ANATOMY OF A WORKER-CLASSIFICATION DISPUTE WITH THE IRS

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The IRS is constantly auditing businesses and attempting to recharacterize their workers as employees, instead of independent contractors, but this article, using life insurance agents as a model, presents arguments for companies to use in defending themselves in a worker-classification case.

Introduction

The IRS often shifts its resources, focusing enforcement efforts in priority areas. In recent years, the IRS has devoted considerable attention to failures to report foreign assets, charitable deductions related to conservation easements, and captive insurance companies. While these matters tend to grab headlines, the IRS continues to plod ahead, largely unnoticed, challenging other tax issues that it finds problematic.

Among these issues is worker classification; the IRS is constantly auditing businesses and attempting to recharacterize their workers as employees, instead of independent contractors. This is a simple matter of economics. The IRS estimated a few years ago that the "tax gap" (*i.e.*, the difference between what taxpayers should pay and what they actually pay) was approximately $345 billion, with a "b," and a significant percentage of this financial shortfall was attributable to worker misclassification and other employment tax non-compliance.[1]

Given the aggressive tactics used by the IRS, the ignorance of many business owners of complex tax rules and procedures, and the potential cost (in terms of taxes, penalties, and interest) associated with involuntarily converting workers from independent contractors to employees, it is critical to analyze and update worker-classification issues periodically. This article does just that, using attacks by the IRS on life insurance agents as a model to advance the discussion.

Four categories of workers

To understand manners of defending against the IRS in a worker-classification dispute, one must grasp the main categories. Workers fall into four groups: they can be (1) statutory employees, (2) statutory non-employees, (3) common law employees, or (4) independent contractors.

Statutory employees are, like they sound, workers who are defined as employees in a statute. For instance, tax provisions explain that the term "employee" includes officers of corporations, as well as individuals who perform the following jobs for compensation: (1) agent-driver or commission-driver engaged in distributing particular products; (2) full-time insurance salespersons; (3) so-called home-workers, who perform work on materials or goods provided by their principals according

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to specifications set by the principals and then return the improved goods to the principals or a designated party, and (4) traveling or city salespersons engaged on a full-time basis in soliciting for their principals orders from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments for merchandise for resale or supplies for use in their business operations.[2]

For their part, statutory non-employees are, logically, workers who are specifically excluded from the definition of employee by a statute. Among the statutory non-employees are direct sellers, who, according to a written contract and on a commission or other performance-driven basis, sell consumer products, personally or through others, in a home or in any other place that is not a permanent retail establishment.[3]

Unlike the preceding two categories, common law employees are not identified in tax statutes; rather, as the name indicates, they are products of judicial evolution. The relevant regulations provide that one of the key factors in determining whether a particular worker should be considered a common law employee is the degree of control that the company possesses and/or exercises over the worker.[4] The regulations clarify that, in making a decision about common law employee status, the IRS must consider "the particular facts of each case."[5] The IRS released a list of 20 factors decades ago that still serves as a guide in this analysis.[6]

Finally, independent contractors are those workers, characterized by flexibility in the manner of performing services, who do not fall into any of the preceding three categories.

H1:Background on the Agency and its workers

The facts in every case vary, of course, but here are some common ones in a situation involving an insurance agency ("Agency") and its sales force. The IRS frequently scrutinizes these types of workers, claiming that they should be categorized as statutory employees or common law employees.

The Agency is an insurance "agency," licensed by the financial services department of the relevant state, which sells policies. It is *not* an insurance "company," which underwrites policies, assumes financial risks, pays claims, etc. The Agency essentially acts as a conduit for multiple insurance companies. Each worker signs some type of independent contractor or agent agreement with the Agency, expressly stating the intent of all parties that the workers are independent contractors, not employees. The role and involvement of the Agency is limited, purposely. It provides the workers with basic initial sales training, presentation materials for potential clients, and periodic leads; the Agency provides nothing else of significance.

Several other factors support the notion that the workers are independent contractors, including (1) the workers only receive commissions based on sales, not set salaries; (2) the workers have no fixed work schedule; (3) the workers have no hourly demands; they can work zero hours or 24 hours per day; (4) the Agency does not require the workers to attend regular meetings; (5) the workers are not obligated to pursue any leads provided by the Agency; (6) the Agency does not mandate a particular dress code for the workers; (7) the workers must rent their own office space, at their own expense; (8) the workers can delegate certain job-related tasks to others, including telemarketers, appointment setters, and clerks; (9) the workers must pay all their own expenses, such as transportation, phone, office supplies, office equipment, mail services, advertising, state licensing fee, professional liability insurance, and others; (10) the Agency grants no benefits to its workers, such as paid vacations, sick pay, pensions, bonuses, paid holidays, insurance benefits, or housing; (11) the Agency does not force the workers to follow its suggestions regarding when, where, and how to work; (12) the workers perform no work on the Agency's premises; (13) the workers are not required to file activity or other types of status reports; and (14) the Agency treats all workers holding similar positions as independent contractors by filing Forms 1099-MISC (Miscellaneous Income) with the IRS.

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1 U.S. Treasury Inspector General for Tax Administration, "While Actions Have Been Taken to Address Worker Misclassification, an Agency-Wide Employment Tax Program and Better Data Are Needed." Report #2009-30-035 (2/4/09), p. 8.

2 *See* Section 3121(d) and Reg. 31.3121(d)-1 (containing the definition of "employee" for FICA purposes), Section 3306(i) (containing the definition of "employee" for FUTA purposes), and Section 3401(c) and Reg. 31.3401(c)-1 (containing the definition of "employee" for federal income tax withholding purposes).

3 Section 3508 and Prop. Reg. 31.3508-1.

4 Reg. 31.3401(c)-1(b). *See also* Reg. 31.31.3121(d)-1(c)(2).

5 Reg. 31.3401(c)-1(c).

6 Rev. Rul. 87-41, 1987-1 C.B. 296.

The Agency deserves relief under section 530

The Agency's primary position likely would be that it is entitled to section 530 relief; accordingly, the IRS should stop its worker-classification examination, and the Agency should be allowed to continue treating the workers as independent contractors without further scrutiny by the IRS.

