Revenue Service Cracks Down on Independent Contractor Misclassification

By Robert W. Wood

Like many other businesses, law firms often make mistakes in classifying workers. Say you hire people for a short special project. It seems simpler and cleaner to hire them as "independent contractors" so you don't need to put them on payroll and deal with tax withholding. You may avoid various employment laws too.

But increasingly, this can be a dangerous game of roulette. What if five years later these workers are working full-time for you, having morphed into trusted employees, er workers, even though you still treat them as independent contractors? Such facts seem to invite the Internal Revenue Service to reclassify them as employees and assess back taxes, penalties and interest.

The tax bills for failure to withhold on wages can be huge, as high as 50 percent on top of what you've already paid to the workers. Plus, it isn't only the IRS at your door. The California Franchise Tax Board, Employment Development Department and Department of Industrial Relations may well come along too. So may worker's compensation or unemployment insurance authorities.

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What's worse, these agencies now exchange information so businesses often face a domino effect of one dispute after the other. That phenomenon can alter the traditional economics of dispute resolution. With worker status disputes, it can sometimes make sense to pay $10,000 to fight a $1,000 tax bill, since one should factor in what other dominoes may fall thereafter.

Surprisingly though, the IRS isn't the toughest agency on the block, due in part to a tax relief provision enacted way back in 1978. If the IRS reclassifies your workers and assesses retroactive taxes and penalties, a key way out for many is Section 530. This tax relief provision doesn't just let you off the hook for the past. It can actually let you keep your independent contractor classification even if it is erroneous.

Under this provision, a business can treat a worker as an independent contractor if: it never treats the person as an employee; it does not treat any other person with a substantially similar position as an employee; all required federal tax returns and Forms 1099 show the worker as an independent contractor; and the business had a "reasonable basis" not to treat the person as an employee.

One can satisfy the fourth requirement by reasonably relying upon judicial precedent or IRS rulings, a past IRS audit or a long-standing practice of a significant segment of the relevant industry.

Even if you can't meet any of these provisions you can still show some other reasonable basis. The IRS finds this a frustrating provision that allows some businesses to go on misclassifying workers forever and Congress has considered repealing Section 530 altogether. For now, however, the IRS has another way to skin the Section 530 cat.

Since Section 530 protects reasonable reliance, the IRS questioned whether the business was *actually* relying on one of the permitted items *at the time it made its worker status decision.* In a recent internal IRS advisory (Program Manager's Technical Advice, Section 530: Reasonable Reliance Safe Harbor (PMTA 2011-15)), the IRS considered whether an employer must show it relied on the safe harbor *before* it engaged a worker to provide services.

A key question is whether the taxpayer must demonstrate that it reasonably relied on one of the permitted items before engaging the worker to perform services. At the time you classified your workers, what if you didn't think about it one way or the other? You just wanted a job done quickly. Suppose you are audited several years later when the worker is still with you. It now may seem obvious that the worker is subject to your control and therefore is really an employee.

Yet if it turns out that judicial precedents, an industry practice or some other basis arguably brings you within Section 530 relief, can it reach back to the original hiring? Put differently, must you show you did not initiate your reliance too late? In *Peno Trucking v. Commissioner*, T.C. Memo. 2007-66, rev'd 296 Fed. Appx. 449 (6th Cir. 2008), the Tax Court ruled that drivers were employees and denied Section 530 relief to the company because it failed to show it *actually relied* on relevant judicial precedent at the time.

Fortunately, the 6th U.S. Circuit Court of Appeals reversed based on a liberal reading of the facts and timeline. The trucking company *could have* relied on an Ohio ruling when it made its hiring decision, the court said. After all, the state ruling (involving the usual 20-factor common law test) predated the tax years in question. Not surprisingly, the IRS doesn't like this hypothetical approach.

The recent IRS release states that to satisfy the IRS, an employer must demonstrate actual and reasonable reliance *before* it made the employment decisions for the pertinent periods. Indeed, employers must demonstrate *reliance in fact*, says the IRS. For example, the taxpayer *would* need to show it was aware of an independent contractor industry practice before making the decision to treat workers as independent contractors. The taxpayer would even need to show that the industry practice was *in fact* the basis of its decision and that relying upon that industry practice was *reasonable*.

The most reliable proof would probably be written documentation that you were relying on a legal opinion, case law or industry practice *before* you make the *initial* hiring decision. In some cases, the IRS acknowledges that while you didn't have the requisite reasonable reliance in fact when you made the *initial* hiring decision, it may be enough to show that you did before the periods under audit. Still, this kind of line-drawing seems unlikely to save too many taxpayers caught on this rocky shoal.

Section 530 relief only applies to IRS liabilities and not to any of the other agencies that may come along to reclassify workers. Nevertheless, since IRS liabilities are among the largest and most feared in worker status disputes, the comfort this provision can bring is palpable. Up until now, many companies have taken for granted the notion that they'll be able to get the relief.

To them, the IRS focus on timing and actual reliance may come as a rude awakening. And since agencies now exchange data freely — the whole multi-tiered *Peno Trucking* mess started with a worker's compensation claim — you never know when the IRS may come calling.

This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.