COMPENSATION & BENEFITS

Winning Independent Contractor Disputes With an IRS Predisposed to Find Employees

Author: By David L. Keligian

DAVID L. KELIGIAN is a partner in Brown & Streza, LLP, in Irvine, California. He is also a CPA, and has previously written for The Journal.

The question of whether a worker is an independent contractor or an employee seems an age-old controversy that shows no signs of diminishing. A safe harbor provides some relief for those eligible, but recurring legislative proposals may restrict that option in the future. The best advice may be to be prepared to justify consistent treatment of workers as independent contractors.

Independent contractor treatment has long been a battleground between the IRS and taxpayers. Ever since the 1950s, the Service has been fairly aggressive in attempting to prevent perceived abuses in the treatment of workers as independent contractors. Although there have been temporary "lulls" in the disputes, [1] due to the current fiscal situation in the U.S. and a revenue-hungry Congress, independent contractor disputes can be expected to heat up again. [2]

The crucial elements in this area include considerations of who is at risk of an IRS audit on worker misclassification, who is an independent contractor, and what is at stake in an independent contractor dispute with the IRS. Practical suggestions may assist practitioners to help protect their clients from the sometimes devastating impact of the reclassification of workers from independent contractors to employees.

AFFECTED INDUSTRIES

Historically, the Service has been very sensitive to independent contractor and worker classification issues. The perception is that the use of independent contractors has led to an ever-widening "tax gap" in lost employment tax revenues from misclassified workers. Although this perception is questionable (for example, employees qualify for many tax-free fringe benefits that independent contractors cannot receive), independent contractor treatment is still perceived as a "loophole" by the IRS and certain members of Congress. This is so even though there is no longer any difference between the Social Security tax rates paid by an independent contractor as compared with the combined employer-employee rates that apply to employees. [3]

In 2010, the Service began a national research project that involves examining over 6,000 taxpayers, with a focus on whether or not they are complying with the rules governing employment tax reporting and withholding. The taxpayers are randomly selected and include large, mid-sized, and small business employers. In addition, nonprofit organizations are included in the project. [4] The examination areas include worker classification issues (independent contractor vs. employees), as well as executive compensation issues and whether the full amount of taxable employment compensation (such as fringe benefits and reimbursement of employee expenses) is being included in the wage base.

In addition to the national research project, the Service has increased the visibility of worker classification issues in its tax audits. IRS audit guides, which are issued to provide specialized audit techniques for different industries, typically require agents to examine independent contractor issues in any standard payroll tax audit. The need for examining agents to review independent contractor vs. employee issues affects industries as diverse as garment contractors, attorneys, transportation, healthcare, and farm workers.

Regardless of industry, employers should consider taking certain steps discussed in this article to minimize their risk of the IRS reclassifying independent contractors as employees.

POTENTIALLY DISASTROUS EFFECTS

To an employer, having independent contractors reclassified as employees raises more potential issues than simply having to pay a retroactive employment tax liability. [5] In addition to the taxes, if the employer has employee benefit plans, reclassifying independent contractors as employees can cause the plans' disqualification because of their failure to cover the reclassified employees under **Sections 401(a)(26)** and **410** . This type of operational failure may be remedied through the IRS voluntary correction program, but such correction may be costly. [6] Proper plan drafting, however, may limit a reclassified employee's entitlement to benefits under an employer-sponsored benefit plan.

Although rare, the IRS has noted a potential plan disqualification issue in the reverse situation, i.e., where a worker for a company who is treated as an employee actually turns out to be an independent contractor. [7]

In addition, where the employer is doing business as a general partnership, sole proprietorship, or single-member LLC, personal liability may arise for the extra employment taxes. Even in the case of a limited liability entity such as a corporation, it is possible that the IRS will assert personal liability under **Section 6672** . [8]

Finally, given the extent of information sharing between the Service, the Department of Labor, and various state agencies, an IRS audit that results in the reclassification of workers as employees can be expected to trigger inquiries by state agencies, whose standards for worker classification are even more stringent than the Service's. Given what is at stake, any client using independent contractors should be advised about the potential risks as well as the likelihood of sustaining the position if challenged by the IRS.

