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By Phyllis Horn Epstein

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by Phyllis Horn Epstein

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In this article, Epstein discusses the distinction between employees and independent contractors and reviews the inconsistent positions of the IRS and the Tax Court on worker classification for statutory employees.

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From housekeepers to corporate directors, people who are compensated for their labor are, for tax purposes, treated as either employees or independent contractors. The distinction is significant for several economic reasons. For example, employees, unlike independent contractors, are covered by workers' compensation insurance for on-the-job injuries. They may share in company benefits like retirement or health insurance. Their compensation is subject to withholding for Social Security and Medicare benefits, unemployment insurance, and of course income tax. Independent contractors share none of those benefits, although they still are required to report their income and pay tax. That responsibility may require the payment of self-employment tax and the filing of quarterly returns. The employer's obligation to withhold tax from the wages of employees and to provide a matching contribution for part of Social Security and Medicare taxes is an added business expense that motivates some to classify their workers as independent contractors rather than employees. The IRS has been targeting employers for the misclassification of workers as independent contractors. If the IRS determines that workers have been misclassified, the employer can be assessed large penalties and compelled to reclassify its workers as employees.

Classifying Workers

In 1947 the U.S. Supreme Court said in *Silk*[1] that someone is classified as an employee or independent contractor based on "the total situation, including the risk undertaken, the control exercised, [and] the opportunity for profit from sound management." The drivers in *Silk* owned their own trucks and paid the expenses of operating them, hired their own helpers, were paid on a per-job basis, and did not account to anyone for their time. Based on those facts, the Court concluded that the drivers were independent contractors. Since *Silk*, the IRS, the Department of Labor, and the courts have tried to create guidelines for understanding the differences between employees and independent contractors. Generally, someone is an independent contractor if his employer has the right to control or direct the result of his work but not the means and method of accomplishing that result.[2] Therefore, if an employer has the right to direct what will be done by workers and how it will be done, there is an employer-employee relationship.

The employment relationship is described in section 3401(c) and reg. section 31.3401(c)-1 for tax withholding purposes; section 3306 and reg. section 31.3306(i)-1 for FUTA purposes; and section 3121(d) and reg. section 31.3121(d)-1 for Social Security (FICA) purposes.

Under section 3121(d), it is clear that some workers are employees by statute for FICA purposes. In short, that list includes corporate officers;[3] employees under section 218 of the Social Security Act; and a list of specific types of employees such as drivers, life insurance salespeople, and some housekeepers. Common law employees are considered statutory employees for this purpose as well.

For purposes of section 3401(c), an employee is any officer, employee, elected government official, or corporate officer. The regulations are more expansive and indicate that in general, physicians, lawyers, dentists, veterinarians, contractors, subcontractors, public stenographers, auctioneers, and others who follow an independent trade, business,

[1]*United States v. Silk*, 331 U.S. 704 (1947).
[2]Reg. section 31.3401(c)-1. *See also* IRS Publication 15-A, "Employer's Supplemental Tax Guide" (2017).
[3]Reg. section 31.3121(d)-1(b).

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or profession are not employees, while superintendents, managers, and other supervisory personnel are employees. The regulations caution that a facts and circumstances analysis may override the designation of statutory employees because an employee's "services may be of such a nature, or performed under such circumstances, that the remuneration paid for such services does not constitute wages within the meaning of section 3401(a)."[4]

Section 3306 and the corresponding regulations contain language similar to section 3121, providing a presumption that some classes of employees such as corporate officers, superintendents, managers, and other supervisory personnel are employees, with the proviso that the facts or circumstances may prevail in otherwise "doubtful cases."[5]

IRS regulations also make it clear that corporate directors are not "employees" simply because they hold that position and that corporate officers who perform minor services for their companies may be independent contractors. The regulation states:

> All classes or grades of employees are included within the relationship of employer and employee. Thus, superintendents, managers, and other supervisory personnel are employees. Generally, an officer of a corporation is an employee of the corporation. However, an officer of a corporation who as such does not perform any services or performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any remuneration is not considered an employee of the corporation. A director of a corporation in his capacity as such is not an employee of the corporation.[6]

In *Seeds*,[7] a district court found that based on the facts and circumstances, the corporate treasurer was an independent contractor. The individual maintained offices away from the company; infrequently visited the company plant and operations; "did not make extensive, required or detailed reports"; wasn't trained by the company; and did not receive regular payments. Also, the treasurer received no additional fringe benefits, including workers' compensation or retirement.

