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HIGHLIGHTS

VIEWPOINT: No Good Deed Unpunished in Independent Contractor Wars
CPAs Michael J. Knight and Edgar Gee write that the American Institute of Certified Public Accountants has totally abdicated its role as representative of the small business CPA community in its refusal to acknowledge the role of Section 530 in the new IRS worker classification audit initiative. ''This abdication occurs over an issue that significantly affects all small businesses and jeopardizes their existence,'' they say. The authors in 1999 lauded changes in IRS's interpretation of the employment laws that represented a significant victory for businesses that use independent contractors. Now, they write, ''The pendulum has swung back. Maybe it had never moved.'' **J-1**

JCT Says Proposed Tax on Unearned Income Would Raise $184 Billion
An analysis from the Joint Committee on Taxation shows that President Obama's proposal to impose a new Hospital Insurance tax on unearned income would replace the ''Cadillac'' plan tax as the main revenue source for a health care overhaul, producing $183.6 billion in new revenues over 10 years. The changes to the Hospital Insurance tax would levy a new 2.9 percent tax on income from interest, dividends, annuities, royalties, rents, and other unearned income for individuals earning more than $200,000 per year ($250,000 for joint filers). The analysis is released by the Senate Republican Policy Committee. White House officials say Obama's proposal would be more fair to everyone because it would subject all high-income people to the tax, regardless of how they receive their income. Meanwhile, President Obama's six-hour health care summit with members of Congress provides an opportunity to renew discussions of controversial issues, but produces no new breakthroughs to allow the bill to move forward in Congress. **G-8**

Neal Says Only TARP Recipients Should Face Proposed Bank Penalty Taxes
Firms that did not receive bailout funds under the Troubled Asset Relief Program should not be subject to the so-called bank tax, says House Ways and Means Select Revenue Measures Subcommittee Chairman Neal. Moreover, Neal tells a Tax Council Policy Institute conference, he thinks Ways and Means Chairman Rangel agrees with his position for the moment. ''I don't think that companies who didn't take the TARP money should be penalized,'' Neal says of the 0.15 percent fee on all covered liabilities held by financial institutions with assets of $50 billion or more to be collected by IRS. **G-1**

Shay Says U.S. Tax Policy Must Reflect Unique Economy, Legal System
Debate over the extent to which U.S. policymakers should be guided by the tax policies of other countries has to take into account the fundamental differences between those countries and the United States, a senior Treasury official says. ''The United States has been accused of tax exceptionalism and tax isolationism,'' Stephen E. Shay, deputy assistant treasury secretary for international tax affairs, says during an International Fiscal Association USA Branch conference. But the economic and legal context in which the United

TEXT

HEALTH CARE: JCT very preliminary estimate of revenue provisions (Title IX) of president's latest health care reform package, as released by Senate Republican Policy Committee. **TaxCore**

TAX EXCLUSIONS: Transcript of Feb. 23 IRS hearing on proposed rules (REG-127270-06) on exclusion from gross income of damages received for personal physical injuries, physical sickness. **TaxCore**

CORPORATE TAXES: IRS correcting amendment to final, temporary regulations (T.D. 9477) on Section 304 transactions that avoid treatment of corporation as issuing corporation. **TaxCore**

EXPATRIATION: Latest IRS quarterly publication of individuals who have chosen to expatriate as required by Section 6039G. **TaxCore**

IRS: IRS notice of recruitment for TAP membership. **TaxCore**

TRANSPORTATION: Surface Transportation Board final rules on annual submission of tax information for use in revenue shortfall allocation method. **TaxCore**

BONDS: Sen. Grassley letter to Goldman Sachs Group Inc. regarding subsidy levels and underwriting fees for Build America Bonds. **TaxCore**

EXCISE TAXES: Treasury report on lost federal tobacco receipts because of illicit trade. **TaxCore**

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Back to the Future: How No Good Deed Goes Unpunished in the Independent Contractor Wars

By Michael J. Knight and Edgar Gee

The American Institute of Certified Public Accountants has totally abdicated its role as representative of the small business CPA community in its refusal to acknowledge the role of Section 530 in the new Internal Revenue Service worker classification audit initiative.