STATUTORY CLASSIFICATION

For income tax withholding purposes, **Section 3401(c)** states that an "employee" includes an officer of a corporation. **Section 3121 (d)** , which addresses employment taxes, contains a much more expansive definition of "employee," which also includes any officer of a corporation. [9] Any taxpayer who attempts to treat the entire amount of compensation paid to a corporate officer as non-employee compensation typically loses on audit. [10]

Section 3121(d)(2) also provides that employee status includes "any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee." Finally, the statute includes certain defined categories of employees set forth in **Section 3121(d)(3)** . [11]

The most significant point about the statutory employee definitions is that they make both the common law tests and the section 530 safe harbor, both discussed below, irrelevant.

TRADITIONAL TESTS

The difficulties with the traditional tests of employment status are that they are factually based and subject to a great deal of interpretation. The key inquiry is contained in **Regs. 31.3401(c)-1(b)** and **(c)** , which provide that an employment relationship exists where the person for whom the services are performed has *the right to control and direct the individual* who performs the services, not only as to the result but also the details and means by which that result is to be accomplished.

It is not necessary that the person for whom the services are performed actually exercise control—the *right to control* is sufficient. The problem is that even where a client deals with an independent contractor, the client will retain some degree of control. For example, job specifications contained in an independent contractor agreement can easily be cited by the IRS as evidence of "control."

The "usual common law rules applicable in determining the employer-employee relationship" [12] are set forth in **Rev. Rul. 87-41, 1987-1 CB 296** , which lists 20 factors to serve as guides to whether the requisite "control" indicative of an employment relationship exists (see sidebar). Because these factors only serve as guides, no one factor is determinative and the importance of each factor varies on the particular set of facts and circumstances and the particular worker/business relationship.

Twenty Factors Indicating Control

As set forth in **Rev. Rul. 87-41, 1987-1 CB 296** , the following 20 factors are guides to whether the requisite "control" indicative of an employment relationship exists:

Instructions. Employees are generally required to comply with instructions as to when, where, and how the work is to be performed, while independent contractors are not.

Training. Providing training is evidence of an employer-employee relationship.

Integration. If a worker's services are "integrated" into the operation of a business, the IRS claims that worker is subject to the employer's direction and control.

Required personal services. If the worker cannot delegate to others, that is an indication of an employment relationship.

Assistants. If the hiring, supervising, and paying of assistants is handled by the employer, that indicates an employment relationship.

Continuing relationships. A permanent relationship tends to indicate an employment relationship.

Set hours of work. Required work hours are an obvious indication of direction and control and hence employment status.

Full-time services required. An independent contractor retains the right to work when and for whom he or she chooses.

Location where services are performed. If the services must be performed on the employer's premises, that is an indication of an employment relationship.

Specifying timing. The IRS claims that controlling the order or sequence of work, including scheduling appointments, is indicative of an employment relationship.

Reports. A requirement for oral or written reports to the principal by the worker is indicative of an employment relationship.

Periodic payment. Regular hourly, weekly, or monthly payment is interpreted by the IRS as evidence of an employment relationship.

Payment of business expenses. The payment of business expenses, via reimbursement or otherwise, indicates an employment relationship.

Furnishing of tools and materials. If the person for whom the services are performed furnishes the necessary tools and materials, an employment relationship is usually found.

Significant investment. If the worker has a significant investment in tools, equipment, or facilities, it tends to indicate an independent contractor relationship.

Risk of profit or loss. Independent contractors can realize a profit or suffer a loss as a result of their endeavors, while employees are not subject to such risks.

Working for more than one firm. Performing services for more than one party is an indication of an independent contractor relationship.

