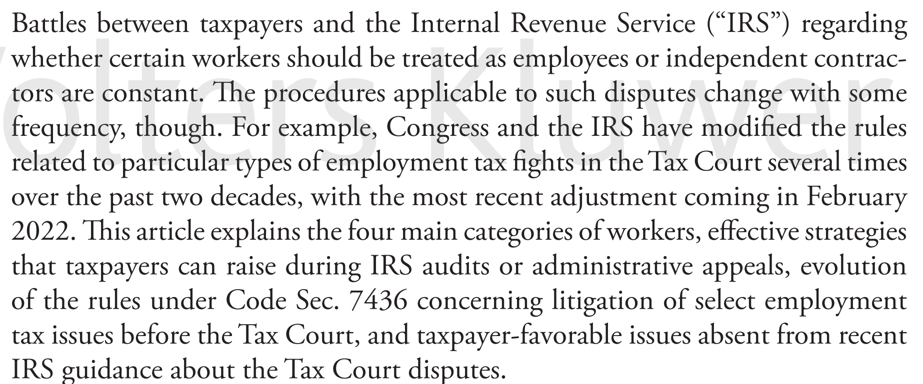
# *New Rules in 2022 for Litigating Worker Classification and Section 530 Relief Cases in Tax Court*

By Hale E. Sheppard*

## I. Introduction



Battles between taxpayers and the Internal Revenue Service ("IRS") regarding whether certain workers should be treated as employees or independent contractors are constant. The procedures applicable to such disputes change with some frequency, though. For example, Congress and the IRS have modified the rules related to particular types of employment tax fights in the Tax Court several times over the past two decades, with the most recent adjustment coming in February 2022. This article explains the four main categories of workers, effective strategies that taxpayers can raise during IRS audits or administrative appeals, evolution of the rules under Code Sec. 7436 concerning litigation of select employment tax issues before the Tax Court, and taxpayer-favorable issues absent from recent IRS guidance about the Tax Court disputes.

## II. Four Categories of Workers

Readers must grasp the main categories of workers to appreciate this article. Workers fall into four groups: statutory employees, statutory non-employees, common law employees, or independent contractors.

Statutory employees are, like they sound, workers defined as employees in a statute. For instance, tax provisions explain that the term "employee" includes officers of corporations, as well as individuals who work as (i) agent-drivers or commission-drivers engaged in distributing particular products; (ii) full-time insurance salespersons; (iii) so-called homeworkers, who perform work on goods provided by their principals according to specifications set by the principals and then return the improved goods to the principals or a designated party; and (iv) traveling or city salespersons who solicit for their principals on a full-time basis orders from wholesalers, retailers, contractors, or operators of hotels, restaurants, or similar establishments for merchandise for resale or supplies for use in their business operations.[1]

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For their part, statutory non-employees are 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.[2]

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 is a common law employee is the degree of control that the company possesses and/or exercises over the worker.[3] The regulations clarify that, in making a decision about common law employee status, the IRS must consider "the particular facts of each case."[4] The IRS released a list of 20 factors decades ago that still serves as a guide in this analysis.[5]

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.

## III. Strategies During IRS Audits and Appeals

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Companies subject to an employment tax audit have several defenses and strategies at their disposal, some of which are described below.

### A. The Company Deserves Relief Under Section 530

A company's primary position in a worker-classification dispute often is that it is entitled to so-called "Section 530 relief." Accordingly, the IRS should stop its worker-classification examination, and the company should be allowed to continue treating the workers as independent contractors without further scrutiny by the IRS.

#### *1. 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.[6] Confusion often results from the fact that this provision has never been codified.

