direction and control. When the success or continuation of a business depends to an appreciable degree upon the performance of certain services, the workers who perform those services must necessarily be subject to a certain amount of control by the owner of the business. See United States v. Silk, 331 U.S. 704 (1947), 1947-2 CB 167.

d. **Services Rendered Personally.** If the services must be rendered personally, presumably the person or persons for whom the services are performed are interested in the methods used to accomplish the work as well as in the results. See Rev. Rul. 55-695, 1955-2 CB 410.

e. **Hiring, Supervising, and Paying Assistants.** If the person or persons for whom the services are performed hire, supervise, and pay assistants, that factor generally shows control over the workers on the job. However, if one worker hires, supervises, and pays the other assistants pursuant to a contract under which the worker agrees to provide materials and labor and under which the worker is responsible only for the attainment of a result, this factor indicates an independent contractor status. Compare Rev. Rul. 63-115, 1963-1 CB 178, with Rev. Rul. 55-593, 1955-2 CB 610.

f. **Continuing Relationship.** A continuing relationship between the worker and the person or persons for whom the services are performed indicates that an employer-employee relationship exists. A continuing relationship may exist where work is performed at frequently recurring although irregular intervals. See United States v. Silk, supra.

g. **Set Hours of Work.** The establishment of set hours of work by the person or persons for whom the services are
performed is a factor indicating control. See Rev. Rul. 73-591, 1973-2 CB 337.

h. Full Time Required. If the worker must devote substantially full time to the business of the person or persons for whom the services are performed, such person or persons have control over the amount of time the worker spends working and impliedly restrict the worker from doing other gainful work. An independent contractor, on the other hand, is free to work when and for whom he or she chooses. See Rev. Rul. 56-694, 1956-2 CB 694.

i. Doing Work on Employer’s Premises. If the work is performed on the premises of the person or persons for whom the services are performed, that factor suggests control over the worker, especially if the work could be done elsewhere. Rev. Rul. 56-660, 1956-2 CB 693. Work done off the premises of the person or persons receiving the services, such as at the office of the worker, indicates some freedom from control. However, this fact by itself does not mean that the worker is not an employee. The importance of this factor depends on the nature of the service involved and the extent to which an employer generally would require that employees perform such services on the employer’s premises. Control over the place of work is indicated when the person or persons for whom the services are performed have the right to compel the worker to travel a designated route, to canvass a territory within a certain time, or to work at specific places as required. See Rev. Rul. 56-694.

j. Order or Sequence Set. If a worker must perform services in the order or sequence set by the person or persons for whom the services are performed, that factor shows that the worker is not free to follow the worker’s own pattern of work but must follow the established routines and schedules of the person or persons for whom the services are performed. Often, because of the nature of an occupation, the person or persons for whom the services are performed do not set the order of the services or set the order infrequently. It is sufficient to show control, however, if such person or persons retain the right to do so. See Rev. Rul. 56-694.
k. **Oral or Written Reports.** A requirement that the worker submit regular or written reports to the person or persons for whom the services are performed indicates a degree of control. See Rev. Rul. 70-309, 1970-1 CB 199, and Rev. Rul. 68-248, 1968-1 CB 431.

l. **Payment by Hour, Week, Month.** Payment by the hour, week, or month generally points to an employer-employee relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed upon as the cost of a job. Payment made by the job or on a straight commission generally indicates that the worker is an independent contractor. See Rev. Rul. 74-389, 1974-2 CB 330.

m. **Payment of Business and/or Traveling Expenses.** If the person or persons for whom the services are performed ordinarily pay the worker’s business and/or traveling expenses, the worker is ordinarily an employee. An employer, to be able to control expenses, generally retains the right to regulate and direct the worker’s business activities. See Rev. Rul. 55-144, 1955-1 CB 483.

n. **Furnishing of Tools and Materials.** The fact that the person or persons for whom the services are performed furnish significant tools, materials, and other equipment tends to show the existence of an employer-employee relationship. See Rev. Rul. 71-524, 1971-2 CB 346.

