Independent Contractor or Employee: How the Law Works Today

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In Brief

Gains for the Taxpayer

The employee/independent contractor distinction is one of the most important issues facing American businesses. Businesses often favor the independent contractor classification because it allows them flexibility in hiring, even though at a higher cost than an employee. The IRS often distrusts businesses when they classify workers as independent contractors, suspecting that they are trying to avoid the payroll tax bite and the cost of fringe benefits. Historically, the IRS has used a 20-factor analysis set forth in Rev. Proc. 85-18 to determine worker status.

The issue was first raised in 1962, and battles have been fought ever since. Congress attempted to bring order to the process of worker classification by establishing safe harbor provisions in the tax act of 1978, now known as Section 530 safe harbors. Complaints of IRS aggressiveness led to the passage in 1982 of IRC section 3508, which granted exemptions for real estate agents and direct sellers. Court cases in the '90s began to favor taxpayers, and in 1996 Congress responded to concerns of businesses with the Small Business Job Protection Act, which shifted the burden of proof to the IRS once a prima facie case under Section 530 safe harbor principles was made.

Two new IRS programs--Classification Settlement and Early Referral to Appeals--are now available to speed the process for resolving worker classification disputes and bring consistency and rationality to penalties for those that have misclassified workers as independent contractors.

The independent contractor issue began to heat up in the early 1960s with Revenue Ruling 62-157, regarding the so-called "B-Girls." A former assistant commissioner of the IRS, who served under six presidents, wrote the ruling, which concluded that the individuals in question were employees and their compensation constituted wages.

From the late 1960s to mid-1970s, several highly publicized bankruptcies occurred after the IRS reclassified some independent contractors as employees and assessed penalties and interest. At the time, the subjective nature of the law and the draconian penalties deterred any significant defense by taxpayers. Even when contested, the enormity of legal fees required to fight a case in Federal court eliminated all but the deep pocketed from litigating the issue.

The Section 530 Safe Harbor

In response to these highly publicized bankruptcies, Congress enacted a provision in the Revenue Act of 1978: the so-called Section 530 safe harbor. The safe harbor provision can be found in IRC

section 3401 as a part of Public Law 95-600.

The original Section 530 set forth a two-pronged initial test for businesses and added three statutory safe harbors to be used once the initial two-pronged test had been met. The initial test involved two conditions: consistency of treatment and consistency of reporting. Both parts had to be met in order for Section 530 to apply or be considered.

The first prong required that the business show that the workers designated as independent contractors were consistently treated as such over the period under review. The business also had to demonstrate that during the review period workers performing similar functions were also treated as independent contractors and not as employees. The second prong, consistent reporting practices, required the business to have consistently reported amounts paid to the workers it treated as independent contractors on Form 1099.

Once both parts of the initial two-prong test had been met, the three nonexclusive statutory safe harbors could be considered. Meeting any one of the three criteria would be enough to pass. The three safe harbors have come to be known as

1) the judicial precedent test,
2) the industry standard test, and
3) the prior audit test. There is a fourth safe harbor--an "any other reasonable basis" test--that served as a catchall.

The judicial precedent test would absolve a business if a revenue ruling or court case had sufficient facts and circumstances similar to its own so that an appropriate analogy could be made. Obviously, the closer the elements of the situation were to the precedent being cited, the stronger the argument could be made for this defense. It did not matter whether the precedent was in the employer's circuit or not.

The industry standard test required a business to demonstrate that a significant segment of the industry treated its workers doing similar work as independent contractors. Because industry practices were not quantified by statute, this test became a matter of contention between the IRS and businesses. Disputes arose as to the definition and meaning of "significant segment." The Reag case (Reag vs. U.S. 92-2 USTC para. 50475) is a good example of how the courts began to rein in the IRS's ongoing attempts to attack what businesses felt were industry-standard practices. In that case, the judge held that Reag's burden of proof for establishing industry practice was at a lesser standard than the IRS claimed.

The prior audit test was met if the IRS had previously examined the business taxpayer and had not challenged an earlier treatment of similarly situated workers as independent contractors. Strangely, even if the IRS had not specifically looked at the treatment of the workers under question in that earlier exam, the business was still deemed to have met the test.