A company that can satisfy all the criteria to warrant Section 530 relief obtains two major benefits. First, the IRS may not assess any back employment taxes, penalties, or interest charges against the company.[7] 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.[8]

Congress introduced Section 530 over 40 years ago in an effort to counter aggressive IRS worker-classification audits on small businesses.[9] According to legislative history, the relief provided to companies by Section 530 was appropriate because the IRS had dramatically increased enforcement of employment taxes, many of the IRS's new positions were contrary to those followed in earlier years, and mandatory reclassification of workers often resulted in double payment of the same taxes by the companies and their workers.[10]

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 [IRS's] proposed reclassifications of workers, until the Congress has adequate time to resolve the many complex issues involved in this area.[11]

Section 530 has remained in effect for more than four decades, despite these early thoughts about a temporary halt to overreaching by the IRS. The law has been amended three times during this period, with each occasion further strengthening the rights of companies invoking Section 530 relief.[12] 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. The law now 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.[13] The Internal Revenue Manual contains additional details in this regard, explaining that Section 530 is a relief provision that the IRS must consider "as the first step in any case involving worker classification" and that the IRS "must first explore the applicability of Section 530" even if the taxpayer does not affirmatively raise the issue.[14]

Congress has stated, and the IRS has officially acknowledged, that Section 530 relief must be "construed liberally in favor of taxpayers."[15]

*2. 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, then 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"), 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").[16]

With respect to the last component, a company has a Reasonable Basis for treating a worker as an independent contractor if it does *any* of the following. First, a company can rely on court decisions or published IRS rulings (regardless of whether they relate to the particular industry or business in which the company is engaged), or on a technical advice memorandum, private letter ruling, or determination letter issued by the IRS to the company. Second, a company can rely on a past IRS audit 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. Third, the company can rely on a longstanding recognized practice of a significant segment of the industry in which the company is engaged.[17]

The IRS must broadly interpret the notion of Reasonable Basis to favor the company.[18] For example, Congress found that reasonable reliance on a qualified, informed tax professional suffices.[19] A company can also meet the Reasonable Basis threshold by showing that it reviewed the common law standards and concluded that the workers in question did not fall into the employee category. According to the pertinent 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."[20]

## B. The Workers Are Not Common Law Employees

At this stage, a company might argue that the audit should cease because it demonstrated that Section 530 applies. The IRS often takes this under advisement, for what that is worth, and proceeds with the audit anyway, claiming that the workers in question are common law employees. The company then 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 perform such services is the legal relationship of employer and employee.[21] According to the regulations, one of the key factors in this determination is the degree of control possessed or exercised by the company:

> 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.[22]

The regulations also make it clear that, in making a worker-classification determination, the IRS must consider "the particular facts of each case."[23] The IRS released a list of 20 factors decades ago that continues to govern.[24]

## C. The Workers Are Not Statutory Employees

The IRS, often plodding and rarely imaginative, frequently proceeds with the audit of a company, 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. As explained earlier in this article, the term "employee" includes officers of corporations, along with individuals who work as agent-drivers or commission-drivers who distribute particular products, full-time insurance salespersons, homeworkers, and certain traveling salespersons.[25] This analysis is more straightforward than others, with few workers falling into these narrow categories.

## D. Classification Settlement Program

Regardless of the strength of the company's position on Section 530, common law employee standards, and statutory employee standards, experience dictates that Revenue Agents often refuse to acknowledge defeat during an audit. This triggers the need to address a longstanding manner of possible resolution with the IRS.

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### 1. Background

General ignorance of the Classification Settlement Program ("CSP") is the norm. This likely is attributable to the obscure materials in which details about the CSP appear. In 1996, the IRS issued a news release announcing the CSP and labeling it a two-year trial program.[26] At the end of this period, in 1998, the IRS decided to extend the CSP indefinitely because it was achieving its goal of resolving worker-classification cases at any early stage.[27] 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.[28] The description of the CSP, below, comes from these two sources.

