The Seven Deadly Sins of Handling an Independent Contractor Case

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Downsizing and outsourcing are facts of life in today's business, and many companies use independent contractors (ICs) instead of employees to help keep costs down but ensure critical functions are carried out. But the mere intent to use independent contractors is no guarantee that the Internal Revenue Service and state authorities will except their status. If the IRS or states decide its independent contractors are really employees due regular benefits, a business could face financial catastrophe. To protect themselves, companies must seek legal and accounting advice to be sure they meet state and federal criteria to qualify their independent contractors. There are seven deadly sins it's vital to avoid.

Not Knowing the Law

Without a thorough grounding in the applicable law for this area, practitioners may not know where to begin on an IC case. The IRS and most state governments evaluate a worker's status by what is known as the Common Law 20 Factor Test. The laws of primary interest for companies that employ ICs are Section 530 of the Revenue Act of 1978 and Section 3508 of the Internal Revenue Code enacted in December 1982, which create certain exceptions to the general rule. It is also helpful to be familiar with the Small Business Jobs Protection Act (SBJPA) of '96 and the Taxpayer Bill of Rights I, II and the '98 Restructuring Act.

For state cases, scrutinize the appropriate state laws, rules and regulations relating to employment taxes because some states have adopted some or all of the above mentioned acts or sections thereof. 1st deadly sin - engaging in the old Common Law 20 Factor Analysis.

Not Knowing IRS or State Procedure

Practitioners often do not understand IRS and state objectives. Put simply, the IRS aim is to reclassify as many ICs whenever, wherever and however possible. The state does not even acknowledge the possible existence of such a creature under the law. They do not want to classify workers as independent contractors because they lose revenue, particularly in unemployment security. Firms must meticulously consider and comply with state laws covering ICs.

There are IRS documents that instruct agents to get as much information as they can about how taxpayers are treating ICs before the taxpayer figures out why they're there. Always question an agent's approach when he insists on interviewing a client or on accumulating volumes of information on the taxpayer's ICs. Any procedure other than an initial determination under Section

530 is wrong and now in violation of the law.

Practitioners should understand that many of the government's agents lack up to date training. A lot of IRS and state agents no longer have a degree in accounting or commensurate training in the area. In many cases, it seems, they don't know the law and, in fact, have little interest in applying it evenly or fairly. For example, in a large case a couple of years ago, the IRS supervisor and agents, in what was supposedly the best employment tax unit in the country, had not even been trained in their own new IRS IC training guide a full year after its supposed introduction and had to have several violations they had committed read to them from their own manual.

Be aware of the limited flexibility and very limited options of the agent on the scene, who may merely have been instructed to go forth and assess mightily. It's useful and probably necessary to have a copy of the IRS agent handbook and especially the employment tax handbook and Market Segment Specialization Program (MSSP) guides, either hard copy or off the Internet.

Certain terms should set off bells and whistles in the practitioner's mind. Compliance check, for example. The IRS must first consider Section 530 of the Internal Revenue Code-the so-called safe harbor provisions-in every question of worker classification. That is, before asking any questions relating to the common law, the IRS must explain the provisions of Section 530 to the taxpayer. To avoid this, the IRS has created the compliance check, which consists of an SS-8 Form that asks question relating to the Common Law 20 Factor Test. If this were an examination or audit, the mandatory language of Section 530 would forbid these questions. The compliance check is therefore an attempt to circumvent the law.
2nd deadly sin - not knowing government procedures and their intended result.

Not Considering Alternatives

It is a mistake to assume the government has any intention other than a major assessment. After all, audits are pursued because somehow the government has determined the return has potential for assessment or collection that could include significant penalty and interest.

Practitioners also often assume there are no alternatives to the government agent's approach. It's an equally serious blunder to allow themselves to be intimidated by agents' accusations that they are refusing to provide information.

It is also almost always detrimental to a case to allow the government to interview a client. Such an interview can in no situation aid the client, and clients should never be allowed to talk to the government once a professional has entered a power of attorney representation.

So how do you repel this onslaught by the government for information? Very simple-know what constitutes an appropriate request by the government.
3rd deadly sin - falling into the trap of following the government lead in the case.

Not Knowing Superior Tactics and Winning Strategies

To handle IC cases, practitioners should consider what approaches best protect their clients. Practitioners often bungle by moving too quickly to provide information or responses to government requests without understanding the implications and effects of sins 1, 2 and 3. Know when and how to redirect the focus of a case to the primary question and not be misdirected by the government. Don't waste time with an agent who does not know the law or refuses to follow the law. In this situation, request a conference with the auditor and his supervisors. The field auditor is often less capable or well-trained than his supervisor and may not have the authority to dismiss or settle the claim.

Immediately break out the IC issue from any others in a regular IRS audit. In a state case, push for a status determination before supplying any information such as names, addresses, pay, social security numbers or other worker information. Other issues may allow the IRS to solicit information to which they would not otherwise have the right to because of the necessity of addressing Code 530 first.