The catchall "any other reasonable basis" test was Congress's attempt to give businesses a chance to defend themselves based upon unforeseen facts and circumstances. "Any other reasonable basis" was not defined and was therefore a judgment matter. Congress did, however, instruct the IRS that this provision was "to be liberally construed in favor of the taxpayer" [see H.R. Rep. No. NO.95-

1748, 95th Cong., 2d sess., 5 (1978), 1978-3 C.B. 633]. Not surprisingly, the IRS granted relief sparingly under such a liberal interpretation.

Congress believed that it had a law in place that would effectively resolve most of the worker classification controversies. However, due to the culture within the IRS, there was a bias against independent contractors and the businesses that used them. This had become obvious by 1982.

IRC Section 3508: An Attempt to End the Argument

In 1982, Congress took another stab at resolving the controversy by reiterating its support for Section 530 and enacting other legislation, including the new IRC section 3508. This gave a statutory exemption to challenge by the IRS of two groups of workers: real estate agents and direct sellers.

Unfortunately, section 1706 of the 1982 act also removed the Section 530 safe harbor from a significant portion of the independent contractor workforce, the technical worker. This removal of safe harbors for technical workers has been the source of unending controversy ever since.

Statutorily exempting real estate agents from challenge to their independent contractor status makes common sense because of the nature of the real estate business. Statutory exemption from challenge for direct sellers, however, was more problematic for the IRS. This was clearly an acknowledgment by the Congress that it was growing weary of the controversy: It had reiterated its support for Section 530, codified some statutory exemptions to employee status (section 3508), and made it more difficult for some independent contractors to receive Section 530 protection (section 1706 workers).

This 1982 act unfortunately did nothing but encourage the opposite argument that more objective standards must be promulgated in order to put independent contractor battles to rest. Congress continued to shirk from its duty to provide clear and objective law. Fortunately, the tide began to turn in favor of businesses through the court system. Cases such as *Lambert's Nursery, Critical Care Nursing, Cleveland Electronics, and The R Corporation (Lambert's Nursery and Landscaping, Inc.,* 90-1 USTC para. 50184; *Critical Care Nursing Inc.,* 91-2 USTC para. 50481; *Cleveland Institute of Electronics, Inc.,* 92-1 USTC para. 50182; *R Corporation,* 94-2 USTC para. 50380) were the precursors to legislation that was ultimately enacted.

Clarification from the Courts

Finally, in 1995 two seminal cases convinced the Congress that courts had accomplished what it could not: clear and precise language that businesses can rely upon. The first case was *Smoky Mountain Secrets* (95-2 USTC para. 50573), the second was *McClellan* (900 Fsupp 101 Michigan 1995).

In the first case, the IRS assessed Smoky Mountain Secrets almost $4 million in payroll taxes for two years' misclassification of telephone solicitors as independent contractors.

Smoky asserted two separate defenses. First, Smoky asserted that its direct sellers (telephone sales and contract couriers) were exempt by statute under IRC section 3508. There was never any

question that all the tests in 3508 had been met by Smoky. The IRS, through the Department of Justice, resisted any expansion of workers under section 3508.

The second defense was reliance on professional advice. Smoky's president and majority stockholder (who was also chair of the board) had sought the advice of one of the authors in the spring of 1983 regarding the application of section 3508 (less than three months after its enactment) to his business. Unbeknownst to the advisor, the taxpayer had also subsequently sought the advice of his CPA, who practiced in a different state. Both CPAs independently advised the president that his treatment of the solicitors as independent contractors was proper.

The IRS attacked the competency and credibility of both CPAs, arguing that reliance on professional advice was not a defense because the two advisors were not experts in employment matters.

The trial judge ruled in favor of the taxpayer on both defenses. A year later the judge awarded attorney's fees to Smoky because the IRS's position was not substantially justified.

Shortly after *Smoky*, the trial judge in *McClellan* was so exasperated by the IRS's tactics against the taxpayer that he said that once a taxpayer has come forward with enough evidence to create a prima facie case, the burden of proof shifts to the IRS to refute the evidence or concede the case. Shifting the burden of proof became the centerpiece of future legislation, as Congress finally began to see the light.

The IRS's Response

While the two cases were being deliberated, the IRS realized it was fighting a losing battle. It introduced a new training manual for the area that moved away from the infamous 20-factor test (see Rev. Proc. 85-18, 1985-1 C.B. 518) and announced two programs--Classification Settlement and Early Referral to Appeals--designed to help settle controversial cases. Three categories in the training manual replaced the 20-factor test: behavioral control, financial control, and relationship of the parties. Advisors and consultants involved in worker classification issues should be familiar with these training materials.