Availability to general public. Making services available to the general public indicates an independent contractor relationship.

Right to discharge. Employers have the right to discharge their employees, but independent contractors cannot be fired as long as they perform the terms of the contract.

Right to terminate. If the worker can end the relationship with the firm without incurring any liability, an employer-employee relationship typically is found. By contrast, an independent contractor can be liable for breach of contract.

Rather than a detailed discussion of the common law factors, many of which appear clear, suffice it to say that even an apparently obvious factor can be very ambiguous in a given situation. One example is distinguishing between the "discharge" of an employee from the cancellation of an oral contract due to the contractor's failure to perform. Another example, although the IRS will claim that regular payments are indicative of an employment relationship, is that a bona fide independent contractor may require periodic

progress payments. If the contractor asks for periodic payments that are equal in amount, the payments will resemble a "salary" and become a negative factor.

In the author's experience, the "integration" test is one of the most ambiguous. The theory is that if the work activity of the contractor is "integrated"—necessary for the business entity to conduct its business—it is indicative of an employment relationship. Especially in today's "virtual" economy, however, many critical business processes and functions are outsourced to independent contractors. They are all "integrated" with the operations of the contracting business. Stated differently, if a service or activity is not important or critical for a business, it is likely the business will not pay for it to be performed, whether by employees or independent contractors.

Because the 20 common law factors are so dependent on specific facts and circumstances, it is extremely difficult to rely on them. The Service's view of which factors are relevant in any given circumstance typically is very different from the taxpayer's. This makes independent contractor audits based on the common law tests very unpredictable.

Using the Traditional Tests

If practitioners are forced to rely on the traditional test to determine employment status, several important points should be kept in mind. First, this article is concerned with the *federal income tax* rules for worker classification. Numerous state agencies (such as workers' compensation boards) have different rules. In virtually all cases, those rules follow the common law tests, i.e., the section 530 safe harbor, which is much better to rely on for federal tax purposes, is not available for state purposes.

Therefore, notwithstanding a taxpayer's ability to meet the section 530 safe harbor, it is still important that steps be taken to show that the workers meet the traditional common law criteria applicable to independent contractors. For example, each of the workers should have written independent contractor agreements prepared and signed. Such agreements should address as many of the 20 common law indicators as possible and make it clear the particular factor supports independent contractor treatment. For example, the agreement should specify that contractors are free to set their own hours, hire their own assistants, and provide their own tools and equipment. Although simply preparing an agreement will not win the issue, [13] not having one is a serious weakness.

In addition, contractors should bid on discrete projects, as opposed to committing to hourly, weekly, or monthly work on a continuous basis. The following would be helpful:

- The contractors submitted bids to multiple businesses other than the taxpayer.
- The taxpayer used different contractors (depending on their bids and capabilities).
- The contractors not only had the freedom to work for others, but actually did so.
- The contractors had their own business cards, phone book listings, business licenses, tools, and facilities.

In those situations in which a taxpayer wants to treat someone as an independent contractor and attempts to do so by simply preparing an independent contractor agreement, but the worker never works for any other party, works continuously for the taxpayer, and does not actually have an independent business (even though deducting various business expenses), independent contractor treatment will be extremely difficult to sustain unless the taxpayer qualifies for the section 530 safe harbor.

THE SERVICE'S HISTORIC APPROACH

For many years, the IRS followed the practice of issuing Revenue Rulings interpreting the application of the common law factors to workers in specific industries. The vast majority of these Rulings always found the workers in question to be employees, not independent contractors. [14]

The IRS issued ruling after ruling, and Service personnel (typically revenue officers in the collection division, who for some time were charged with responsibility for investigating independent contractor cases) would then cite the Revenue Rulings as authority. Simply stated, the IRS created its own authority in a concerted effort to reclassify as many workers to employees as possible.