History of section 530. Section 530 is not found in the Internal Revenue Code; rather, it is a reference to "section 530" of the Revenue Act of 1978.[7] Confusion often results from the fact that this provision has never been codified. The consequence is that those looking for section 530 in the current version of the Internal Revenue Code will be disappointed, finding rules about "Coverdell education savings plans," not relief from overzealous employment tax audits by the IRS.

The company that satisfies all the criteria to warrant so-called "section 530 relief" obtains two major benefits. First, the IRS may not assess any back employment taxes, penalties, or interest charges against the company.[8] Second, and perhaps more importantly, the IRS cannot obligate the company to reclassify the workers as employees going forward, regardless of the fact that applicable law supports reclassification. The company gets a free pass, if you will, for past *and* future behavior, if it can prove that section 530 applies.

It looks innocuous enough, but the general rule of section 530 is powerful:

> If, for purposes of employment taxes, the [company] did not treat an individual as an employee for any period, and . . . all Federal tax returns (including information returns) required to be filed by the [company] with respect to such individual for such period are filed on a basis consistent with the [company's] treatment of such individual as not being an employee, then, for purposes of applying such taxes for such period with respect to the [company], the individual shall be deemed not to be an employee unless the [company] has no reasonable basis for not treating such individual as an employee.[9]

Congress introduced section 530 in the Revenue Act of 1978 in an effort to counter aggressive IRS worker-classification audits on small businesses.[10] According to the legislative history, the congressional relief provided to companies by section 530 was appropriate because the IRS had dramatically increased enforcement of employment tax laws, many of the positions that the IRS began taking were contrary to those followed in earlier years, and mandatory reclassification of workers often resulted in double payment of the same taxes because companies were obligated to pay federal income tax liabilities and FICA taxes for workers, even though such workers may have already paid their own income and self-employment taxes.[11]

Congress initially contemplated a short-term reprieve for companies, while studies were conducted to analyze the scope of the problem and potential solutions. The relevant legislative history described it in the following manner:

> The [Senate Finance] Committee believes that it is appropriate to provide *interim relief* for taxpayers who are involved in employment tax status controversies with the Internal Revenue Service, and who potentially face large assessments, as a result of the Service's proposed reclassifications of workers, until the Congress has adequate time to resolve the many complex issues involved in this area.[12]

Section 530 has remained in effect since 1978, despite these early thoughts about a temporary halt to overreaching by the IRS. The law has been amended during this period three times, with each occasion further strengthening the rights of companies invoking section 530 relief.[13] For instance, the law and IRS policies have evolved to ensure that the IRS, not the company under attack, has the duty of broaching the issue of potential relief. Section 530(e)(1), enacted in 1996, states that IRS personnel conducting a worker-classification audit "shall" provide the company with written notice of the existence and terms of section 530 "before or at the commencement of" the audit.[14] The Internal Revenue Manual contains additional detail in this regard, stating the following:

[7] P.L. 95-600, 11/6/78.

[8] For purposes of this article, the term "employment taxes" refers to three items: (1) the federal income taxes that an employer is required to withhold from an employee; (2) amounts under the Federal Insurance Contributions Act ("FICA"), consisting of Social Security taxes and Medicare, which are paid partly by the employer and partly by the employee; and (3) amounts under the Federal Unemployment Tax Act ("FUTA"), which are paid solely by the employer.

[9] section 530(a)(1).

[10] P.L. 95-600, 11/6/78, section 530.

[11] Senate Report No. 95-1263, 95th Cong. 2d Sess. (1978), pp. 209-211.

[12] Senate Report No. 95-1263, 95th Cong. 2d Sess. (1978), p. 201 (emphasis added).

[13] *See* Revenue Act of 1978 (P.L. 95-600, 11/6/78), Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248, 9/3/82), Tax Reform Act of 1986 (P.L. 99-514, 10/22/86), and Small Business Job Protection Act of 1996 (P.L. 104-188, 8/20/96).

[14] section 530(e)(1); Small Business Job Protection Act of 1996 (P.L. 104-188, 8/20/96), section 1122).

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> Section 530 is a relief provision that must be considered as the first step in any case involving worker classification. Relief is available to taxpayers or employers that are under examination or involved in administrative (including Appeals) or judicial proceedings with respect to assessments based on employment status reclassification . . . It is not necessary for the taxpayer to claim section 530 relief for it to be applicable. In order to correctly determine tax liability, the examiner must first explore the applicability of section 530 even if the taxpayer does not raise the issue.[15]

Congress has stated, and the IRS has officially acknowledged, that section 530 relief must be "construed liberally in favor of taxpayers."[16]

Workers fall into four groups: they can be (1) statutory employees, (2) statutory non-employees, (3) common law employees, or (4) independent contractors.

Three criteria for section 530. The law is like a self-fulfilling prophecy. It provides that if a company treated a worker as an independent contractor for certain tax periods, the worker *shall* be deemed to be an independent contractor for such periods, provided that the company:

- Filed federal tax and information returns in a manner consistent with the worker's status as an independent contractor ("Reporting Consistency"), and
- Treated all workers holding substantially similar positions as independent contractors ("Substantive Consistency"), and
- Had a "reasonable basis" for treating the worker as an independent contractor ("Reasonable Basis").[17]

With respect to the third component, a company has a Reasonable Basis for treating a worker as an independent contractor if the company reasonably relies on *any* of the following:[18]

- Court decisions or published IRS rulings (regardless of whether they relate to the particular industry or business in which the company is engaged), or technical advice, a private letter ruling, or a determination letter from the IRS pertaining to the company ("Precedent Safe Harbor"); or
- A past IRS audit of the company in which there was no assessment attributable to the treatment, for employment tax purposes, of workers holding positions substantially similar to those of the workers whose status is at issue ("Prior Audit Safe Harbor"); or
- A longstanding recognized practice of a significant segment of the industry in which the company is engaged ("Industry Practice Safe Harbor"); or
- Some other reasonable basis for treating the workers as independent contractors ("Other Reasonable Basis Safe Harbor").