The authors in 1999 lauded changes in IRS's interpretation of the employment laws that represented a significant victory for businesses that use independent contractors. Now, they write, "The pendulum has swung back. Maybe it had never moved."

This abdication occurs over an issue that significantly affects all small businesses and jeopardizes their existence. As to why we make such a bold statement, let us review the history.

Michael J. Knight is managing partner with Michael J. Knight & Co. CPAs in Fairfield, Conn., and Edgar Gee is a CPA in Knoxville, Tenn. Knight was the plaintiff in the recent U.S. Supreme Court case Knight v. Commissioner.

The Future Looked Bright

"I'm from the IRS and I'm here to help"—unfortunately, the joke is on us. We have previously written[*] how changes, beginning in 1995, to IRS's stringent and biased interpretation of the employment laws represented a significant victory for businesses that use independent contractors. No longer would they live in fear that an uneducated former tax collection employee can put them out of business with draconian assessments of delinquent employment taxes.

In fact, we were buoyant that finally the practitioner and his client had a level playing field. We based this optimism on the following points:

- In 1995, *McClellan v. United States* (E.D. Mich.), established the principal that once a taxpayer made a prima facie case for independent contractor status, the burden of proof shifts to IRS to refute the evidence or concede the case.
- In 1996, the Worker Classification Training Manual was produced, which changed the old fashioned 20-factor test for worker classification to a three-pronged one described as behavioral control, financial control, and relationship of the parties. In addition, numerous examples and admonishment cautioned IRS to respect and treat fairly almost to the point of a presumptive test in favor of the taxpayer who uses independent contractors.
- Coterminous with the training manual, IRS introduced a new settlement program that allowed agents in the field to settle a case based on one of three classifications. The first prong of this classification settlement

[*] "Independent Contractor or Employee: How the Process Works Today," New York State Society of CPAs, *The CPA Journal*, December 1999.

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program (CSP) again reiterated the right of the taxpayer to utilize independent contractors and to avail themselves of Section 530 relief.

■ Also in 1996 as a result of the above, the new Small Business Job Protection Act of 1996 codified the prima facie and shifting of the burden of proof procedures that the *McClellan* case introduced. This act also made Section 530 of the 1978 Act an official part of the Internal Revenue Code.

■ In 1998, the Taxpayer Bill of Rights 2 allowed for punitive damages where an IRS agent does not follow the service's own promulgated guidelines. This raised hope in practitioners' eyes since the items listed above would appear to have set a road map for both parties to follow.

■ Also in 1998, Congress passed the IRS Reform and Restructuring Act of 1998, which solidified the shifting of the burden of proof at trial to all areas of the tax code—not just employment tax—and subjected individual agents and IRS to lawsuits where abusive procedures are used against taxpayers.

Against this backdrop, we optimistically stated ''Institutions and bureaucracies change slowly . . . gradually . . . grudgingly . . . they do change.''

How Wrong We Were

The pendulum has swung back. Maybe it had never moved.

Our previous article, in 1999, *Independent Contractor or Employee: How the Process Works Today*, which won the New York Society of CPAs Max Block Award for article of the year, lauded the changes. Unfortunately, it is now ''back to the future,'' with frightening repercussions to the taxpayer and the independent contractor as if the beneficial changes of 1995 through 1998 never happened.

The Systemic Cultural Bias

In spite of the laudatory statements in the IRS Worker Classification Manual about fairness and objectivity for independent contractors, the IRS agent is always fed contradictory messages.

At the lowest levels this comes in the form of biased if not outright hostile comments in Market Segment Specialization Program (MSSP) writings. We have inquired many times as to how the MSSPs seem to contradict the manual, SBJPA of 1996 legislative intent, etc., and the answer to this is that the MSSP is written by separate groups who have no real knowledge of the new independent contractor rules.

In this day and age where agencies realize they must share information so everyone is on the same page and dealing with the same facts, this is a scary and downright unacceptable answer.