SECTION 530 SAFE HARBOR

The most potent weapon practitioners have to guard against a reclassification of independent contractors as employees by the IRS is the safe harbor found in section 530 of the Revenue Act of 1978. The section 530 safe harbor should be considered the first step in

any case involving a worker misclassification.

In 1978, Congress became concerned that the IRS was too aggressive in its attempts to reclassify independent contractors as employees. In response, Congress created what was supposed to be a temporary "freeze" on such efforts by creating a safe harbor. That safe harbor was temporarily extended several times until it was finally made permanent in 1982. [15]

The effect of the section 530 safe harbor is that employers may continue to treat misclassified workers as independent contractors for federal employment tax purposes provided the employers have a reasonable basis for such treatment. Thus, if an employer is eligible for the section 530 safe harbor, the employer's tax liability for failure to pay its share of employment taxes and failure to withhold for federal income taxes can be eliminated for all past and future years. The requirements for the section 530 safe harbor are as follows:

> (1) The taxpayer must have filed all required documents that are consistent with independent contractor status. This primarily means Forms 1099 and 1096 have been filed for the independent contractors.
>
> (2) Each group of workers must be treated consistently. For example, if a taxpayer uses 100 independent salespeople but treats a single one of them as an employee (perhaps so that person can qualify for medical insurance), the section 530 safe harbor will be lost for all the salespeople. It is relatively easy for the IRS to check whether the same personnel ever had both Forms W-2 and 1099, even in different tax years.
>
> (3) The taxpayer must have a "reasonable basis" for its treatment of its workers as independent contractors. For this purpose, a "reasonable basis" includes reliance on Revenue Rulings or court cases, whether they deal with the same industry as the taxpayer or not, or a past audit (which, for audits beginning before 1997, could be an income tax audit in which independent contractor issues were not even considered).

In addition, a "reasonable basis" can be established by the prevailing practice in a "significant segment" of a taxpayer's industry, even if the practice is not uniform. For this purpose, showing that at least 25% of the industry follows the same practice will suffice. Defining what exactly constitutes the taxpayer's "industry," however, is not always a straightforward proposition.

Finally, "any other" reasonable basis can provide a taxpayer with a means for reliance on section 530 safe harbor. Written advice from an accountant or attorney would constitute such a "reasonable basis" if the professional in question was qualified to provide such advice. The "reasonable basis" standard is to be construed liberally in favor of the taxpayer, a position that the IRS accepts. [16]

How to Use the Safe Harbor

Because reliance on the traditional common law factors is so risky, practitioners should be as proactive as possible in advising their clients who use independent contractors how to make use of the section 530 safe harbor. The following points should be kept in mind.

Satisfy the common law test. Even if the taxpayer is relying on the section 530 safe harbor, best efforts should be made to document why the workers meet the common law tests for independent contractor treatment. This would include well-drafted independent contractor agreements and a careful assessment of whether, from a business standpoint, the common law tests can be met. The reason is that even though the section 530 safe harbor may apply for federal purposes, state agencies use the common law tests. A business that fits within the section 530 parameters for federal income tax purposes still can incur significant liability if a state agency investigates and reclassifies the workers.

File information returns. Taxpayers must be scrupulous in filing Forms 1099 for all of their independent contractors, as well as Form 1096 (the transmittal for Forms 1099). If a taxpayer has failed to timely file Form 1099, late forms should be prepared and filed, even though the Service's position is that timely filing is required to obtain relief under the section 530 safe harbor. [17] Nevertheless, in *Medical Emergency Care Associates, S.C.,* **120 TC 436** (2003), the Tax Court permitted section 530 relief and noted that nothing in the statutory language required timeliness in connection with the taxpayer's filings.

Consistent treatment. Because there must be consistent treatment of workers, practitioners should encourage their clients to do a detailed review comparing all W-2 personnel with all independent contractors to make sure (a) specific individuals have not been treated under both regimes and, more important, (b) that there has been consistent treatment with respect to each specific category of workers.