It is clear that the last component should be broadly interpreted to favor the company.[19] For example, Congress found that reasonable reliance on a qualified, informed tax professional satisfies the Other Reasonable Basis Safe Harbor:

> Under case law, reliance on the advice of an attorney or an accountant may constitute a reasonable basis for treating a worker as an independent contractor. The IRS appears to agree with this position, provided there is a showing that the attorney or accountant was knowledgeable about the law and facts in rendering the advice.[20]

Likewise, the IRS has also acknowledged the reasonable-reliance defense in its own Internal Revenue Manual:

> Reliance on an attorney or accountant may constitute a reasonable basis. The taxpayer need not independently investigate the credentials of the attorney or accountant to determine whether such advisor has any specialized experience in the employment tax area. However, the taxpayer should establish at a minimum, that it reasonably believed the attorney or accountant to be familiar with taxpayer's tax issues and that the advice was based on sufficient relevant facts furnished by the taxpayer to the adviser.[21]

In addition to reasonably relying on a tax professional, Congress has also recognized that a company can meet the Other Reasonable Basis Safe Harbor by showing that it reviewed the common law standards and concluded that the workers in question do not fall into the "employee" category. According to the congressional report, "[t]axpayers generally have argued successfully that reliance on the common law test can constitute a reasonable basis for purposes of applying section 530."[22]

Application of the law to the Agency's situation. As explained above, the Agency is entitled to the

[15] I.R.M. section 4.23.5.2.1 (2/1/03) (emphasis in original).
[16] H. Rept. No 178 (95th Cong., 2nd Sess., 5 (1978); I.R.M. section 4.23.5.2.1 (2/1/03).
[17] section 530(a)(1); Rev. Proc. 85-18, 1985-1 CB 518.
[18] section 530(a)(2); Rev. Proc. 85-18, 1985-1 CB 518.
[19] Rev. Proc. 85-18, 1985-1 CB 518, section 3.01.
[20] S. Rep. 104-281, 104th Cong., 2nd Sess., 24 (1996).
[21] I.R.M. section 4.23.5.2.2.7 (2/1/03).
[22] S. Rep. 104-281, 104th Cong., 2nd Sess., 24 (1996).

protection of section 530 if there is Reporting Consistency, Substantive Consistency, and Reasonable Basis. Normally, a company has little problem meeting the first two criteria, because it files Forms 1099 and treats all workers, except managers and officers of the company, as independent contractors. Thus, the focus of the IRS ordinarily is on whether the company had a Reasonable Basis.

The Agency only needs to show that it meets one of the four ways of establishing Reasonable Basis, but it might present a few for good measure. First, the Agency might argue that it falls into the Precedent Safe Harbor because, at the time that it began classifying the workers as independent contractors, (1) there were dozens of court decisions and IRS rulings holding that life insurance salesmen were considered independent contractors under a common-law analysis, a statutory-employee analysis, or both, (2) the leadership of the Agency was aware of such authorities, and (3) the legal and tax advisors on whom the Agency relied with respect to the classification issue were cognizant of such authorities, too.

A partial list of the relevant authorities is set forth below.

- *Bell*, 13 TC 344 (1949).
- Rev. Rul. 54-309, 1954-2 CB 261.
- Rev. Rul. 59-103, 1959-1 CB 259.
- TAM 6101053170A.
- TAM 6710314410A.
- Ltr. Rul. 6801190500A.
- Rev. Rul. 69-288, 1969-1 CB 258.
- *Reserve National Insurance Co.*, 1974 WL 572 (W.D. Ok. 1974).
- *Standard Life & Accident Insurance Co.*, 1975 WL 543 (W.D. Ok. 1975).
- *Simpson*, 64 TC 974 (1975).
- *Investors Heritage Life Insurance Co.*, 1979 WL 1303 (E.D. Ky. 1979).
- TAM 7608201890A.
- Ltr. Rul. 8217098.
- Ltr. Rul. 8532099.
- Ltr. Rul. 8617094.
- Ltr. Rul. 9306029.
- *Butts*, TCM 1993-478, *aff'd* 49 F.3d 713 (CA-11, 1995).
- *Smithwick*, TCM 1993-582.
- *Ware*, 850 F. Supp. 602 (W.D. Mich. 1994).
- *Mosteirin*, TCM 1995-367.
- TAM 9518001.
- *Feivor*, TCM 1995-107.
- *Birchem v. Knights of Columbus*, 116 F.3d 310 (CA-8, 1997).
- *Lozon*, TCM 1997-250.
- TAM 9736002.
- *Wickum*, TCM 1998-270.
- Chief Counsel Notice N(35)000-141a (11/12/98).
- *Byer*, TC Summary Opinion 2006-125.
- *Geneser*, TCM 2017-110.

Second, the Agency might contend that is also satisfied the Industry Practice Safe Harbor because there is a longstanding and widespread practice within the insurance industry of treating soliciting agents, such as those working for the Agency, as independent contractors. It is also important to note that this threshold is quite low, as the law was modified by Congress in 2006 to clarify that a company can meet the Industry Practice Safe Harbor by merely showing that more than one-quarter of the industry treats similarly-situated workers as independent contractors.[23]

Even after setting this small figure, Congress indicated that the bar could be even lower: "The provision is intended to be a safe harbor; a lower percentage may constitute a significant segment of the taxpayer's industry based on the particular facts and circumstances."[24] Based on decades of experience in the insurance industry, active participation in various insurance groups (local, state, and national), and regular interactions with colleagues and competitors, leadership of the Agency might argue that it understood that nearly 100% of insurance agencies treat their soliciting agents as independent contractors for employment tax purposes.

Section 530 is not found in the Internal Revenue Code; rather, it is a reference to "section 530" of the Revenue Act of 1978.

Third, the Agency likely would maintain that it had a Reasonable Basis for labeling the agents as independent contractors because it relied on guidance and advice from accountants and attorneys, who were fully aware of the business operations, who analyzed the classification issue, and who prepared the annual Forms 1099 (and not Forms W-2) for the agents. This position would be strengthened, of course, if the Agency could present tangible evidence of reliance, such as a writ-

[23] section 530(e)(2)(B).

[24] S. Rep. 104-281, 104th Cong., 2nd Sess., 26 (1996); H.R. Conf. Rep. 104-737, 104th Cong., 2nd Sess., 203 (1996).

ten legal/tax opinion, invoices for professional services, affidavits from the accountants and attorneys, etc.