For nonstatutory employees or nonstatutory independent contractors, the IRS suggests an examination of the working relationship under the following common law rules.

Behavioral Control Test: The more control the company has over how a worker performs her work, the more likely it is that that person is an employee. Behavioral control is demonstrated by directing when and where to work, what tools and equipment to use, what assistants may be hired, where to purchase supplies or other services, what work must be performed by the individual rather than delegated, what order or sequence of work to follow, and the level of training provided by the employer to do the job.

Financial Control Test: The more control over the business relationship, the more likely it is that the worker is an employee. The courts will consider whether the worker has a personal investment in his tools or trucks, is paid a regular wage, can realize a profit or loss, and is reimbursed for expenses.

Relationship Test: Other indicators shed light on the type of relationship involved — for example, the existence of a written contract describing the working relationship, the permanency of the relationship, and the provision of work benefits.

An employer may seek to document the employment relationship with an independent contractor agreement. While these types of agreements are relevant to employer and employee intent, they are not determinative. The IRS articulated its position in two private letter rulings that stated:

> A written agreement describing a worker as an independent contractor is viewed as evidence of the parties' intent to create a non-employee relationship. However, a contractual designation, in and of itself, is not sufficient evidence to base a determination of worker status. It is the substance of the relationship, rather than the label, that governs this determination.[8]

The U.S. Tax Court reached a similar conclusion, holding that those contracts may be "set aside" if they contradict the common law principles defining the relationship.[9] Therefore, while the agreement is evidence of the type of relationship that was intended, the actual circumstances surrounding the relationship will be controlling and may contradict the agreement.

Voluntary Classification Settlement Program

Under the Voluntary Classification Settlement Program (VCSP), taxpayers not currently in a worker classification or employment tax dispute

[4]Reg. section 31.3401(c)-1(h).
[5]Reg. section 31.3306(i)-1; reg. section 31.3306(c)-2.
[6]Reg. section 31.3401(c)-1(f).
[7]*Seeds Inc. v. United States*, 2 A.F.T.R. 2d 98-6426 (E.D. Wash. 1998).
[8]LTR 199923014; LTR 199923015.
[9]*Jones v. Commissioner*, T.C. Summ. Op. 2003-61; *Professional and Executive Leasing Inc. v. Commissioner*, 89 T.C. 225 (1987), *aff'd*, 862 F.2d 751 (9th Cir. 1988).

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with the IRS or under examination with the Department of Labor or a state agency may reclassify their workers as employees for employment tax purposes for future tax periods with partial relief from past due federal employment taxes. The taxpayer is not in a dispute with the IRS simply because there has been a request to reconsider the determination of worker status by submitting a Form SS-8. However, a dispute with the IRS by a member of a consolidated group will make the taxpayer ineligible to participate. An employer may apply for the VCSP by filing Form 8952, ''Application for VCSP.''

Under the VCSP, employers agree to treat their workers as employees and for the first three years agree to a six-year statute of limitations on assessments instead of a three-year limit. In return, the employer pays a reduced amount of federal employment taxes for prior years and no interest or penalties. The tax is equal to 10 percent of the past year's employment taxes for the reclassified workers. Part IV of the application provides the calculation for the assessment. The employer must demonstrate that it has consistently treated a class of workers as independent contractors, has timely issued Forms 1099 within the past three years to those workers, and agrees to treat them as employees.

A VCSP application concludes with a voluntary closing agreement that provides for the payment of the assessment and the reclassification of workers as employees as of a specific date. The opportunity to set that date is on the application form and must be at least 60 days after the filing date. The date may be significant to employers who will need to shift workers from Form 1099 to Form W-2 status. Included with the application is a list of names of all workers and their Social Security numbers. The agreement also states, ''Nothing in this agreement shall entitle the taxpayer to relief under section 530 of the Internal Revenue Act of 1978 as amended.''

Section 530 Relief

Section 530 of the Revenue Act of 1978 allows an employer to continue treating its workers as independent contractors without liability for penalties for nonpayment of employment taxes retroactively or prospectively. To qualify for section 530 safe harbor relief, an employer should demonstrate that it (1) consistently treated such workers as independent contractors, (2) issued Forms 1099-MISC when required, and (3) had a reasonable basis for classifying the workers as independent contractors, even if that reasonable classification is judicially determined to be incorrect. Section 530 relief applies to employers already under audit who have not applied for or are ineligible for that program.