*Because unpaid employment taxes constitute a major component of the tax gap, and because companies have serious financial incentives to treat workers as independent contractors, the safe bet is that the IRS will continue to aggressively audit employment tax issues, particularly worker classification.*

In employment tax cases, a Revenue Agent must determine whether a worker misclassification occurred, whether the company is eligible for Section 530 relief, and, if not, whether the company is entitled to a CSP offer.[29] If the Revenue Agent and his superiors conclude that a CSP offer is in order, they must decide which of the 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, then the CSP offer entails assessment of 100 percent of the employment tax liability for just the one tax year under audit, computed using the special rates under Code Sec. 3509, if applicable ("One-Year-100-Percent Offer"). The second offer is better. In cases where the company had Reporting Consistency and has a "colorable argument" that it also had Substantive Consistency or Reasonable Basis, the CSP offer contemplates assessment of just 25 percent of the employment tax liability for the one tax year under audit, computed using the special rates under Code Sec. 3509, if applicable ("One-Year-25-Percent Offer").[30] 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.[31]

To appreciate the benefit of the two CSP offers, readers must look to two obscure provisions: Code Sec. 3509 and Code Sec. 6205.

### 2. Reduced Tax Rates Under Code Sec. 3509

In 1982, Congress realized that two "major problems" existed with forcing a company to reclassify its workers as employees. First, the company could be assessed income taxes, Federal Insurance Contributions Act ("FICA") taxes, and Federal Unemployment Tax Act ("FUTA") taxes for *all* years still open under the statute of limitations, which is generally three. Second, overpayments of federal income taxes and FICA might occur if the company were obligated to pay these amounts in situations where workers had personally paid these amounts already.[32] Congress, therefore, enacted Code Sec. 3509. It was designed to simplify the law, reduce burdens on companies, and approximate the true tax liability of a company.[33]

Here is how Code Sec. 3509 works. As mentioned above, both the One-Year-100-Percent Offer and the One-Year-25-Percent Offer indicate that the employment tax liability for the year in question might be calculated under the special rates found in Code Sec. 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. Assuming that the company did not intentionally disregard its duty to withhold, Code Sec. 3509 sets forth two different levels of payback. In situations where the company filed annual Forms 1099 for the workers, it must pay (i) income tax withholding calculated as 1.5 percent of the worker's wages, (ii) 20 percent of the employee's share of FICA, and (iii) 100 percent of the company's share of FICA.[34] The outcome is slightly worse for a company that did not file Forms 1099 for the workers. In such cases, it must pay (i) income tax withholding calculated as 3 percent of the worker's wages, (ii) 40 percent of the employee's share of FICA, and (iii) 100 percent of the company's share of FICA.[35]

### 3. Interest-Free Payments Under Code Sec. 6205

As explained above, a company agreeing to resolve a worker-classification case under the CSP limits its

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exposure to the one year under audit by the IRS, avoids penalties, and, depending on the circumstances, enjoys the reduced tax rates under Code Sec. 3509. Settling under the CSP could trigger one more benefit for a company, interest waiver. The intricacies of the relevant provision, Code Sec. 6205, far exceed the scope of this article, but it is important to be aware of its existence and basic function. Code Sec. 6205 and the regulations thereunder contain rules allowing for "interest-free adjustments" under certain circumstances.[36] Importantly, the IRS has liberally interpreted these rules for decades, thereby allowing companies that concede worker-classification cases to avoid interest charges.[37]

## IV. Evolving Rules Regarding the Tax Court Litigation

If taxpayers are unable to resolve employment tax issues during an audit or an administrative appeal, litigation often ensues. Taxpayers historically could not fight such issues in the Tax Court, which normally is the most efficient and least expensive venue for such a legal battle.[38] This changed in 1997, when Congress passed Code Sec. 7436.[39]

### A. Overview

The original law generally provided that if, in connection with an IRS examination of any person, there is "an actual controversy" involving a "determination" by the IRS that one or more individual workers are "employees" of the person or that the person is not entitled to Section 530 relief with respect to such workers, then, upon filing of a Petition, the Tax Court has jurisdiction to rule as to whether the IRS's "determination" was correct.[40] The law further stated that only the person for whom the relevant services were performed could seek review by the Tax Court.[41] That meant that just the company, and not the workers or a third party, could file a Petition with the Tax Court. In addition, the law explicitly stated that it was limited to employment taxes imposed under Subtitle C of the Internal Revenue Code, which encompasses federal income taxes subject to withholding, FICA, and FUTA.[42]

