How to Shift the Burden of Proof to the IRS on Independent Contractor Status

The Small Business Job Protection Act of 1996 (SBJPA) clarified and modified Section 530 of the Revenue Act of 1978 to provide more uniform standards on the classification of workers. After 1996, if a taxpayer makes a *prima facie* case for independent contractor treatment, the burden of proof shifts to the IRS to show that the workers are employees. This article examines this favorable new provision, as well as the Taxpayer Relief Act of 1997's provision allowing Tax Court review of an unfavorable IRS determination regarding employee status.

Prior to the enactment of the Small Business Job Protection Act of 1996 (SBJPA), Section 530 of the Revenue Act of 1978 (Section 530) prevented the IRS from arbitrarily retroactively reclassifying a business's workers as employees if the business (1) treated all similar workers as independent contractors (substantive consistency), (2) filed all proper Federal tax documents (e.g., Forms 1099) on a basis consistent with the treatment as nonemployees (reporting consistency) and (3) had a "reasonable basis" for the nonemployee classification. For this purpose, a "reasonable basis" consisted of:

- ☐ Judicial precedent, published rulings, or technical advice, letter rulings or a determination letter to the taxpayer.
- ☐ A past IRS audit (whether or not an employment tax audit) of the taxpayer in which no assessment of employment taxes was made on similarly treated individuals.
- ☐ A "long-standing" recognized practice of a "significant" segment of the taxpayer's industry (neither term was defined).
- ☐ Any other reasonable basis.

While Section 530 provided some guidance, it did not (1) address the taxpayer's burden of proof in demonstrating a reasonable basis for treating a worker as an independent contractor, (2) require the IRS to notify an employer of Section 530's requirements either before or during the course of an audit involving the classification issue or (3) address whether relief was available only after the IRS determined that a worker was an employee under common-law standards.

Need for Further Legislation

Although the courts had addressed some of these issues, sufficient controversy continued to exist prior to the enactment of the SBJPA such that Congress found it necessary to make amendments to Section

EXECUTIVE SUMMARY

- The IRS must now provide a taxpayer with written notice of the provisions of Section 530 before or at the start of any audit relating to the employment status of an individual who performs services for the taxpayer.
- If the taxpayer fully cooperates with reasonable requests for information from the IRS and establishes a *prima facie* case for treating the worker as an independent contractor, the burden of proof falls on the IRS to show such classification was unreasonable.
- Safe harbors are provided for meeting Section 530's industry practice test.

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530. The SBJPA Senate Report notes that many worker classification disputes involve small businesses without adequate resources to challenge the IRS.[1] Post-SBJPA, if the taxpayer fully cooperates with reasonable requests for information from the IRS, the burden of proof should generally fall on the IRS once the taxpayer establishes a *prima facie* case that it was reasonable not to treat the worker as an employee.[2] For this purpose, an IRS request for information is *not* reasonable if (1) it does not relate to the particular basis on which the taxpayer relied for establishing reasonable basis or (2) complying with the request would be impracticable given the circumstances and costs involved.[3]

New Provisions

Prior to the SBJPA, a worker first had to be classified as an employee for Section 530 to apply. Now, under SBJPA Section 1122(a), which applies to periods after 1996, Section 530 can apply without a finding of employee status. This represents a reversal of the IRS's position.[4] In addition, under the new law, a taxpayer's subsequent treatment of a worker as an employee does not preclude the availability of Section 530 relief for prior treatment of the worker as an independent contractor.

SBJPA Section 1122(a) also requires the IRS to provide a taxpayer with written notice of the provisions of Section 530 before or at the start of any audit relating to the employment status of an individual who performs services for the taxpayer. However, if the classification issue does not arise until after an examination has begun, notice need only be given when such issue is first raised with the taxpayer.[5]

Reliance on Prior Audit

A taxpayer may rely on an audit commencing after 1996 to show a reasonable basis for treating an individual as a nonemployee only if the audit included an examination for employment tax purposes of whether the worker involved (or any similarly situated worker) should have been treated as an employee. The SBJPA does not affect a taxpayer's ability to rely on a pre-1997 audit that did not involve employment tax matters.[6]

Reliance on Industry Practice

SBJPA Section 1122 makes great strides in clarifying when a taxpayer can rely on industry practice for its worker classification; it now provides a definition of the safe harbor for a "long-standing" recognized practice of a "significant" segment of an industry. For safe harbor purposes, the practice must be used for 10 years and by 25% of the taxpayer's industry (excluding the taxpayer). If the facts and circumstances warrant, a shorter period and smaller industry segment may also meet the industry practice test.[7]

However, the new legislation also triggers a number of questions: what if the taxpayer is in a new industry? Is the "industry" community-wide, statewide, nationwide or worldwide?

The Burden of Proof

According to the IRS, the burden of proof is on the taxpayer to demonstrate that it had a reasonable basis for treating a worker as an independent contractor.[8] However, in *McClellan*,[9] the Eastern District of Michigan held that Section

[1] S. Rep. No. 104-281, 104th Cong., 2d Sess. 157 (1996); see, e.g., Gee, "*Smoky Mountain's* Secret to Successfully Claiming Workers to Be Independent Contractors," 27 *The Tax Adviser* 370 (June 1996), in which the taxpayer was assessed almost $4 million in payroll taxes.

[2] None of the following reflect the new legislation: the IRS's Market Segment Specialization Program and Market Segment Understanding Program, the Classification Settlement Program, note 11, and the early referral procedures for Appeals, note 11.

[3] H. Rep. No. 104-737, 104th Cong., 2d Sess. 205 (1996) (hereinafter, "Committee Report").