Thus, in the real world, it comes down to a game of cards—who trumps who. An agent throws down an MSSP guideline. Taxpayer throws down worker training manual. Agent throws down classification settlement program. Taxpayer throws down *McClellan*. Agent says it does not apply. Taxpayer throws down the law, the SBJPA of 1996. Agent says he must check with his supervisor, which usually means the IRS Office of Chief Counsel.

Fold the cards and the game is over, because it is at this highest level that the punishment really begins.

Counsel's Office Punishment

The authors have reviewed an instruction manual written by the Chief Counsel's Office for training of agents in independent contractors cases. It is a frightening document laden with hostility and admonishments to agents of how to entrap taxpayers who use independent contractors.

On numerous occasions, the authors have attempted to discover if this material has been officially rescinded since changes in the law make its contents obsolete. The fact is it has not. In fact, it has been verbally stated to one of the authors from the counsel's office that they do not believe in the law of the Small Business Job Protection Act of 1996.

As abhorrent as that is, it only proves the point that the authors are trying to make, there is a cultural and institutional bias that permeates the agency that all the laws in the world cannot change.

The Punishment in the Field

Even if a taxpayer and the representative are lucky enough to encounter an agent well versed in the new law, the twisting and contorting of the law to fit these preordained biases show through. A number of recent cases that the authors have experienced illustrate the point.

In one case, an abundance of evidence pointed to the fact that the taxpayers' use of independent contractor status was standard for the industry. Although the case was won using Section 530 case law, the service was adamant about not agreeing to the industry standard exception.

Of course, a client is happy to get a no change audit without understanding the nuances of why. But the enduring question is . . . why the aversion by IRS to granting no changes under the industry standard exception of Section 530? Would that make too objective of a standard, thereby taking away subjective arguments by the service because vague is better? Or is it fear that if enough taxpayers win based on an objective criteria, industry standard, the services ability to browbeat another taxpayer in the same industry would be lost?

The enduring question is . . . why the aversion by IRS to granting no changes under the industry standard exception of Section 530?

Or consider the case where the agent ran roughshod over the taxpayer's rights, ignoring every and all aspects of the new law requiring at the outset that the agent consider Section 530. One of the authors was called in midway through this abuse. In spite of the obvious violations, supervisors never punished the examining agent and forced the taxpayer to a classification settlement option No. 2—prospectively reclassing the worker. We advised against this but since the worker was retiring, the taxpayer just wanted the case to end with no penalties.

A third case involves the obdurate refusal by IRS to accept any type of evidence such that the burden of

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proof shifts to IRS, even after it concedes that the taxpayer meets the first two prongs of Section 530—reporting consistency and substantive consistency. This blatant refusal to follow the law flaunts legislation and should invite a Treasury Inspector General for Tax Administration investigation.

Classification Settlement Program Punishment

Turning the Very Rule Designed To Assist Taxpayers Against Them

With IRS, of course, nothing is what it seems. Like Alice in Wonderland, you can never be sure that the reflection in the mirror is really you.

The CSP has three prongs—the first of which takes the agent through the mandatory relief of Section 530 if the taxpayer ''clearly meets'' the criteria. Never in any of the authors' experience have the agents adhered to the first prong. They always offer the CSP option only if you decide to convert the workers to employees.

So the very tool that was to allow agents to settle a case at the earliest point in the audit is used against the taxpayer under a misapplication of the program.

The Appeals Punishment

Exam agents do not consider the hazards of litigation. Their primary role is to make adjustments mainly based on documentary evidence (or their rejection of such) submitted by the taxpayer or representatives. Representatives should always request meetings with the agent's supervisors if an agent displays a lack of knowledge of the law or disregards the evidence.

Supervisors may or may not support an agent, depending on the supervisor's knowledge, experience, and training. Unfortunately, despite IRS's reassurances publicly and to Congress, not all supervisors or agents are currently trained in the worker classification training. They may be trained in CSP, which does not take into consideration ''prima facie cases'' and shifts of the burden of proof to IRS.

Again, the procedures used by IRS to prosecute independent contractor cases, by ignoring prima facie evidence, do not reflect the avowed intent of Congress in the 1996 act and prior congressional directives to liberally construe the law in favor of taxpayers.