The workers are not common law employees

At this stage, the Agency might argue that the audit should cease because it demonstrated that section 530 applies. The IRS likely would take this under advisement, for what that is worth, and proceed with the audit anyway, claiming that the insurance agents are common law employees. The Agency might defend itself on the following grounds.

The relevant regulations provide that, for purposes of federal income tax withholding, the term "employee" includes individuals performing services if the relationship between him and the person for whom he performs such services is the legal relationship of employer and employee.[25] According to the regulations, one of the key factors in this determination is the degree of control possessed or exercised by the company:

Congress introduced section 530 in an effort to counter aggressive IRS worker-classification audits on small businesses.

> Generally, the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done . . . In general, if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he is not an employee.[26]

The regulations also make it clear that, in making the worker-classification determination, the IRS must consider "the particular facts of each case."[27] The IRS released a list of 20 factors decades ago that continues to guide the analysis.[28]

[25] Reg. 31.3401(c)-1(a).

[26] Reg. 31.3401(c)-1(b).

[27] Reg. 31.3401(c)-1(c).

[28] Rev. Rul. 87-41, 1987-1 CB 296.

[29] Section 3121(d)(3)(B) (emphasis added).

[30] Reg. 31.3121(d)-1(d)(1)(ii).

The earlier section of this article titled "Background on the Agency and Its Workers" contained a long list of factors demonstrating that the Agency did not have or exercise control over the workers; it was concerned with the results, not the means. The Agency might conclude that this type of evidence has repeatedly convinced the IRS and the courts to classify the workers as independent contractors. An illustrative list of these authorities is set forth in the earlier discussion about the Precedent Safe Harbor.

The workers are not statutory employees

The IRS, often plodding and rarely imaginative, likely will proceed with the audit of the Agency, despite strong defenses under section 530 and the common law standards. Probabilities are that the next attack by the IRS will center on the concept of statutory employees.

Relevant legal standards. Section 3121 provides that, for FICA purposes, the term "employee" includes:

> any individual [other than an officer of a corporation or an individual who is considered an "employee" under the common law rules] who performs services for remuneration for any person . . . *as a full-time life insurance salesman* . . . if the contract of service contemplates that substantially all of such services are to be performed personally by such individual; except that an individual shall not be included in the term "employee" under the provisions of this paragraph if such individual has a substantial investment in facilities used in connection with the performance of such services (other than in facilities for transportation), or if the services are in the nature of a single transaction not part of a continuing relationship with the person for whom the services are performed.[29]

The corresponding regulations identify various occupational groups, the members of which generally are considered employees. Among these groups are those who work as a "full-time life insurance salesman."[30] Importantly, the regulations contain an example reflecting the IRS's intent that the scope of this group be limited:

> An individual whose entire or principal business activity is devoted to the solicitation of life insurance or annuity contracts, or both, *primarily for one life insurance company* is a full-time life insurance salesman.
>
> Such a salesman ordinarily uses the office space provided by the company or its general agent, and

> stenographic assistance, telephone facilities, forms, rate books, and advertising materials are usually made available to him without cost.
>
> An individual who is engaged in the general insurance business under a contract or contracts of service which do not contemplate that the individual's principal business activity will be the solicitation of life insurance or annuity contracts, or both, *for one company*, or any individual who devotes only part time to the solicitation of life insurance contracts, including annuity contracts, and is principally engaged in other endeavors, is not a full-time life insurance salesman.[31]

The regulations go on to further narrow the category of full-time life insurance salesman. They state that, even if an individual initially falls within one of the occupational groups, such individual is not to be considered an "employee," unless (1) the contract of service contemplates that substantially all the services to which the contract relates in the particular designated occupation are to be performed personally by such individual, (2) such individual has no substantial investment in the "facilities" used in connection with the performance of such services, and (3) such services are part of a continuing relationship with the person for whom the services are performed and are not in the nature of a single transaction.[32]

Reasons why the Agency's workers are not statutory employees. The Agency might counter the IRS attack by arguing that its workers are not "full-time life insurance salesman," and thus are not statutory employees, based on three main arguments.

The Agency did not provide certain items to the workers. First, the relevant regulations indicate that a full-time life insurance salesman ordinarily uses office space provided by the insurance company or its general agent, and typing assistance, telephone facilities, forms, rate books, and advertising materials are usually provided to the individual free of charge.[33] The Agency does *not* provide office space to the workers. They are free to establish a home office or lease outside space. In all cases, though, the workers are financially responsible for such offices. Moreover, the Agency does *not* offer free typing assistance, telephone facilities, or advertising to the workers. They are each personally responsible for these matters.

The workers did not work on a full-time basis. Second, the workers are not "full-time" salesman for the Agency, as this concept has been described by the IRS for over four decades. This argument finds support in Rev. Rul. 69-288, a portion of which is included below.

> The company, under its agency organization, enters into a contract with a general agent. The contract gives the general agent the exclusive right to solicit applications for insurance and annuity contracts within a specified territory. The company has a large number of general agencies, each one of which maintains an office at its own expense and is compensated by commissions and collection fees based upon a fixed percentage of insurance premiums. Each general agent contracts with certain district agents and special agents for the development of various parts of the territory covered by the general agency contract. The district agents and special agents in turn contract with soliciting agents who solicit applications for life insurance and annuity contracts. However, the other agents in the organization, including the general agents, may also solicit such applications. The district agents, special agents, and soliciting agents also conduct their business operations at their own expense and receive their entire remuneration in the form of commissions. All insurance matters, including insurance applications and premium collections, relating to the territory of each general agent pass through his office. The agent's contracts do not permit the company to prescribe rules governing the development of clientele or the time or place of solicitation, or otherwise control the physical activities of the agent. *The agents are not full-time life insurance salesmen, they can come and go as they please, and they are not required to spend a fixed amount of time working for the company.* The company does not furnish or control the means of transportation nor is it required to pay for the means used by the agent. It has no right to say whether an agent shall or shall not advertise. If the agent does advertise, the advertising copy must first be submitted to the company in order that there be no misrepresentation or statements in violation of law or contrary to rulings of insurance departments. The agent usually has an extensive territory and maintains his office wholly upon his own responsibility and at his own expense.