Whether the employer's classification of workers is reasonable may be based on (1) judicial precedent, (2) past IRS audit results, (3) industry practice, or (4) some other reasonable basis. If an employer is able to demonstrate that in its segment of industry, there is a long-standing practice of treating some workers as independent contractors, the employer may prevail in continuing to treat them that way. A taxpayer has not acted reasonably if, based on relevant facts and circumstances, treating workers as independent contractors constitutes negligence, intentional disregard of rules and regulations, or fraud.

Nelly Home Care was a district court case involving the classification of non-medical home care providers in which the court held that the taxpayer had a reasonable basis for classifying workers as independent contractors and was therefore entitled to section 530 relief. Finding that ''a taxpayer need only satisfy one of the four safe harbors provided under section 530 to prove that it is entitled to relief,'' it held that Nelly Home Care had demonstrated ''other reasonable basis'' facts (the fourth safe harbor) to support classifying its workers as independent contractors. The owner of Nelly Home Care had researched the industry and concluded that most home companions were treated as independent contractors. Having been through previous IRS audits in which her practice was unquestioned, the court determined that it was reasonable for the owner ''to interpret the IRS's silence on the independent contractor classification as acquiescence.''

Section 530(d) was added by the Tax Reform Act of 1986 and provides that 530 safe harbor relief does not apply for an individual who performs services as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled technology service. Instead, it requires an analysis of whether that worker is an employee or independent contractor under common law rules.

When section 530 relief is unavailable — perhaps because the employer has not been compliant with issuing Forms 1099 — and when the employer is ineligible for the VCSP program because it is already engaged in a worker classification dispute with the IRS, there may be a resolution through the Classification Settlement Program during the administrative process, in which there is an exam in either the Small Business/Self-Employed, Tax-Exempt and Government Entities, Large Business and International divisions, or Appeals. Classification Settlement Program agreements that alter the prospective classification of workers will be binding on the IRS and the employer for future years. The amount of penalty assessed depends on the employer's compliance. Therefore, if an employer has been filing all necessary returns, has been treating similarly situated workers alike, and has a reasonable basis argument for its treatment of workers, the

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penalty may be as low as 25 percent of the employment tax liability, compared with 10 percent in the VCSP program.

Tax Court Jurisdiction

A taxpayer may seek Tax Court review of a worker classification determination, made by the IRS in accordance with section 7436, which provides that ''if the Secretary sends by certified or registered mail notice to the petitioner of a determination by the Secretary described in subsection (a),'' the taxpayer has 90 days to petition the Tax Court. The restrictions on assessment and collection apply ''in the same manner as if the Secretary's determination described in subsection (a) were a notice of deficiency.''

In Notice 2002-5, 2001-1 CB 320, the IRS took the position that a notice of determination of worker classification (NDWC) was a prerequisite for Tax Court jurisdiction. Taking a contrary position in *SECC Corp.* and *American Airlines*,[10] the Tax Court held that it had jurisdiction over employee classification cases without the necessity of an NDWC as long as that case arose:

- in an exam in connection with an audit;
- there is a determination that workers are employees or the employer is not entitled to 530 relief;
- there is an ''actual controversy'' involving the determination in exam; and
- an appropriate pleading is filed in the Tax Court.

In a decision that elevated substance over form, the Tax Court in *SECC* held that a closing letter from Appeals on the subject of worker classification was the equivalent of a determination letter and that there was an actual controversy in connection with an audit. Those two events were sufficient for Tax Court jurisdiction. In *American Airlines*, the IRS had not issued an NDWC and argued that the Tax Court did not have jurisdiction without one. As in *SECC*, the court found that a determination had been made in connection with an audit even though an NDWC had not been formally issued. In 2015 the IRS changed its position, as enunciated in Chief Counsel Notice 2016-002, and instructed IRS attorneys to no longer argue that the NDWC was a prerequisite to Tax Court jurisdiction as long as the above four conditions existed.