Why did Congress introduce Code Sec. 7436? The legislative history stated that Congress felt it would be "advantageous to taxpayers to have the option of going to the Tax Court to resolve certain disputes [with the IRS] regarding employment status."[43] It went on to explain that the IRS could make a "determination" for these purposes through a mechanism similar to the employment tax early referral procedures.[44] It also indicated that "a failure to agree" would constitute a "determination" to the extent permitted under the Tax Court rules.[45] Moreover, it stated that the Tax Court would analyze the issues on a *de novo* basis; it would not simply be reviewing the earlier administrative record compiled during the examination and/or reconsideration by the Appeals Office.[46] Finally, it clarified that taxpayers could seek recoupment of costs and fees under Code Sec. 7430, if they prevailed in the Tax Court regarding a worker-classification issue and met other criteria.[47]

### B. Initial IRS Guidance

The IRS did not issue regulations swiftly, opting instead to provide guidance to taxpayers about Code Sec. 7436 through Notice 98-43 ("First Notice").[48] Important aspects of the First Notice are discussed below.

*The rules applicable to the Tax Court litigation of worker classification and Section 530 relief cases have changed several times since their introduction in 1997, with the IRS announcing the most recent alterations in 2022.*

The First Notice supposedly created parameters for what, exactly, the Tax Court could resolve. It acknowledged that the Tax Court had jurisdiction to review a determination by the IRS about whether certain workers were employees and whether the company was entitled to Section 530 relief with respect to such workers. However, the First Notice warned that Code Sec. 7436 did not authorize the Tax Court to (i) decide "any amount of employment tax or penalties," (ii) address employment tax issues beyond those in Subtitle C of the Internal Revenue Code, such as the classification of workers for pension plan purposes or the proper treatment of income tax deductions, (iii) consider any IRS determinations not made as part of an examination, like those found in Private Letter Rulings, Technical Advice Memoranda, or responses to Forms SS-8 (*Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding*).[49]

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Importantly for this article, the First Notice also claimed that the IRS would not issue a Notice of Determination until after it had determined that one or more individuals were employees *and* that the company was not eligible for Section 530 relief.[50]

The IRS declared that the Notice of Determination constituted its "determination" for purposes of Code Sec. 7436 and thus a "prerequisite to invoking the Tax Court's jurisdiction."[51] Lest there be any doubt about the IRS's thought on this particular matter, the First Notice stated that "Tax Court proceedings seeking review of these determinations may not be commenced prior to the time the [IRS] issues a Notice of Determination to the taxpayer."[52]

## C. First Critical Case

Only a few years passed before issues arose. Specifically, a Tax Court battle occurred in 1999, which focused on whether the Tax Court had the power to determine *the amount* of an employment tax liability. Based on the text of law, legislative history, and a comparison of various types of judicial actions, the Tax Court held in *Henry Randolph Consulting v. Commissioner* that it lacked the ability to decide the amount of employment taxes a company owed during a case brought under Code Sec. 7436.[53]

## D. Amending the Law

Congress was displeased with, or awoken by, the Tax Court ruling in *Henry Randolph Consulting v. Commissioner* in 1999. Either way, it amended the law the next year to address the jurisdictional shortcoming highlighted by the case. Code Sec. 7436 initially said that the Tax Court could judge the IRS's determination that certain workers were employees (instead of independent contractors) and/or that the company for which the services were being performed was not entitled to Section 530 relief.[54] In 2000, Congress supplemented Code Sec. 7436, expressly stating that the Tax Court could also rule on "the proper amount of employment taxes."[55]

## E. Updated IRS Guidance

The IRS needed to modernize its interpretation of Code Sec. 7436 in view of the congressional amendment in 2000. Therefore, it issued Notice 2002-5 ("Second Notice").[56] It retained much of the original information from the First Notice, while adding details focused on the Tax Court's ability to calculate the amount of an employment tax liability. Among other things, the Second Notice explained that the term "employment taxes" includes not only taxes but also related penalties.[57] The Second Notice also attached an exhibit featuring a sample Notice of Determination. It indicated that the IRS would start specifying the workers who should be classified as employees, relevant tax periods, tax liabilities, and penalty amounts.[58]