Congress has stated, and the IRS has officially acknowledged, that section 530 relief must be construed liberally in favor of taxpayers.

The IRS determined in Rev. Rul. 69-288 that the worker was *not* an employee under a common law analysis and a statutory employee analysis. In coming to the latter conclusion, the IRS focused on the following: "[S]ince the agents are not full-time life insurance salesmen

[31] Reg. 31.3121(d)-1(d)(3)(ii) (emphasis added).

[32] Reg. 31.3121(d)-1(d)(4)(i).

[33] Reg. 31.3121(d)-1(d)(3)(ii).

they are not employees of the company as defined in Section 3121(d)(3)(B) . . . "

The Agency might explain to the IRS that, like the situation in Rev. Rul. 69-288, the salesmen working for the Agency are free to come and go as they please, and they are not required to spend a certain, fixed period of time working for the Agency. Accordingly, based on the precedent set and followed by the IRS for over four decades, the Agency's workers should not be considered "full-time" life insurance salesmen.

The IRS released a list of 20 factors decades ago that continues to guide the analysis in worker-classification cases.

The workers did not work for just one insurance agency. Third, the Agency's workers are not working "primarily for one life insurance company," as the regulations require in order to be classified as a statutory employee.[34] As explained above, the Agency is an insurance "agency," *not* an insurance "company" that underwrites policies, assumes financial risks, pays claims, etc. The Agency essentially acts as a conduit for multiple insurance companies; it is not an insurance company in any legal or practical sense of the word. Indeed, workers for the Agency earn renewal commissions from the sale of products from multiple insurance companies.

The Tax Court issued a decision a few years ago that solidifies this point. In *Byer*, TC Summary Opinion 2006-125, the issue was whether the worker was a full-time life insurance salesman. The worker was an agent for Corben Financial Services, which represented several life insurance companies. At trial, the worker testified that he had placed insurance for his clients with at least six separate insurance companies. In holding that the worker was *not* a full-time life insurance salesman, the court stated the following: "*It is quite evident, therefore, that petitioner's work with Corben was not devoted to one insurance company.*"

Over the years, several courts have held that life insurance salesmen should be classified as independent contractors, under both a common law analysis and a statutory employee analysis, *even when* the worker was restricted from representing certain entities. See, for example, *Reserve National Insurance Co.*, 1974 WL 572 (W.D. Ok. 1974) ("Most of the contracts recited that the salesmen could do no business for or be appointed by any other insurance company without the prior written permission of an officer of the taxpayer"); *Standard Life & Accident Insurance Co.*, 1975 WL 543 (W.D. Ok. 1975) ("Contractual provisions which call for an agent's devotion of full time … attention to the business of the company and/or which restrict or prohibit his sales for other companies do not, by themselves, require the conclusion that the agents are employees"); and *Simpson*, 64 TC 974 (1975) ("The restriction on Simpson's ability to sell insurance for other companies admittedly restricted his freedom to pick and choose, from competing insurance policies, those policies that best suited the interest of his clients. This restriction did not, however, serve to control petitioner with regard to the means or details by which he sold Farmers' insurance policies").

[34] Reg. 31.3121(d)-1(d)(3)(ii).

In *Butts*, TCM 1993-478, *aff'd* 49 F.3d 713 (CA-11, 1995), the agreement between the worker and Allstate Insurance Agency included the following restriction on the worker's sales activities:

> Under the agreement, Mr. Butts agreed to devote all of his business time to selling Allstate insurance products . . . Mr. Butts also agreed not to represent or solicit insurance for any other company without Allstate's prior written approval.

In arguing that the worker should be classified as an employee, the IRS pointed to several provisions in the agreement, including the one that restricted the worker's ability to sell other products. The Tax Court swiftly rejected the IRS's argument, stating the following:

> [B]ased on the record in this case and settled legal principles, we conclude that Respondent's emphasis on these Agreement provisions is misplaced. In fact, with the exception of Respondent's argument regarding one of the Agreement's discharge provisions, we have previously addressed whether the types of restrictions Respondent points to in this case bear on an insurance company's control of an insurance agent's professional behavior, and we have squarely concluded that they have no bearing on such inquiry.

In *Feivor*, TCM 1995-107, a case with facts similar to those in *Butts*, the IRS again tried to argue that the restriction on a worker's ability to sell certain insurance products converted the worker into an employee. Consistent with its previous decision, the Tax Court rejected the IRS's position:

EXHIBIT 1 CSP Analysis Chart

Are the Workers Employees?	Were Forms 1099 Filed?	Is Company Entitled to section 530 Relief?	Type of CSP Offer
Yes	No	No	None
Yes	Yes	No	1 year tax + CSP
Yes	Yes	Maybe	25% tax + CSP

> Respondent focuses on the fact that petitioner could not sell insurance products other than through American Family or Brokerage [*i.e.*, a wholly owned subsidiary of American Family]. The restriction on petitioner's ability to place insurance with other insurance companies did not serve to control the means and details by which he conducted his business activities. The restriction admittedly restricted petitioner's freedom to pick and choose, from competing insurance policies, those policies that best suited the interests of his clients; however, it did not serve to control petitioner with regard to the means or details by which he sold American Family insurance policies.

After *Butts*, the courts issued a number of decisions, and the IRS issued several rulings, following the principles established in *Butts*. They found that the insurance salesmen in each case were independent contractors. *See Smithwick*, TCM 1993-582; *Ware*, 850 F. Supp. 602 (W.D. Mich. 1994), *aff'd* 67 F.3d 574 (CA-6, 1995); *Mosteirin*, TCM 1995-367; *Lozon*, TCM 1997-250; TAM 9736002; *Wickum*, TCM 1998-270.

Based on the decisions in the preceding cases, the Agency would argue that any restrictions that it imposed on the insurance agents about working for competitors would not convert the relationship into one of employee-employer.[35]

Classification settlement program

Experience dictates that, regardless of the strength of the Agency's position on section 530, common law employee standards, and statutory employee standards, Revenue Agents often refuse to acknowledge defeat. This triggers the need to address the IRS's classification settlement program ("CSP").