Classification Settlement Program. The Classification Settlement Program (CSP) was implemented on a two-year basis beginning March 5, 1996, and was included in the first draft of the worker classification training manual. IRS notice 98-21 announced that the CSP would be indefinitely extended until further notice. Under this program, a three-tiered settlement offer is available to those taxpayers that do not have a Section 530 defense or that agree that workers should be reclassified.

Under the first tier, if the taxpayer clearly meets the requirements of filing Form 1099 (i.e., the consistency and reasonable basis tests), no penalty assessment will be made. In addition, the taxpayer can continue to treat the workers as independent contractors.

Under the second tier, if the taxpayer has a "colorable" argument for independent contractor status, the CSP provides for penalties equivalent to 25% of the employment tax liability. A colorable argument is one in which the taxpayer has been filing the appropriate Form 1099 (reporting consistency) but does not meet the substantive consistency and reasonable basis tests to the IRS's satisfaction. For example, a painting company hired college students to paint during the summer

months. The owner treated the students as independent contractors based upon his personal experience. He had worked as a painter and was given the option to be treated as an employee or an independent contractor. In addition, during discussions at a trade show with other business owners, he learned that others in his industry were treating their workers as independent contractors. The IRS claimed that this worker classification was not valid. Although the taxpayer met the reporting and substantive consistency test, the taxpayer failed the reasonable basis test. Since the taxpayer had a colorable argument, the assessment was limited to 25% of the employment tax liability for the year under audit. However, the taxpayer had to agree to classify its workers as employees on a prospective basis, ensuring future compliance.

Under the third possibility, if the taxpayer "does not clearly meet" the standard for independent contractor status, then the CSP provides for penalties of 100% of the employment tax liability for the period under audit. This penalty will apply under situations where the taxpayer meets the reporting requirements but clearly does not meet either the substantive consistency requirement or the reasonable basis test. For example, if the owner of the painting company had treated one of the students as an employee and another as an independent contractor, then the taxpayer would have failed both the substantive consistency test and the reasonable basis test. And, of course, the taxpayer must agree to classify its workers as employees on a prospective basis. The penalties described above are determined under IRC section 3509 unless willful disregard of the rules is proven.

Early Referral to Appeals Program. The Early Referral to Appeals Program was first announced in Rev. Proc. 96-9, for a two-year test period. Announcement 96-13, issued March 18, 1996, applied the provisions of the revenue procedure to employment tax issues for a one-year period. Announcement 97-52, issued May 27, 1997, extended the program for an additional year. Section 3465 of the 1998 IRS Restructuring and Reform Act created the new IRC section 7123, which codified the Early Referral to Appeals Program.

Under this program, if there is disagreement between the IRS auditor and the taxpayer's representative, the taxpayer can request an immediate meeting with an appeals officer to determine if the burden of proof has shifted to the IRS or if a CSP is available. On July 1, 1999, the IRS released Revenue Procedure 99-28, effective July 19, 1999, which further clarified the Early Referral to Appeals Program.

In August of 1996, the Small Business Job Protection Act (SBJPA) was enacted. In respect to independent contractors, the SBJPA shifts the burden of proof to the government provided the taxpayer makes a prima facie case. (The language in the act was taken from *McClellan*.) This means that if the taxpayer can show a reasonable basis for treating the worker as an independent contractor, the burden of proof is shifted to the government. The basis for making the case is to use an updated version of Section 530 principles, which finally were incorporated into the IRC. For example, if all of the Form 1099s have been timely filed (referred to as the reporting consistency test), the substantive consistency and reasonable basis tests must be met for the burden of proof to shift.

To satisfy the substantive consistency test, the determination of what is substantially similar work rests on an analysis of the facts. The day-to-day services that workers perform and the method by which they perform those services are relevant in determining whether workers treated as independent contractors hold substantially similar positions to workers treated as employees.

Comparison of job functions is an important fact. For example, if a company treats one engineer as an independent contractor while other engineers performing similar tasks are treated as employees, the IRS will claim that the worker treated as an independent contractor was misclassified.