## F. Two More Impactful Cases

Two cases refined the intricacies of Code Sec. 7436. First, *SECC Corporation v. Commissioner* involved a worker-classification dispute in which the IRS never issued a Notice of Determination.[59] The taxpayer treated its workers in a dual capacity, as employees in certain contexts and as independent contractors in others. The IRS audited and concluded that certain lease payments to workers should be treated as wages for employment tax purposes. The IRS then issued an Examination Report stating that the IRS had made a "final determination on the issue," but clarifying that the proposed tax adjustments and penalties were not based on a worker-classification determination.[60] The taxpayer challenged the Examination Report by filing a Protest Letter. Ultimately, the Appeals Office sent the taxpayer a letter indicating that it sided with the audit team, an agreement could not be reached, and the IRS would be assessing the relevant employment taxes and penalties.[61] Even though neither the Revenue Agent nor the Appeals Office issued a Notice of Determination regarding worker classification or Section 530 relief, the taxpayer filed a Petition with the Tax Court under Code Sec. 7436.

The Tax Court addressed the issue by analyzing other tax provisions requiring the IRS to make a "determination," legislative history to Code Sec. 7436, the Examination Report, the letter from the Appeals Office, and the Case Memo prepared by the Appeals Office. Together, these sources indicated that the IRS can make a "determination" in nontraditional ways, a disagreement between the IRS and the taxpayer can constitute a "determination," and the IRS's own documents explain in detail the disagreement over the taxpayer's position.[62] The Tax Court concluded that "a taxpayer who is the subject of a determination by the IRS under Code Sec. 7436(a) can file suit [in the Tax Court] without receiving a Notice of Determination."[63]

The second case was *American Airlines, Inc. v. Commissioner*.[64] It involved payments to flight attendants who were based abroad, had limited contact with the United States, and worked pursuant to a restricted visa. The IRS conducted an audit related to the workers and took the position that the company was liable for employment taxes and mandatory income tax withholding on non-resident aliens. Wrangling before the Appeals

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Office ensued, with the company continuously arguing that it was eligible for relief under Section 530. Agreement was unfeasible, so the IRS issued a Notice of Deficiency regarding the tax withholding issue. It did not, however, send a Notice of Determination.

The company filed a Petition with the Tax Court, disputing the tax withholding issues noted in the Notice of Deficiency and arguing that the Tax Court had jurisdiction to decide the worker classification and Section 530 relief matters, too, despite the fact that the IRS never issued a Notice of Determination.[65]

The IRS argued that the Tax Court lacked jurisdiction because there was no "actual controversy" regarding the relevant matters. Specifically, even though Code Sec. 7436 expressly states that the controversy can be about worker classification "or" the applicability of Section 530 relief, the IRS contended that *both* issues must be in dispute.[66] The Tax Court swiftly and decisively discarded this position, underscoring that the "plain language" of Code Sec. 7436 says that a fight over just Section 530 suffices.[67]

The IRS next maintained that the IRS never made a "determination," which is necessary to trigger involvement by the Tax Court. Citing to *SECC Corporation v. Commissioner*, the Tax Court referenced a Technical Advice Memo issued during the audit, the Examination Report, and the Case Memo prepared by the Appeals Office. It explained that these three documents show a "clear failure to disagree" about the applicability of Section 530 relief, which satisfies the concept of determination under the applicable legislative history.[68] The Tax Court then reasoned that the IRS's assessment of employment taxes "was obviously a memorialization of [its] determination" and "was preceded by a determination rejecting" the claim of Section 530 relief by the company.[69] It also concluded that the "absence of a Notice of Determination of worker classification or any other document bearing a particularly title does not bar our jurisdiction."[70]