Have a capable litigator in the case early on, which accomplishes several things. First, it clearly establishes the taxpayer's commitment to see the case through by engaging both legal and tax counsel and sends a clear message to the government. Second, it provides the practitioner with an early understanding as to how strong the case is should trial be necessary. Third, it indicates the client's fiscal and psychological commitment to the case.

In state cases, practitioners must understand the taxpayer will probably not win initially and must be prepared (and have the client so prepared) to go to the second level and higher because state auditors generally rubberstamp assessments at the first level. In fact, practitioners should already have their notebook of prima facie evidence (see the seventh sin) with them at the initial level and let everyone know that they and counsel are already ready for trial.

Know which state forum to litigate in when you do business in multiple jurisdictions. Several states have adopted 530, 3508 or a statute that includes the provision that says federal law governs in case of a conflict or dispute. Obviously, these states are the appropriate forum as opposed to one that has no statute or a less favorable one.
4th deadly sin - not knowing and employing superior tactics and winning strategies at the very inception of the case as soon as the IC issue is raised.

Not Knowing When To Say When

CPAs are historically compliance oriented by nature, but not every government request for information or documents emanates from heaven on high. Nothing could be further from the truth. A practitioner absolutely must know what constitutes a reasonable government request and must say no to an SS-8 request.

To know what constitutes a reasonable request from the IRS in an IC matter, go to the Conference

Committee Report of the SBJPA of '96:

> "With respect to the burden of proof in Section 530 cases, the conferees intend that a request for information by the IRS will not be treated as reasonable if (1) it does not relate to the particular basis on which the taxpayer relied for establishing its reasonable basis, or (2) complying with the request would be impracticable given the particular circumstances and the relative costs involved."

This section relates to shifting the burden of proof to the IRS in Section 530 and says an IRS request is not reasonable if it does not relate to the particular basis on which the taxpayer relied for establishing its reasonable basis. This has the practical and legal effect of limiting the IRS inquiries to your already asserted prima facie cases.
5th deadly sin - agreeing to fill out an SS-8 form and not recognizing this is an improper and unreasonable request.

Not Knowing How To Make a Prima Facie Case

To advance the evidence or proof to create a prima facie case one must assess, long before it may be necessary, what actual defenses a client may have in place. One should study the judge's opinion in McClellan v. The United States (Fed Sup 101, Mich., 1995) and the SBJPA of '96 committee reports in this regard. Prima facie cases are the lowest level of proof in the judicial system and may be made in a variety of ways. First, involving judicial precedent because of a close analogy of facts and circumstances may require only introduction of facts and evidence already in existence and not in dispute. Second, using industry standard may require only the presentation of a recent industry or trade association survey showing a percentage acknowledging use of independent contractors. Third, an affidavit sworn and notarized, if not refuted and not controverted, constitutes proof sufficient to support a prima facie case.

Not getting a professional opinion in writing on the status of the workers in question from a qualified CPA or attorney is a fundamental blunder. Relying on professional advice is the easiest defense for the IRS to accept and is often used as a basis for granting 530 relief by simply providing the IRS with a copy of the CPA or attorney opinion. In the absence of a formal, written professional opinion, a sworn affidavit to the effect of the advice rendered and when and to whom it was given may suffice. Both parties-the provider of the opinion and the taxpayer who relied on such-can provide such an affidavit. Get this before the issue comes up.

It is said that the best offense is a good defense. In today's law, the best defense is to go on the offensive immediately. Create as many prima facie cases as possible before handing the ball to the IRS. Remember sins 3, 4 and 5. In other words, do not respond to inquiries for any information that is not based on a prima facie case you have already made because, by definition, this constitutes an improper request to the IRS.
6th deadly sin - responding to any request by the IRS to anything other than a prima facie case you have already presented to them. It's the IRS's job at that juncture is to refute your case or concede

the issue.

Not Taking the Bull by the Horns

Many practitioners err by not immediately taking charge of the direction of the case once the issue is raised. Before providing any information whatsoever to the IRS, at the very inception of the issue being raised, practitioners should immediately request a meeting with the agent and supervisor who has settlement authority in the IC matter. Set forth the various prima facie defenses (cases) in writing and submit this to the IRS. At that time a wonderful thing occurs-the burden of proof shifts to the IRS.
7th deadly sin - not going to prima facie defenses stat.

Avoiding the seven deadly sins helps practitioners protect their clients, but don't let your guard down until when time comes for settlement. Settling with the state or IRS doesn't mean the matter is over. They share information with each other. And settling on a prospective basis is a trap and will probably violate benefit packages, including pensions. If the taxpayer settles a case with the state or IRS by agreeing that independent contractors should be treated as employees invites an audit from the other entity. Avoiding such an admission may be a matter of survival for the taxpayer.

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