o. **Significant Investment.** If the worker invests in facilities that are used by the worker in performing services and are not typically maintained by employees (such as the maintenance of an office rented at fair value from an unrelated party), that factor tends to indicate that the worker is an independent contractor. On the other hand, lack of investment in facilities indicates dependence on the person or persons for whom the services are performed for such facilities and, accordingly, the existence of an employer-employee relationship. See Rev. Rul. 71-524. Special scrutiny is required with respect to certain types of facilities, such as home offices.

p. **Realization of Profit or Loss.** A worker who can realize a profit or suffer a loss as a result of the worker’s services (in
addition to the profit or loss ordinarily realized by employees) is generally an independent contractor, but the worker who cannot is an employee. See Rev. Rul. 70-309. For example, if the worker is subject to a real risk of economic loss due to significant investments or a bona fide liability for expenses, such as salary payments to unrelated employees, that factor indicates that the worker is an independent contractor. The risk that a worker will not receive payment for his or her services, however, is common to both independent contractors and employees and thus does not constitute a sufficient economic risk to support treatment as an independent contractor.

q. **Working for More Than One Firm at a Time.** If a worker performs more than de minimis services for a multiple of unrelated persons or firms at the same time, that factor generally indicates that the worker is an independent contractor. See Rev. Rul. 70-572, 1970-2 CB 221. However, a worker who performs services for more than one person may be an employee of each of the persons, especially where such persons are part of the same service arrangement.

r. **Making Service Available to General Public.** The fact that a worker makes his or her services available to the general public on a regular and consistent basis indicates an independent contractor relationship. See Rev. Rul. 56-660.

s. **Right to Discharge.** The right to discharge a worker is a factor indicating that the worker is an employee and the person possessing the right is an employer. An employer exercises control through the threat of dismissal, which causes the worker to obey the employer’s instructions. An independent contractor, on the other hand, cannot be fired so long as the independent contractor produces a result that meets the contract specifications. Rev. Rul. 75-41, 1975-1 CB 323.

t. **Right to Terminate.** If the worker has the right to end his or her relationship with the person for whom the services are performed at any time he or she wishes without incurring liability, that factor indicates an employer-employee relationship. See Rev. Rul. 70-309.
See also, IRM, ch. 4600, Employment Tax Procedures.

6. As Acting Assistant Secretary Lubick recently noted, the 20 factors set forth in Rev. Rul. 87-41 were designed as a guide in analyzing the facts and circumstances of particular cases. The critical issue in any application of the common law test for employee status is whether the requisite level of control existed.

III. THE SPECIAL SAFE HARBOR PROVISIONS OF SECTION 530 AS AMENDED BY THE SMALL BUSINESS JOB PROTECTION ACT OF 1996

A. Background

1. Prior to 1978, the Service was aggressively auditing employers to correct perceived abuses in worker classifications.

2. The number of business involved as well as the size of the proposed employment tax assessments apparently engendered complaints by the business community to Congress. See, e.g., S. Rep. No.1263, 95th Cong., 2d Sess. 209-11 (1978).

3. In 1978, Congress enacted what was supposed to be a temporary relief provision which provided safe harbors to prevent the Service from reclassifying workers as employees in certain circumstances. Revenue Act of 1978, Pub.L. No.95-600, § 530, 92 Stat. 2763 [hereinafter Section 530].

4. Section 530 was intended as a temporary measure while Congress resolved the complex issues involved in the employee versus independent contractor battle.

5. Unfortunately, Congress did not create a new or clearer test. Rather, it extended the safe harbor provisions of Section 530 and ultimately made them permanent in 1982. Congress also enacted Section 3508 to set forth the requirements for real estate agents and direct sellers of consumer goods to be treated as independent contractors and Section 3509 which limits the amount of tax liabilities that can result from the reclassification of independent contractors as employees.

7. In 1996, Congress again modified Section 530 in response to concerns that Section 530 was not being applied properly by the Service and/or the courts.

B. Section 530 In Operation Prior to Amendment by the 1996 Act

1. This "off-Code" provision was enacted as part of the Revenue Act of 1978 to prevent the Service from retroactively reclassifying a worker as an employee who was not treated as an employee for tax purposes for any period ending before January 1, 1980 unless the employer had no reasonable basis for the classification.