[4] See *Employee or Independent Contractor: Does Section 530 Apply? (IRS Training Guide*, 10/30/96) (hereinafter, "*IRS Training Guide*"), p. 1-36.

[5] Committee Report, note 3, p. 205.

[6] Id., p. 203.

[7] Id., p. 204.

[8] *IRS Training Guide*, note 4, p. 1-17.

[9] *Paul D. McClellan*, 900 F Supp 101 (E.D. Mich. 1995)(76 AFTR2d 95-7017, 95-2 USTC ¶50,559); see also *REAG, Inc.*, 801 F Supp 494 (W.D. Okla. 1992)(71 AFTR2d 93-1524, 92-2 USTC ¶50,475) (the taxpayer need only show a substantial rational basis for its decision to treat workers as independent contractors).

530 requires the taxpayer to come forward with an explanation and enough evidence to establish *prima facie* grounds for a finding of reasonableness, a relatively low threshold burden that can be met with any reasonable showing. Once the taxpayer has made such a showing, the burden then shifts to the IRS to verify or refute the taxpayer's explanation.

SBJPA Section 1122(a) codifies the holding in *McClellan*[10]; however, the shift in the burden of proof applies only if there is:

1. Reporting consistency.
2. Substantive consistency.
3. Reasonable basis for the classification (i.e., judicial/administrative precedent, prior audit or industry practice).

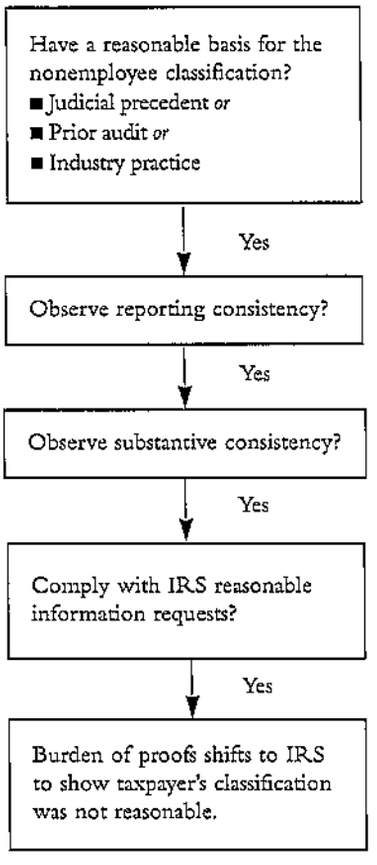
The *prima facie* case is not made (and the burden of proof does not shift) if the taxpayer's reasonable basis for the classification is shown in some other manner. Thus, for example, provided the taxpayer establishes its *prima facie* case and fully cooperates with the IRS's reasonable requests, the burden of proof shifts to the IRS with respect to all other aspects of Section 530, including whether the taxpayer had a reasonable basis for treating the worker as an independent contractor under the judicial/administrative precedent, prior audit or industry practice safe harbors, and whether the taxpayer observed reporting and substantive consistency.

After the SBJPA, the IRS noted that it "will undertake the determination of worker status only after it is determined that the business does not qualify" for Section 530 relief.[11] Thus, if on audit, the taxpayer can make a *prima facie* case for its classification, Section 530 may apply to resolve the issue.

Making the *Prima Facie* Case

The Committee Report states that a *prima facie* case can be established by the taxpayer's showing that it (1) observed reporting and substantive consistency among workers with substantially similar positions and (2) had a reasonable basis for treating the workers as nonemployees.[12] If the taxpayer makes this showing and establishes that it complied with the IRS's reasonable information requests, the burden of proof will shift to the Service to prove the taxpayer's classification of workers was not reasonable. This process is illustrated at right.

Making the *Prima Facie* Case



Conclusion

The SBJPA's amendments to Section 530, which shift the burden of proof to the IRS, combined with the Classification Settlement Program and the early referral procedures to Appeals, provide clear direction for taxpayers involved in a classification dispute, allow for proper planning to avoid a dispute in the first place and, hopefully, will reduce the volume of litigation in this area.

Even if the taxpayer cannot shift the burden of proof, under the Taxpayer Relief Act of 1997 (TRA '97), Section 1454, which added Sec. 7436, effective Aug. 5, 1997, if the IRS determines on audit that one or more of an employer's workers are employees, or that the employer is not entitled to Section 530 relief, the employer can apply for Tax Court *de novo*, binding review within 90 days of such determination. Assessment and collection of the tax would be suspended while the matter is pending in the Tax Court; further, a Sec. 7430 award may be available if the Tax Court holds for the taxpayer. Thus, both the SBJPA and TRA '97 have improved the taxpayer's arsenal against the IRS. **TTA**

[10] Committee Report, note 3, p. 204, n. 25.

[11] See *IRS Employment Tax Procedures for Classification of Workers Within Limousine Industry* (4/22/97), n. 2, citing *IRS Training Guide*, note 4, Chapter 1. In addition, Ann. 97-52, IRB 1997-21, 22, extended the Service's employment tax early referral procedures for Appeals (as originally set forth in Ann. 96-13, IRB 1996-12, 33) for an additional year beginning on May 27, 1997. According to the announcement, the application of Section 530 is an appropriate issue for such early referral. Taxpayers disagreeing with a District's determination regarding the application of Section 530 can immediately request early referral of the issue from the District to Appeals; if the issue cannot be resolved at the Appeals level, it will be returned to the District for consideration of the worker classification issue. Another alternative is use of the IRS's Classification Settlement Program, which, in a trial two-year period beginning March 5, 1996, offers businesses a worker classification settlement using a standard closing agreement; see IR-96-7 (3/5/96).

[12] Committee Report, note 3, p. 204, n. 24.