The IRS will look for examples of inconsistent treatment. It may be possible to salvage the availability of the section 530 safe harbor if the taxpayer knows of any inconsistency before there is any audit. If an inconsistency is found, its impact can be lessened by

carefully defining specific subcategories of workers to minimize the number of workers who have been inconsistently treated. [18]

Reasonable basis. Although the author recommends that multiple prongs of the "reasonable basis" test be met if possible, the easiest requirement to satisfy is for the practitioner to write a detailed letter to the client supporting the client's independent contractor treatment of its workers. Typically, the letter would cite cases with facts as close as possible to the client's situation, in which independent contractor treatment had been upheld.

It is very difficult, for example, to rely on the "industry practice" segment of the safe harbor unless the taxpayer is a member of a trade group or association in which many members treat their workers as independent contractors, and the trade group or association is aware of the issue and tracks sufficient data to be able to show that the "industry practice" test is met. Otherwise, especially if the taxpayer is under audit, it will be extremely difficult to be able to show the IRS that at least 25% of the taxpayers in the same local area are using independent contractors in the same fashion as the taxpayer. [19]

As far as what standards must be met in providing written advice to a taxpayer, there is very little authority. In *Smoky Mountain Secrets, Inc.,* **76 AFTR 2d 95-6974** , 910 F Supp 1316 (DC Tenn., 1995), a corporate president's consultation with the corporation's CPA, as well as his personal CPA, was held to satisfy the standard necessary to establish a "reasonable basis" under the section 530 safe harbor.

A stricter standard was suggested in *Arndt,* **78 AFTR 2d 96-6295** , 201 BR 853 (DC Fla., 1996). There, the court stated that "an accountant's advice is not the type of 'technical advice' that can serve as a basis upon which a taxpayer can reasonably rely." In the author's opinion, however, *Arndt* does not state the correct standard. Even the IRS appears to have a more liberal standard. In **TAM 9801001** , IRS cited *Smokey Mountain Secrets* and held that a taxpayer's reliance on legal advice from a tax lawyer constituted a "reasonable basis" under the section 530 safe harbor. There is no apparent reason why advice from a similarly qualified CPA should not suffice.

Timing. As far as relying on written advice, the sooner practitioners prepare letters for their clients, the more protection the client obtains as to any open tax years. The author has been involved in situations where, after the fact, tax advisors wrote letters supporting independent contractor treatment. The IRS took the position that because the letters were prepared after the fact, the taxpayer could not have relied on them in its treatment of its workers as independent contractors.

Several points are noteworthy. First, even the IRS seems to recognize that an after-the-fact letter still can demonstrate that there was a reasonable basis for treatment of workers as independent contractors. [20] In a Program Manager Technical Assistance (PMTA 2011-15), the IRS Office of Chief Counsel stated that an employer must demonstrate that it actually and reasonably relied on one of the safe harbor criteria only for the tax period or periods at issue. This means that a taxpayer can rely on a case or on industry practice arising well after the date the taxpayer initially hired the workers in question, as long as that reliance occurred before the years at issue. The PMTA also stated, however, that the reasonable reliance standard was more clearly met if the taxpayer "can demonstrate actual and reasonable reliance on the asserted reasonable basis prior to engaging the services of the workers at issue."

Even an after-the-fact letter can memorialize prior discussions between the taxpayer and the tax advisor in which independent contractor treatment was discussed in detail, if the advisor indicated that independent contractor treatment was warranted at the time of the discussion.

The "reasonable basis" and "reliance" issues are especially important in connection with the next two items.