2. Section 530(a) (codified at 26 USC § 3401 note) provides that, if a taxpayer did not treat an individual as an employee for federal employment tax purposes, and all federal tax returns for periods after December 31, 1978 required to be filed with respect to such individual are filed on a basis consistent with the taxpayer's treatment of the individual, the individual shall be deemed not to be an employee unless the taxpayer had no reasonable basis for the treatment.

3. The Reasonable Basis Requirement. Under Section 530, a taxpayer must be treated as having a reasonable basis for not treating an individual as an employee if the taxpayer's treatment was in reasonable reliance on any of the following:

   a. judicial precedent, published rulings, technical advice with respect to the taxpayer, or a letter ruling to the taxpayer;

   b. a past IRS audit of the taxpayer in which there was no assessment attributable to the treatment of individuals holding substantially similar positions for employment tax purposes;

   c. long-standing recognized practice of a significant segment of the industry in which such individual was engaged. Section 530(a)(2). See also, Rev. Proc. 85-18, 1985-1 CB 518.

4. The safe havens set forth in Section 530(a)(2) are not the only ways of establishing a reasonable basis. A taxpayer who can demonstrate a reasonable basis in some other way can qualify for relief under Section 530(a)(1). H.R. Rep. No. 95-1748, 95th Cong., 2d Sess. 3-4 (1978). See also, Rev. Proc. 85-18, 1985-1 CB
518, Sec. 3.01 (1985); American Institute of Family Relations v. United States, 79-1 USTC ¶9364 (C.D. CA. 1979); Queensgate Dental Family Practice, Inc. v. United States, 91-2 USTC ¶50,536 (M.D. Pa. 1991).

5. A taxpayer may establish that it has a reasonable basis for not treating a worker as an employee by utilizing the traditional common law rules for determining whether workers are employees or independent contractors. Critical Care Registered Nursing, Inc. v. United States, 776 F. Supp. 1025 (E.D. Pa. 1991), non-acq. 1994-32 IRB 4. However, a taxpayer using the common law rules need only show that its treatment was reasonable. Id. Note: The Court in Critical Care rejected the Service’s argument that a taxpayer must prove “reasonable basis” by a preponderance of the evidence and found that a lesser standard of proof was appropriate. 776 F. Supp. at 1028.


7. The Consistent Treatment Requirement. The employer must establish that it has not treated the worker as an employee.

a. The employer must establish that it did not treat the worker for whom safe harbor protection under Section 530 is sought as an employee for employment tax purposes for any period. Section 530(a)(1).

(1) Revenue Procedure 85-18, 1985-1 CB 518 provides that the withholding of either income tax or FICA tax from a worker’s wages or the filing of employment tax returns including the worker constitutes “treatment” of the worker as an employee.

(2) However, filing of a delinquent return or an amended return as a result of a compliance initiative by the Service does not constitute “treatment” of the worker as an employee. Id.
b. For all periods after December 31, 1978, all federal tax returns (including Form 1099) required to be filed by the employer with respect to the worker must report the worker consistently as an independent contractor, and not as an employee. Section 530(a)(1)(B).

c. For any period ending after December 31, 1978, the employer must not have treated any worker holding a "substantially similar position" as an employee for federal employment tax purposes for any period ending after December 31, 1977. Section 530(a)(3).

(1) The critical issue here is what test is applied to determine if a position is "substantially similar".

(2) The test can focus on the nature of the services provided or the nature of the worker's relationship to the employer's business. See, e.g., TAM 8616002 which focused on both areas.

d. An employer may lose its ability to satisfy the consistent treatment requirements of Section 530 through a well intentioned but uninformed attempt to respond to the Service's audit concerns. See, e.g., Institute for Resource Management, Inc. v. United States, 90-2 USTC ¶50,586 (Cl.Ct. 1990); Rev. Rul. 85-18, 1985-1 CB 518, 519.


9. However, the Service has taken the position that there must first be a determination of whether a worker is an employee under the common law test before a Section 530 determination is made. TAM 9410005 (March 1994).