Background on the classification settlement program. General ignorance of the CSP is the norm. This is probably attributable to the obscure materials in which details about the CSP appear. In 1996, the IRS issued a news release announcing the CSP and identifying it as a two-year trial program.[36] At the end of this initial period, in 1998, the IRS decided to extend the CSP indefinitely because both an internal review and public comments indicated that it was achieving its goal of resolving worker-classification cases at an early stage.[37] Details about the CSP are somewhat challenging to find because they derive primarily from a Field Service Advisory in 1996, as restated and expanded in the Internal Revenue Manual.[38] The description of the CSP, below, comes from these two sources.

In cases where it appears that a company may have misclassified a worker, the Revenue Agent must fully develop the issue and determine, among other things, whether a misclassification occurred under applicable law, whether the company is eligible for section 530 relief, and, if not, whether the company is entitled to a CSP offer.[39] If the Revenue Agent and his superiors conclude that a CSP offer is in order, they must decide which of two "graduated settlement offers" the IRS will make.

In situations where the company had Reporting Consistency, but clearly lacked either Substantive Consistency or Reasonable Basis, the CSP offer entails assessment of 100% of the employment tax liability for the one tax year under audit, computed using the special rates under Section 3509, if applicable ("One-Year-100% Offer").

The second offer is better. In cases where the company had Reporting Consistency and has a

[35] Chief Counsel Notice N(35)000-141a (11/12/98). Based on the *Butts* line of cases, the IRS instructed its employees in 1998 not to further pursue reclassification in similar cases. In this regard, the IRS Office of Chief Counsel stated the following: "In these cases, the taxpayer's claim of independent contractor status should not be challenged."

[36] IRS News Release 96-7 (3/5/96).

[37] Notice 98-21, 1998-1 CB 849.

[38] FS-96-5; I.R.M. section 4.23.6.

[39] FS-96-5; I.R.M. section 4.23.6.11 (3/1/03).

EXHIBIT 2 Section 3509(a) Example

Section 3509(a) Example	Percentage
Company's share of FICA	7.65%
20% of employee's share of FICA (.20 x 4.2% plus .20 x 1.45%)	1.13%
Total FICA	8.878%
Income Tax Withholding	1.50%
Total Section 3509(a)	**10.28%**

"colorable argument" that it also had Substantive Consistency or Reasonable Basis, the CSP offer contemplates assessment of just 25% of the employment tax liability for the one tax year under audit, computed using the special rates under Section 3509, if applicable. ("One-Year-25% Offer").[40] The downside is that, under either scenario, the company must agree to reclassify the workers in question as employees going forward, starting the first day of the quarter following the date of the Closing Agreement.[41]

IRS personnel are instructed to consult the "CSP Analysis Chart" in Exhibit 1 in making determinations in worker-classification cases.[42] Visualizing the process may help some readers comprehend the IRS's decision-making tree better.

To appreciate the benefit of the two CSP offers, one must look beyond the Internal Revenue Manual to two obscure provisions: Section 3509 and Section 6205.

Reduced tax rates under Section 3509. In 1982, Congress realized that three "major problems" existed with forcing a company to reclassify its workers as employees: (1) The company could be assessed income taxes, FICA taxes, and FUTA taxes for all years still open under the statute of limitations; (2) Overpayments of federal income taxes may occur if the company were obligated to pay these amounts in situations where workers personally paid these amounts earlier via estimated tax payments or with their individual income tax returns; and (3) Overpayments of FICA taxes could occur, too, if the company were required to pay these amounts in cases where the workers already did so through self-employment taxes.[43]

Congress understood that, in the case of a forced reclassification, the IRS generally would adjust/lower assessments for the company's failure to withhold, provided that the company could furnish certificates, signed by those workers who were reclassified, showing that the workers had personally paid the taxes.[44] However, Congress underscored the practical challenges associated with this supposed clemency by the IRS: Obtaining certificates would be a "difficult burden" and a "serious retroactive tax burden" on a company in cases involving jobs with high turnover rates, or where workers were numerous, uncooperative, and/or poor record-keepers.[45]

In light of this reality, Congress enacted Section 3509, which was hailed as a new procedure designed to substantially simplify the law, reduce burdens on companies, approximate the average tax liability of a company after assuming certain levels of tax compliance by individual workers who were reclassified, and punish the company for its violations.[46]

[40] FS-96-5; I.R.M. section 4.23.6.13.1 (10/30/09).
[41] FS-96-5; I.R.M. section 4.23.6.13.1 (10/30/09).
[42] I.R.M. section 4.23.6.13.3 (10/30/09). Inapplicable portions were removed from the chart.
[43] Senate Report 97-494(I), 97th Cong., 2d Sess. (1982), at pp. 1103.
[44] Senate Report 97-494(I), 97th Cong., 2d Sess. (1982), at pp. 1104.
[45] Senate Report 97-494(I), 97th Cong., 2d Sess. (1982), at pp. 1103-1104.
[46] Senate Report 97-494(I), 97th Cong., 2d Sess. (1982), at pp. 1104.

EXHIBIT 3 Section 3509(b) Example

Section 3509(b) Example	Percentage
Company's share of FICA	7.65%
40% of employee's share of FICA (.40 x 4.2% plus .40 x 1.45%)	2.26%
Total FICA	9.91%
Income Tax Withholding	3.0%
Total Section 3509(b)	**12.91%**

Here is how Section 3509 works. As mentioned above, both the One-Year-100% Offer and the One-Year-25% Offer indicate that the employment tax liability for the year in question might be calculated under the special rates found in Section 3509. When a company incorrectly treats an "employee" as an independent contractor, the company is liable for the employee's federal income tax withholding and the employee's share of FICA taxes, not to mention the company's share of the FICA taxes and unemployment taxes.[47] Assuming that the company did not intentionally disregard its duty to withhold, Section 3509 sets forth two different levels of payback.