The question remains what is meant by ''an exam in connection with an audit.'' This is one of the conditions set by the Tax Court in *SECC* and *American Airlines, Inc*. For guidance, Rev. Proc. 2005-32 provides a list of activities that are not audits. So, for example, if the IRS requests the preparation of a return, that is not an exam in connection with an audit.[11]

IRS vs. Tax Court

There is still some discrepancy between the IRS and the Tax Court on their approach to worker classification. For example, the IRS has allowed section 530 relief even for those workers classified as statutory employees in the code. Corporate officers, while considered statutory employees under section 3121(d), may be considered independent contractors rather than employees because they are not specifically excluded from safe harbor relief by the statute or legislative history.

In comparison, the Tax Court has held that section 530 relief is available only when a worker's status as an employee is determined under the common law rules and is unavailable for any employee covered by the statutory definition found at section 3121(d)(1) for corporate officers; section 3121(d)(3) for specific drivers, life insurance salespeople, home workers, and other salespeople; and section 3121(d)(4), state and local government workers treated as employees under section 218 agreements.[12]

Upholding the Tax Court, the Third Circuit in *Nu-Look* held that a common law analysis of employment was not required if an individual was already a corporate officer under section 3121(d)(1):

> Mindful of these statutory provisions and Stark's status as a corporate officer, the Tax Court appropriately focused on the nature of the services Stark rendered and whether the distributions Nu-Look paid were remuneration for those services. It found that Stark performed more than minor services and that the distributions Stark received were, in fact, remuneration for his services. Those findings led the Tax Court to conclude that Stark was an employee for purposes of the FICA and the FUTA. We agree.

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[10]*SECC Corp. v. Commissioner*, 142 T.C. 225 (2014); *American Airlines Inc. v. Commissioner*, 144 T.C. 24 (2015).

[11]The national taxpayer advocate's annual report to Congress for 2016 offers the following: ''The National Taxpayer Advocate has previously written about 'real' versus 'unreal' audits. Section 7602(a)(1) grants the IRS the authority to examine any books, papers, records, or other data that may be relevant to ascertain the correctness of any return. The IRS interprets this provision narrowly; thus Automated Underreporter (AUR), Automated Substitute for Return (ASFR), Substitute for Return (SFR), and math and clerical error assessments, along with the entire category of questionable refund and return procedures are not classified as 'real' audits.''

[12]*Joseph M. Grey Public Accountant v. United States*, 119 T.C. 121 (2002); *Nu-Look Design Inc. v. Commissioner*, 356 F.3d 290 (3d Cir. 2004); and sections 3111, 3121, 3301, 3401, and 3509.

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> Nu-Look argues, however, that Stark was not an employee under the usual common law rules applicable in determining employer-employee relationships and therefore was not an employee under section 3121(d)(2). Nu-Look contends that, under section 3121(d)(2), it must exercise specific control over Stark for him to be classified as an employee and that such control was not demonstrated because Stark himself managed Nu-Look's business affairs. This argument is without merit because it completely ignores the plain language of section 3121(d) and would render subparagraph (1) superfluous. Section 3121(d) defines employee by using the disjunctive "or" between subparagraphs (1) and (2). Thus, an individual may qualify as an employee under either set of circumstances. Here, because Stark was a corporate officer, he came within section 3121(d)(1) and the Tax Court was not required to consider whether he was an employee under the common law rules made applicable under section 3121(d)(2).

It's unclear what that means for settlement purposes, because safe harbor relief depends on the willingness of the IRS and the courts to look beyond the statutory designation of any individual to the facts and circumstances analysis suggested by the regulations. A common law analysis might have led to an alternative conclusion that the corporate officer in *Nu-Look* could be treated as an independent contractor consistent with reg. section 31.3401(c)-1(f) and that every case warrants that type of analysis.

More recently, SB/SE issued a memo[13] instructing auditors to contact IRS counsel if a taxpayer raises section 530 relief during an audit concerning wage issues that might include, for example, withholding or reasonable compensation determinations. The guidance also clarifies that for "traditional" worker classification issues, auditors need not contact TE/GE counsel and should follow the usual procedures as set out in IRM 4.23.10. This increased focus on section 530 relief may address the inconsistent positions taken by the IRS and the Tax Court on worker classification for statutory employees. ■

[13]SBSE-04-0916-0050, "Emergency Interim Guidance — Contact TEGEDC [0]When Taxpayers Raise Worker Classification or Section 530 Matters Concerning Wage Adjustment Issues" (Sept. 8, 2016).

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