C. Section 530 As Amended by the 1996 Act

1. Section 1122 of the Small Business Job Protection Act of 1996 amended Section 530 in several material respects.
a. It added subsection (e) which sets forth several new rules that will affect the application of Section 530 prospectively. They are as follows:

1. At the commencement of an audit inquiry regarding the classification of a worker, the Service must give notice to the taxpayer of the provisions of Section 530. Section 530(e)(1) as amended.

2. A taxpayer may not rely on any audit commenced after December 31, 1996 in order to use the “prior audit” safe harbor of Section 530(a)(2)(B) unless the audit included an examination for employment tax purposes of whether the worker (or a worker in a substantially similar position) should be treated as an employee. Section 530(e)(2)(A) as amended.

3. The long-standing recognized practice requirement of Section 530(a)(2)(C) shall not be construed (as the Service had required previously) (i) as requiring the practice to have continued for more than 10 years, and (ii) as requiring that a practice must have been in existence before 1978. Section 530(e)(2)(C) as amended.

4. The “significant segment” requirement of Section 530(a)(2)(B) does not require a reasonable showing of the practice of more than 25% of the industry. Section 530(e)(2)(B) as amended.

5. In order for Section 530 relief to apply, it is not necessary that the worker must qualify as an employee. Section 530(e)(3) as amended.

6. The burden of proof which is imposed in Section 530 disputes is clarified.

(a) If the taxpayer establishes a prima facie case that it was reasonable not to treat the worker as an employee, and if the taxpayer has fully cooperated with reasonable requests from Service personnel, then the burden of proof with respect to such treatment is on the Service. Section 530(e)(4)(A) as amended.
(b) If a taxpayer is claiming that it had a reasonable basis for not treating the worker as an employee, the rules set forth above apply only with respect to Section 530(a)(2)(A), (B) or (C).

(7) Even if a taxpayer treated a worker as an employee for a subsequent period, this fact will not deprive the taxpayer of its right to claim Section 530 relief for prior periods if the requirements for relief are otherwise met. Section 530(e)(5) as amended.

(8) In determining whether a worker holds a position "substantially similar" to another, the relationship between the taxpayer and such individuals shall be considered. Section 530(e)(6) as amended.

b. The effective dates of the amendments to Section 530 are as follows:

(1) In general, the amendment to Section 530 applies to periods after December 31, 1996.

(2) The notice requirement of Section 530(e)(1) applies to audits commenced after December 31, 1996.

(3) The burden of proof rules of Section 530(e)(4) apply to disputes involving periods after December 31, 1996 and shall not be "construed to infer the proper disposition of burden of proof issues in disputes involving periods before January 1, 1997."

IV. OTHER RECENT DEVELOPMENTS

A. Court Decisions


2. *Arndt v. United States*, 78 AFTR 2d ¶96-5325 (D.C. Fla. 8/12/96)

4. In *Lee v. United States*, 74 AFTR 2d ¶ 94-5720 (W.D.D.C. Tx. 1994), the United States District Court for the Western District of Texas held that an employer who manufactured clothing using "piece workers" as part of his labor force was entitled to summary judgment on the grounds that (1) the piece workers had a "substantial investment in facilities used in connection with the performance of" the services within the meaning of Section 3121(d)(3); and (2) the employer, in any event, was entitled to Section 530 relief.

5. In *Weber v. Commissioner*, 103 T.C. No. 19 (1994), the Tax Court ruled, in a test case for the United Methodist ministers, that a pastor was an employee of the United Methodist Church and, consequently, was not in a trade or business permitting the use of a Schedule C.

6. In contrast, the Tax Court in *Shelley v. Commissioner*, T.C. Memo 1994-432 held that an ordained minister and pastor of the Christian Heritage Church was an independent contractor entitled to file a Schedule C. The critical common law factors emphasized by the Court were the lack of supervision and control by the church board, the pastor’s ability to hire and fire staff, and his right to seek additional work outside the church.