Audit strategy. If there is an audit, the factors supporting the availability of the section 530 safe harbor should be prepared and presented in a thorough, complete fashion at the earliest opportunity. That includes, for example, a detailed description of each work category and those workers who fall within that category. Using as many work categories as possible is recommended, because it tends to limit the damage if the taxpayer has treated workers inconsistently. If the Service finds examples of inconsistent treatment, any disallowance of safe harbor treatment should be confined to the disallowance of such treatment for inconsistently treated workers within a smaller subcategory. [21]

Be prepared. Thorough preparation is well worth it, since the IRS now instructs its agents to discuss with the taxpayer the reasons the workers were treated as independent contractors as early as possible during the examination. As in so many other areas, first impressions (in the form of a clear statement supporting the reasons why the taxpayer qualifies for the section 530 safe harbor and the factors supporting a reasonable basis for the treatment) are important.

Statute of limitations. Employment tax returns should always be filed, even if the taxpayer believes that it has no employees and relies exclusively on independent contractors. The filing of Forms 1099 will not trigger the running of the statute of limitations, but the filing of employment tax returns should.

RECENT DEVELOPMENTS

As indicated at the beginning of this article, disputes over worker classification never really go away, given the IRS antipathy to independent contractor treatment. There have been new developments from both Congress and the Service.

Legislative proposals. It is understandable, in light of the government's current fiscal situation, that there have been several proposals which would greatly weaken a taxpayer's ability to contest the reclassification of its workers.

For example, one proposal contained in the "Taxpayer Responsibility, Accountability, and Consistency Act of 2009" permitted the section 530 safe harbor, but terminated its protection "for any periods beginning after the date of notice of a determination that such individual should be treated an employee of the taxpayer." Under this bill, once the IRS decided that workers should be reclassified, the taxpayer could no longer rely on the safe harbor going forward.

H.R. 6128 (the "Fair Playing Field Act of 2010") also provided that the safe harbor would not apply once the IRS redetermined the status of workers. In addition, it would have given Treasury the authority to issue Regulations to "clarify the proper employment status of individuals" for employment tax purposes. Essentially, under this proposal, the reclassification of workers could be triggered by the issuance of Regulations, at which time safe harbor treatment would be denied. In light of the history of IRS Revenue Rulings dealing with employee classification issues, it could be expected that Regulations issued under this legislation would make independent contractor treatment much harder to justify.

Administrative action. In **Ann. 2011-64, 2011-41 IRB 503** , the IRS announced a Voluntary Classification Settlement Program (VCSP), under which taxpayers who are not being audited can agree to voluntarily reclassify as employees workers previously treated as independent contractors. Essentially, the VCSP program extends relief similar to that obtainable in the Service's current Classification Settlement Program for taxpayers who are under audit to taxpayers who are not.

VCSP eligibility requires a taxpayer to have consistently treated the workers as non-employees, and to have filed all required Forms 1099 for the workers for previous years. The taxpayer cannot currently be under audit by the IRS, the DOL, or by any state government agency. If the eligibility criteria are met, the taxpayer agrees to prospectively treat the affected workers as employees for future tax periods.

In exchange, the taxpayer is obligated to pay only 10% of the employment tax liability that may have been due for the most recently closed tax year, using the reduced rates of **Section 3509** . In addition, there is no interest or penalty applicable to the liability, and the Service will forgo any employment tax audit with respect to the reclassified workers for the prior years. The program requires entry into a closing agreement with the IRS and the taxpayer's extension of the period of limitations on assessment of employment taxes for the first three years beginning after the date on which the taxpayer has agreed to begin treating the workers as employees.

The IRS released additional information about the VCSP in the form of "frequently asked questions" (FAQs). The FAQs state that application for the VCSP is made on Form 8952 ("Application for Voluntary Classification Settlement Program"), which became available in October of 2011 and should be filed at least 60 days from the date the taxpayer wants to begin treating its workers as employees. The FAQs make it clear that a taxpayer does not have to reclassify all of its workers, but that if it chooses to reclassify workers as employees, all workers in the same work category must be treated as employees. The program is also available to exempt organizations.