So what about appeals you ask? Surely, appeals (an independent function according to IRS) will consider the evidence and law, you say. All too often it has been the authors' experience that appeals conferees use the appeals hearing as an early attempt (and poorly veiled) at pretrial discovery—something it is not supposed to be.

Consider the following directives given to appeals conferees by IRS. Under Section 530 cases, ''where hazards [to the IRS] exist, there are a number of 'chips' which can be played, dependent on the type and degree of hazard present.'' This begs the questions: What about a search for the truth? When did playing ''chips'' replace the government's quest for the only thing it should be searching for—the truth?

Additionally, from the same IRS directives to appeals conferees, this is under resolutions: ''If the hazards to the government are substantial [more in favor of the taxpayer than the service], another important 'chip' may be available. Other than full concession of the issue by the government, concession of the tax for the years at issue, as well as intervening years, could be conceded in exchange for the prospective treatment of the workers as employees.''

In other words, IRS directs its appeals officers to try to get taxpayers (even when the taxpayer/representatives have already proven their case) to convert workers to employees in exchange for IRS dropping the case. Judge Clay Land talks about this kind of treatment below.

Curing the Affliction

What further changes are required, on top of the ones already mentioned, which initially we thought were quite enough, to eliminate this bias? Unfortunately, perhaps nothing will.

Judge Land, in *Howard H. Callaway Foundation Inc. v. United States* (M.D. Ga. 7/20/02), in awarding attorneys' fees to the taxpayer, stated that ''Nowhere is the federal government's mighty hand felt more directly then when the Internal Revenue Service comes calling with a demand for unpaid taxes. . . . When the power is unleashed in an inconsistent, threatening, and arrogant manner, the powerless taxpayer, who for all practical purposes is at the mercy of the government has little recourse to remedy such abuses.''

Further on, the judge continues, ''Defendants' 'trust us, we're from the IRS' argument ignores both common sense and Plaintiff's own personal unpleasant experience with Defendants error-prone bureaucracy.''

However, we offer the following as recommendations for IRS to regain our trust:

- Remove training from its current position to outside professionals (outside IRS), such as attorneys and accountants, to instruct agents in actual applications of Section 530. This would cut training time in half or better. The government relies on outside independent providers in almost all areas. Why not in the training of its own agents?
- Remove the Office of Chief Counsel from all cases unless already docketed for trial. The scent of counsel advice permeates appeals (and supervisors) all too often to render a fair hearing to taxpayers. ''Liberally in favor of taxpayers'' is an alien concept to the Office of Chief Counsel, and as such that office should not be involved at either exam or review or appeals.
- Abolish the SS-8 units. These units make a ''determination'' using Form SS-8 that only incorporates the old 20-factor common law analysis, never considers Section 530, and almost never rules in favor of independent contractor status. Can one side (the SS-8 unit) always be 90 percent correct? Why do we allow this?
- Consider allowing the IRS Oversight Board to review independent contractor cases after appeals but before docketing for court, with the authority to send cases back for further review by an independent appeals officer (or another appeals jurisdiction not previously involved). If this second review favors the taxpayers position, IRS would not further pursue the case against the taxpayer.
- Accounting fees should be awarded at the audit level where the abuse first occurs. Only then might there be can incentive for an agent to be ''objective'' in evaluating worker status.

These solutions are workable, common-sense approaches to overhaul the process from inception (training) to conclusions (settlement or ''no-change'') that will restore the public and taxpayers' confidence that they can deal fairly with the government and the government will deal fairly with its law-biding taxpaying citizens and their representatives.

Conclusion

If the AICPA is to ask CPAs to be a part of the organization, the CPAs also have an obligation. CPAs might ask, ''When will you represent us in our hour of need?''

IRS, if not following the Section 530 rules at the beginning of these new worker classification audits, will be totally ignoring the rules that have been promulgated that before an audit begins, Section 530 must be considered first. That is the law.

When this was brought to the attention of our own organization, the AICPA, to intercede on CPAs' behalf to make sure IRS follows procedure, the answer was, ''Let's wait and see.''

Let's not. Let's all follow the rules.

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