Similarly, if a worker was classified as an employee and at a later date was reclassified as an independent contractor, the employer will not be eligible for prima facie protection. Therefore, it is imperative that worker classification remains consistent. If there were a substantial change in the worker's job function, there would be the opportunity to reevaluate the classification.

The next step toward shifting the burden of proof is to meet the reasonable basis tests. As stated previously, they are judicial precedent, industry standard, and prior audit. The fourth test, other reasonable basis, cannot be used to shift the burden of proof.

The reasonable basis test for a safe harbor based upon industry practice has been given more objectivity. A taxpayer's position will be accepted if it can be established that 25% of the industry has been treating employees as independent contractors for a period of 10 years or more. Shorter time frames will be appropriate if an industry has not existed for 10 years.

The reasonable basis test of prior audit has been made more restrictive. In order for the prior audit position to work, the prior audit must have included a worker classification review.

Although the fourth category, other reasonable basis, does not shift the burden of proof, it may still be used to sustain independent contractor status. For example, other reasonable basis may include the reliance on advice received from an attorney or accountant regarding the classification of a worker's status. The courts tend to require an employer to provide evidence of the attorney's or accountant's educational and experiential qualifications as well as evidence that the advice was given based on relevant facts. The previously mentioned *Smoky* case is an excellent example of this.

Additionally, in cases where a worker has been given independent contractor and then employee status, the switch cannot be used against the taxpayer in determining whether independent contractor status in the earlier years was appropriate. However, if the switch goes the opposite way, from employee to independent contractor status, the taxpayer should expect some scrutiny.

The SBJPA also made Section 530 and IRC section 3508 permanent sections of the IRC.

The Taxpayer Bill of Rights 2, enacted in 1997, is also of benefit in the worker classification area. It states that the IRS is unjustified in its position if it does not follow its own guidelines. This would include those in training manuals and published guidelines. Finding a violation of the IRS's own pronouncements can be very rewarding in an independent contractor inquiry. The Taxpayer Relief Act of 1997, effective August 5, 1997, also created a new right to take employment cases to Tax Court instead of the Federal District Court. Under the new IRS section 7436, the court must make a de novo (review) of the case.

Restructuring Act of 1998

Just when you thought it couldn't get any better from a taxpayer's standpoint, along comes the IRS Restructuring and Reform Act of 1998. This act shifts the burden of proof to the IRS at trial on any

issue (not just employment taxes) once the taxpayer has made a prima facie case. This solidified the 1996 SBJPA burden of proof rules on independent contractor issues into the code on a permanent basis.

The Restructuring and Reform Act also provided some potentially severe penalties and repercussions against agents and the IRS that commit certain enumerated abuses. It subjects even individual agents to lawsuit.

Tactics and Strategies in Dealing with the New IRS

While the 1996 and 1998 acts clearly give taxpayers new weapons in their arsenal of dealing with the IRS, certain realities remain.

First, the taxpayer's representation must be able to prove a prima facie case in order to shift the burden of proof. Facts and documents will be crucial. Whether it is finding an analogous case, using a sworn affidavit, or presenting a conforming contract, the tax practitioner must become adept at the strategy and tactic of aggressively defending the case at its inception. The practitioners are advised to partner with knowledgeable and proven litigators that can quickly and accurately assess the strengths and weaknesses of actual case situations. This will save time, money, headache, and heartache.

Some specific strategies deserve mention. In the authors' opinion, practitioners that fill out an SS-8 form Section 530 at the request of the IRS are probably committing malpractice. This document can be lethal when used against the client in a proceeding. It is based on the archaic and outmoded common law, and its questions will almost never help the client. So, "just say no" to an IRS request to fill out an SS-8. Instead, go immediately to a prima facie case that you can prove under Section 530 or IRC section 3508.

Often an independent contractor issue will arise on a state level when a former "independent contractor" files a claim for unemployment with a state agency. These types of cases have the potential for disaster if not handled properly. Many states have statutes that mirror Section 530 and IRC section 3508. Many states also have a statute that defers to Federal law in the FICA or FUTA areas.

States, however, have a vested interest in not allowing exemptions for independent contractors because of lost employment taxes. Also, a settlement with a state will be communicated to the IRS.

The Department of Labor believes that no law applies to worker classification issues except for the Fair Labor Standards Act. Some advisors recommend taking the same approach with the DOL as with the IRS by making a prima facie case under Section 530 and IRC section 3508. Whether this approach will work is currently an open question. *