The VCSP would be beneficial for any situation in which the taxpayer is fairly certain its workers would be classified as employees on audit. Even though there are beneficial aspects to the program, however, the VCSP consistency requirement and the requirement to file all required Forms 1099 are also requirements to qualify for the section 530 safe harbor. Thus, taxpayers who have met the eligibility requirements for the VCSP and who also have a reasonable basis for their prior treatment of workers would not need to participate because they qualify under the safe harbor.

CONCLUSION

Given the potentially disastrous effects of worker reclassifications and the increased scrutiny the IRS is again devoting to taxpayers who use independent contractors, practitioners with clients who make extensive use of independent contractors should determine the applicability of the section 530 safe harbor to such clients, and take some of the steps outlined in this article. Practitioners also need to be sensitive to any new legislation, including remaining alert to the issuance of new Regulations or Revenue Rulings that could remove a taxpayer's ability to rely on the section 530 safe harbor.

Practice Notes

Notwithstanding a taxpayer's ability to meet the section 530 safe harbor, it is still important that steps be taken to show that the workers meet the traditional common law criteria applicable to independent contractors. For example, each of the workers should have written independent contractor agreements prepared and signed. Such agreements should address as many of the 20 common law indicators as possible and make it clear the particular factor supports independent contractor treatment. For example, the agreement should specify that contractors are free to set their own hours, hire their own assistants, and provide their own tools and equipment. Although simply preparing an agreement will not win the issue, not having one is a serious weakness.

In addition, contractors should bid on discrete projects, as opposed to committing to hourly, weekly, or monthly work on a continuous basis. It would be helpful if the contractors submitted bids to multiple businesses other than the taxpayer, if the taxpayer used different contractors (depending on their bids and capabilities), if the contractors not only had the freedom to work for others, but actually did so, and if the contractors had their own business cards, phone book listings, business licenses, tools, and facilities.
[1]

The "section 530 safe harbor," passed as part of the Revenue Act of 1978 and discussed at length later in this article, marked a legislatively mandated but tenuous "truce" between taxpayers and the IRS. This provision is not a part of the Code.
[2]

For example, several legislative proposals would significantly weaken the effect of the section 530 safe harbor, as discussed in the text, below.
[3]

In fact, in 2011, the total combined rate applicable to employees was reduced from the normal 6.2% to 4.2% by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (P.L. 111-312, 12/17/10).
[4]

Independent of this research project, the IRS also has instituted a program to audit large nonprofits, including private colleges and universities. Compensation, fringe benefits, and potential excess benefit issues are all being considered.
[5]

Unexpected retroactive tax liabilities alone can put taxpayers competing in low-margin industries at a severe competitive disadvantage.
[6]

See **Rev. Proc. 2008-50, 2008-35 IRB 464** , which permits retroactive corrections in certain circumstances. See generally Rosner and Miller, "New Updates Further Streamline Voluntary Corrections and Provide Additional Types of Relief," **110 JTAX 92 (February 2009)** .
[7]

See Butts, **TC Memo 1993-478** , RIA TC Memo ¶93478 , and Smithwick, **TC Memo 1993-582** , RIA TC Memo ¶93582 , both *aff'd per cur.* by Butts, **75 AFTR 2d 95-1701** , 49 F3d 713 (CA-11, 1995), both dealing with situations where workers treated as employees by the employer and covered under their qualified plans were actually independent contractors. Here, the issue is possible jeopardy to the plans' qualified status due to violation of the **Section 401(a)(2)** "exclusive benefit" rule. The plan might be able to protect itself by provisions that automatically and retroactively exclude individuals from participation if they are found not to be an employee (see **Ltr. Rul. 9546018**), or through the mechanisms set forth in **Rev. Proc. 2008-50** , *supra* note 6.
[8]

Although **Section 6672** requires "willfulness"—the intentional act of paying other creditors in preference to the U.S. government—in some cases "reckless disregard" has been held to satisfy the "willfulness" standard. See Whiteside, **70 AFTR 2d 92-5105** (Cls. Ct., 1992). In addition, **Section 6672** liability can arise independently once employment taxes are assessed and a taxpayer pays other creditors in preference to the government. See Oppliger, **107 AFTR 2d 2011-1518** , 637 F3d 889 (CA-8, 2011), *cert. den.*
[9]