7. In *In re Bentley*, 94-2 USTC ¶ 50,560 (E.D. Tenn. 1994), aff’d. 94-1 USTC ¶ 50,140 (B.Ct. E.D. Tenn. 1994), the United States District Court affirmed the Bankruptcy Court’s order granting summary judgment in favor of the debtors on the issue of whether they were entitled to relief under Section 530 from the alleged misclassification of its truck drivers as independent contractors. The Court determined that the debtors reasonably relied upon the practice of a “significant segment of the industry” in classifying its drivers as independent contractors. The proof in support consisted of two affidavits -- one from the debtor and one from the owner of a bookkeeping business with a number of clients involved in the trucking business. The Service offered the affidavit of a truck company owner who stated that he had treated his drivers as employees since 1983 and that others in the industry did as well. However, the Court rejected the Service’s argument that a “significant segment of the industry” meant a majority of the industry.

(11th Cir. 4/10/95), the Tax Court held that an agent of Allstate Insurance Company was an independent contractor and, therefore, entitled to report his business income and expenses on Schedule C. See also, Smithwich v. Commissioner, T.C. Memo 1993-582, 66 TCM (CCH) 1545 (1993), aff’d, ___ F.3d ___, 72 DTR K-4 (April 14, 1995) (11th Cir. 4/10/95); Mosteirin v. Commissioner, No. 3996-94 (U.S. Tax Ct., Jan. 13, 1995).

B. Administrative Developments

1. In May 1994, the Service issued its first guide or “market segment understanding” on worker classification geared to a specific industry. The guide entitled “Classification of Workers Within the Television Commercial Production and Professional Video Communication Industry” was developed in conjunction with representatives of the affected industries and purports to tell IRS personnel and employers how to apply the common law test to the specific facts and circumstances of the industry.

2. Announcement 96-13 -- Employment Tax Early Referral Procedures

a. In Announcement 96-13, 1996-12 IRB ___ (March 18, 1996), the Service announced that it was extending the early referral procedures outlined in Rev. Proc. 96-9, 1996-2 IRB 15, to employment tax issues for a one-year test period beginning on March 18, 1996.

b. Under Announcement 96-13, a taxpayer may request early referral “of any developed unagreed employment tax issue that is under the jurisdiction of the District Director arising from an audit.”

c. Examples of appropriate early referral issues include --

(1) whether a worker is employee or independent contractor;

(2) whether Section 530 of the Revenue Act of 1978 applies;

(3) whether Section 3509 applies in calculating the amount of employment tax due, if any;
whether the taxpayer qualifies for relief from interest under Section 6205.

d. The procedures set forth in Rev. Proc. 96-9 must be followed to request early referral of an employment tax issue.

e. If an early referral request is approved, the District will issue an employment tax report for each approved early referral issue. The taxpayer must then respond in writing. The writing must contain information similar to that required in a protest.

3. The Classification Settlement Program ("CSP")

a. The Classification Settlement Program, also announced in March 1996, "establishes new procedures under an optional classification settlement program that will allow businesses and tax examiners to resolve worker classification cases as early in the administrative process as possible."

b. The CSP works as follows:

(1) When it appears that a business may have erroneously treated a worker as an independent contractor, the examiner will develop the issue including whether Section 530 relief is appropriate.

(2) The examiner then will consult with his/her group manager who, after reviewing the facts of the case, will confirm the business’ eligibility for CSP.

(3) A series of graduated settlement offers are available under CSP:

(a) If the business satisfies the reporting consistency requirement of Section 530 but does not satisfy clearly the substantive consistency requirement or the reasonable basis test, the offer will be a full employment tax assessment for one taxable year computed using Section 3509 if applicable.
(b) If the business meets the reporting consistency requirement and has a "colorable" argument that it meets the other requirements of Section 530, the offer will be an assessment of 25% of the employment tax liability for the audit year.

Note: If each of the cases set forth above, a prerequisite to settlement is that the business must agree to classify its workers properly as employees prospectively.

(c) If the business clearly meets the requirements of Section 530, no assessment will be made and the business may choose to continue treating its workers as independent contractors.

Note: If, however, the business prefers to treat the workers as employees prospectively, an agreement for prospective treatment will be made available.

4. On August 2, 1996, the Service issued the final version of Worker Classification training materials. The materials are published in 150 Daily Tax Report L-1 et seq. (August 5, 1996).