In situations where the company filed annual Forms 1099 for the workers, the company must pay (1) income tax withholding calculated as 1.5% of the worker's wages, (2) 20% of the employee's share of FICA, and (3) 100% of the company's share of FICA.[48] Exhibit 2 is an example.[49]

The outcome is slightly worse for a company that did not file Forms 1099 for the workers. In such cases, the company must pay (1) income tax withholding calculated as 3% of the worker's wages, (2) 40% of the employee's share of FICA, and (3) 100% of the company's share of FICA.[50] Exhibit 3 is an example.[51]

Interest-free payments under Section 6205. As explained above, a company agreeing to resolve a worker-classification case under the CSP limits its exposure to the one year under audit by the IRS, avoids penalties, and, depending on the circumstances, enjoys the reduced rates under Section 3509 related to the federal income taxes and FICA taxes that it failed to withhold from its workers and remit to the IRS. Settling under the CSP could trigger one more benefit for a company, interest waiver.

The intricacies of the relevant provision, Section 6205, far exceed the scope of this article, but it is important to be aware of its existence and basic function. Section 6205 and the regulations thereunder contain rules allowing for "interest-free adjustments" under certain circumstances.[52] Importantly, these rules have been liberally interpreted by the IRS for decades, thereby allowing companies that concede worker-classification cases to avoid interest charges.[53]

Burden of proof shifts to IRS

If a company establishes a prima facie case that it was reasonable to treat the workers as independent contractors, and the company has fully cooperated with reasonable requests from the IRS dur-

[47] The legislative history leaves no doubt that, even if the company is entitled to the reduced rates under Section 3509 for taxes not withheld and remitted to the IRS on behalf of the workers, the company remains fully liable for its own employment tax obligations. The relevant Congressional report states that "[e]ven if this procedure applies, the employer still will be liable for the employer's share of FICA taxes and FUTA taxes." Senate Report 97-494(I), 97th Cong., 2d Sess. (1982), at p. 1105.

[48] Section 3509(a); I.R.M. section 4.23.8.5.1 (6/7/11).

[49] I.R.M. section 4.23.8.5.1 (6/7/11). This example uses FICA rates from 2011.

[50] Section 3509(b); I.R.M. section 4.23.8.5.1 (6/7/11).

[51] I.R.M. section 4.23.8.5.1 (6/7/11). This example uses FICA rates from 2011.

[52] Section 6205; Reg. 31.6205-1.

[53] Rev. Rul. 75-464, 1975-2 CB 474, obsoleted by Rev. Rul. 2009-39, 2009-52 IRB 951.

ing the audit, the burden of proof with respect to the classification issue shifts to the IRS.[54] Citing the high incidence of worker classification disputes, the fact that many of these disputes involve small businesses without adequate resources to challenge the IRS, and the "costly litigation" resulting from the disputes, Congress further clarified its reasons for placing the burden on the IRS:

> [I]n light of the unique nature of the legislative history to section 530 which provides it should be construed liberally in favor of taxpayers, the Committee believes that *the burden of proof should generally be on the IRS once the taxpayer establishes a prima facie case* that it was reasonable not to treat the worker as an employee and provided the taxpayer fully cooperates with reasonable requests for information by the IRS.[55]

termination, collection, or refund of any tax, interest, or penalty may be awarded reasonable administrative and/or litigation costs.[57] Recoverable administrative costs may include charges imposed by the IRS, legal fees, reasonable expenses for expert witnesses, and costs of any study, analysis, report, test, or project necessary for the preparation of the taxpayer's case.[58] The litigation costs for which the taxpayer may seek reimbursement follow similar guidelines.[59]

The term "prevailing party" generally means a party in any tax-related administrative proceeding or litigation that (1) has substantially prevailed with respect to either the amount in controversy or the most significant issues pre-

Over the years, several courts have held that life insurance salesmen should be classified as independent contractors, under both a common law analysis and a statutory employee analysis, even when the worker was restricted from representing certain entities.

Keeping in mind the Congressional mandate that section 530 relief must be "construed liberally in favor of taxpayers," the Agency might argue that it has established a prima facie case that it was reasonable to treat the soliciting agents as independent contractors.[56] Accordingly, the burden is on the IRS, during the audit and in a Tax Court trial, to show that such treatment by the Agency was unreasonable.

Notice of intent to seek reimbursement of fees

In addition to claiming that it is entitled to shelter under section 530, it was correct in classifying the workers as independent contractors, and it can move the burden of proof to the IRS on the issues, the Agency might also warn the IRS that it plans to seek reimbursement of all legal and accounting fees going forward, if the IRS insists on protracting the dispute, because the IRS's positions are no longer "substantially justified."

Generally, the "prevailing party" in any administrative proceeding against the IRS or in any litigation brought by or against the U.S. government in connection with the de-

sented, and (2) has a net worth that does not exceed certain statutory thresholds.[60] Even if the taxpayer substantially prevails and meets the net worth requirement, the taxpayer will not be deemed the "prevailing party" if the government establishes that its position was "substantially justified."[61] In other words, if the government manages to prove that the position it took during the administrative dispute or litigation was substantially justified, the taxpayer is precluded from recovering costs. Understanding what constitutes a "substantial justification," therefore, is paramount.

Until 1996, the burden was on the taxpayer to demonstrate that the government's position was *not* substantially justified. This radically changed with the enactment of the Taxpayer Bill of Rights 2, which shifted the onus to the government.[62] According to congressional reports, "the successful taxpayer will receive an award of attorney's fees unless the IRS satisfies its burden of proof."[63] This legislation introduced another major change; it required the IRS to follow its published guidance disseminated to the public, as well as its private guidance provided to particular taxpayers.[64] If it fails

[54] section 530(e)(4)(A).

[55] S. Rep. 104-281, 104th Cong., 2nd Sess., 26 (1996) (emphasis added).

[56] H. Rept. No 178 (95th Cong., 2nd Sess., 5 (1978); I.R.M. section 4.23.5.2.1 (2/1/03).

[57] Section 7430(a).

[58] Section 7430(c)(2).

[59] Section 7430(c)(1).

[60] Section 7430(c)(4)(A).

[61] Section 7430(c)(4)(B)(i).

[62] P.L. 104-168, 7/30/96.

[63] H.R. Rept. 104-506, 104th Cong., 2d Sess. (1996), p. 37.