See **Section 3121(d)(1)** . It is possible for an officer of a corporation to hold two different roles, with the officer role categorized as that of an "employee" and the other role categorized as an independent contractor relationship. See, e.g., **Reg. 31.3401(c)-1(f)** , which distinguishes a corporate employee, including an officer, from a corporate director acting in his capacity as such.
10

See Donald G. Cave a Professional Law Corp., **TC Memo 2011-48** , RIA TC Memo ¶2011-048 .
11

Examples include full-time life insurance salespeople and certain "home workers" who perform work according to specifications furnished by another party, which also furnishes the materials for goods required to be returned to such party by the home worker.
12

Section 3121(d)(2) .
13

For example, the Internal Revenue Manual Market Segment Specialization Program (MSSP) provisions dealing with audits of farm workers in the swine industry state: "A written agreement describing the worker as an independent contractor is viewed as evidence of the parties' intent that a worker is an independent contractor—especially in close cases. However, a contractual designation, in and of itself, is not sufficient evidence for determining worker status."
14

See, e.g., **Rev. Rul. 58-268, 1958-1 CB 353** (dental hygienist who worked one or two days a week for a fee of 50% of the amount charged the patient was held to be an employee); **Rev. Rul. 56-155, 1956-1 CB 478** (floor layer who used his own tools and laid floors on a full-time piecework basis was held to be corporate employee where the corporation furnished all materials, carried workers' compensation insurance on the worker, and made frequent inspections); and **Rev. Rul. 56-694, 1956-2 CB 694** (photographers held to be employees where they received leads and locations for taking home portraits and were required to follow a set pattern of poses for different age groups).
15

TEFRA section 269(c).
16

See **Rev. Proc. 85-18, 1985-1 CB 518** .
17

Rev. Rul. 81-224, 1981-2 CB 197 .
18

As an example, a business that sold commercial carpeting used a pool of independent contractors for installations. Motivated by compassion, the business paid a single installer as an employee so the installer could be covered under the company's health plan. That treatment could have disqualified the entire pool of workers as independent contractors. A careful analysis of what work this specific individual actually did disclosed that he installed only hard flooring, not carpet. By precisely defining his job classification, and also carefully defining other subcategories of the entire worker pool, the company was able to preserve section 530 safe harbor treatment for most of its independent contractors.
19

Imagine the following: You are in competition with another business, and a representative of that business comes to you and says, "Our business is under audit. The IRS is trying to reclassify all our workers as employees. Can we tell the IRS you are doing the same thing as we are?"
20

In the Internal Revenue Manual MSSP provisions dealing with audits of the auto body and repair industry, the IRM stated that "a taxpayer cannot have relied on recently decided cases for years prior to the decision." See MSSP Training Guide, Auto Body/Repair Industry, Chapter 9. Nevertheless, the audit guide then stated that "an opinion letter from an attorney written after the examination began is less persuasive than one that was written when the employer first began using the workers and treating them as independent contractors." It is hard to see how an after-the-fact opinion letter can be useful in proving reliance by a taxpayer for an open tax year unless the letter refers to facts and circumstances that the taxpayer previously considered, with the letter only affirming that the taxpayer's conclusions were supportable. The letter would help as to tax years after the letter. See PMTA 2011-15, discussed in the text.
21

In the author's experience, the IRS is also much more likely to accept the taxpayer's definition and categorization of work categories and which workers fit in them if they are presented in writing at the commencement of any employment tax audit. If practitioners allow

the examining agents to come to their own conclusions, there is a risk that, for example, all workers will be dumped into a single category, meaning that a single example of inconsistent treatment can disqualify the safe harbor for all of the workers.