[64] P.L. 104-168, 7/30/96, section 701; H.R. Rept. 104-506, 104th Cong., 2d Sess. (1996), pp. 36-37.

to do so, it runs the risk of lacking an acceptable justification for a proposed tax treatment.

Congress further advanced the issue in favor of taxpayers in 1998 with the passage of the Taxpayer Bill of Rights 3.[65] This legislation empowered the courts to take into account whether the government has lost on similar issues in appellate courts for other circuits in determining if the government's position is substantially justified.[66] The relevant congressional reports reveal the purpose for this increased pressure: Congress was concerned that the IRS would continue to litigate issues that have been previously decided in other circuits.[67] This brand of stubborn litigiousness, say the reports, would place an undue burden on those taxpayers forced to dispute decided issues.[68]

The legislative modifications discussed above have been incorporated into the Internal Revenue Code and corresponding regulations. The general rule still stands that a taxpayer will not be considered a "prevailing party," and thus will not be entitled to reimbursement, if the government's position was substantially justified.[69] However, there is now a rebuttable presumption that the government's position is *not* substantially justified if it failed to follow its "applicable published guidance" during a proceeding.[70] Such guidance includes regulations (final or temporary), revenue rulings, information releases, notices, and announcements.[71] It also encompasses various items issued to the particular taxpayer involved in a dispute, such as private letter rulings, technical advice memoranda, and determination letters.[72] In deciding whether the position taken by the government was substantially justified, the courts are instructed to consider whether it lost on similar issues in federal appeals courts.[73]

The regulations provide additional clarity regarding what constitutes a substantial justification. For instance, they explain that the government's position is substantially justified only if it has a reasonable basis in both fact and law.[74] A significant factor in making this determination is whether the taxpayer presented all the relevant information under his control to the appropriate IRS personnel.[75] This seems logical because a taxpayer should have little room to complain about the government's position when he fails to provide the information, documentation, and arguments necessary to support his own stance.

Along with the legislative history and the regulations, case law is helpful in identifying what represents a substantial justification. Certain courts have developed a framework, a non-exhaustive list of factors to be considered. Among these factors are (1) the stage at which the issue or litigation is resolved, (2) the opinions of other courts on the same underlying issues, (3) the legal merits of the government's position, (4) the clarity of the governing law, (5) the foreseeable length and complexity of the litigation, and (6) the consistency of the government's position.[76]

General ignorance of the classification settlement program (CSP) is the norm, which is probably attributable to the obscure materials in which details about the CSP appear.

Other courts have utilized a different approach, scrutinizing whether the position taken by the IRS was reasonable.[77] These courts hold that a position is substantially justified if it is "justified to a reasonable degree that could satisfy a reasonable person or that has a reasonable basis in both law and fact."[78] Still other courts rely on a different test, presenting the question as whether the government knew or should have known that its position was invalid at the time it took it.[79]

Conclusion

As this article demonstrates, when ambushed by the IRS with allegations that its workers should be treated as employees, a well-represented com-

[65] P.L. 105-206, 7/22/98.

[66] P.L. 105-206, 7/22/98, section 3101, codified as Section 7430(c)(4)(B)(iii).

[67] H.R. Rept. 105-364, 105th Cong., 1st Sess. (1997), p. 58; Sen. Rept. 105-174, 105th Cong., 2d Sess. (1998), p. 48.

[68] H.R. Rept. 105-364, 105th Cong., 1st Sess. (1997), p. 58; Sen. Rept. 105-174, 105th Cong., 2d Sess. (1998), p. 48.

[69] Section 7430(c)(4)(B)(i).

[70] Section 7430(c)(4)(B)(ii).

[71] Section 7430(c)(4)(B)(iv)(I); Reg. 301.7430-5(c)(3).

[72] Section 7430(c)(4)(B)(iv)(II); Reg. 301.7430-5(c)(3).

[73] Section 7430(c)(4)(B)(iii).

[74] Reg. 301.7430-5(c)(1).

[75] Reg. 301.7430-5(c)(1); Reg. 301.7430-5(h), Ex. 1.

[76] *National Fed'n of Republican Assemblies*, 263 F. Supp.2d 1372, 1378 (S.D. Ala. 2003).

[77] *See, e.g., Kennedy*, 89 TC 98 (1987) (holding that the IRS's position was unreasonable where it acted contrary to its own regulations and case law, and without factual support).

[78] *Wilkes*, 289 F.3d 684, 688 (CA-11, 2002).

[79] *See, e.g., Downing*, TCM 2005-73.

pany, such as the Agency studied in these pages, might defend itself by raising some or all the following arguments:

- Section 530 is a relief provision that must be considered by Revenue Agents as "the first step" in any audit involving worker classification.
- The Agency meets all the requirements of section 530; therefore, the IRS should discontinue its worker-classification audit, and the Agency should be allowed to continue treating the workers as independent contractors forevermore.
- If the Agency somehow fails to qualify for section 530 relief, it would nonetheless *not* be subject to any employment tax deficiencies, penalties, or interest, and would be entitled to continue treating the workers as independent contractors, because such workers are neither common law employees nor statutory employees.
- To the extent that the Agency agrees to resolve the case for strategic and economic reasons, as opposed to legal reasons, it would be entitled to the best possible terms under the CSP, meaning that it would only pay 25% of the employment tax liability for one tax year, computing such liability using the special rates under Section 3509, without interest charges.
- The Agency established during the audit a prima facie case that it was reasonable to treat the workers as independent contractors, and the Agency and its representatives fully cooperated with the audit. Accordingly, under section 530(e)(4)(A), the burden of proof with respect to the worker-classification shifts to the IRS.
- If the IRS declines to conclude the audit in favor of the Agency, the Agency is forced to incur fees and costs to defend itself with the Appeals Office and/or in court, and the Agency ultimately prevails, the Agency intends to seek reimbursement from the IRS of all relevant fees and costs under Section 7430 because, based on evidence provided to the IRS during the audit, the IRS's positions that the Agency fails to satisfy section 530 and the workers are not independent contractors are not "substantially justified."

The building blocks for mounting a formidable worker-classification defense are timeless, and they will become crucial again, when the IRS inevitably refocuses its limited resources on this perennial issue. ■