## G. Newest IRS Guidance

In what has become a familiar pattern, the IRS found itself in need of updating its guidance regarding Code Sec. 7436 yet again after the Tax Court decisions in *SECC Corporation v. Commissioner* and *American Airlines, Inc. v. Commissioner*. It did so by releasing Rev. Proc. 2022-13 ("Third Notice") in February 2022.[71]

The IRS, as one would expect, retained much of the First Notice and Second Notice but made changes in the Third Notice to incorporate the recent reasoning by the Tax Court. Specifically, the Third Notice acknowledges that the IRS previously stated that (i) a company must receive a Notice of Determination from the IRS before it can file a Petition with the Tax Court, and (ii) the IRS would only issue a Notice of Determination after it had determined that *both* certain workers were employees *and* the company was not eligible for Section 530 relief.[72] The Third Notice then explains that the two recent cases expanded the Tax Court's jurisdiction beyond the earlier limits described in the First Notice and Second Notice.[73]

According to the Third Notice, taxpayers may now lodge a Petition with the Tax Court regarding determinations by the IRS about worker classification or Section 530 relief, even if the IRS fails to issue a Notice of Determination, provided that all four of the following criteria have been met.[74]

First, the IRS must conduct an examination in connection with an audit of any person (*i.e.*, a company) for which the services in question were performed.[75] The Third Notice clarifies that, for these purposes, an examination includes reconsideration of issues by the Appeals Office and "is not complete until the Appeals process concludes."[76] It further states that an audit of a taxpayer's income taxes, excise taxes, pension plans, employer-shared responsibility payments for health coverage, and other items unrelated to worker classification or Section 530 relief do not provide a basis for the Tax Court jurisdiction.[77] Moreover, the Third Notice emphasizes that determinations made by the IRS outside an examination are not deemed determinations for purposes of Code Sec. 7436. It adds to the growing list of ineligible matters, computer-generated correspondence from the IRS, like CP 2000 letters, and decisions made during an examination about backup tax withholding.[78]

Second, as part of the audit, the IRS must determine that one or more workers are employees for worker-classification purposes or the company is not entitled to Section 530 relief with respect to such workers.[79] The Third Notice explains that several items do not fall into these categories, including employment tax adjustments based on the IRS's rejection of assertions by a taxpayer that amounts paid to workers are loan repayments, distributions, or are exempt from the definition of "wages" or "employment."[80] The Third Notice reiterates that conclusions by the IRS that a taxpayer is liable for backup withholding are not determinations for purposes of Code Sec. 7436 because such withholding does not apply when workers are employees.[81]

Third, an actual controversy must exist about a determination made by the IRS as part of an examination.[82] The Third Notice states that there is no actual controversy involving worker classification if the taxpayer agrees that it made payments in connection with an employer–employee relationship but argues that such payments do not constitute "wages" and/or that the particular services provided are not "employment."[83]

Fourth, the person for whom the pertinent services were performed must file an appropriate Petition with the Tax Court.[84] The Third Notice clarifies that the following persons generally cannot submit a Petition: individual workers, certified professional employer organizations, reporting agents, payroll-processing entities, or third-party payer agents.[85] The Third Notice then reminds taxpayers that the 90-day period during which a Petition must be filed cannot be extended or suspended, and contacting the IRS for additional information, receiving correspondence from the IRS, or other events will not change such period.[86]

*Therefore, when approached by the IRS regarding employment tax issues, taxpayers would be wise to retain professionals with a profound understanding of the ever-changing laws and procedures.*

The notion that a taxpayer can file a Petition with the Tax Court even if the IRS fails to issue a Notice of Determination provides additional comfort, but it might be superfluous. Why? The Third Notice declares that the IRS "will provide" taxpayers with a Notice of Determination (i) at the conclusion of every examination involving a determination of worker classification and/or Section 530 relief or (ii) after reconsideration of such matters by the Appeals Office.[87] The Third Notice then provides the IRS a safety net. It explains that in situations where the IRS erroneously assesses employment taxes without first sending taxpayers the requisite Notice of Determination or obtaining a settlement agreement it will abate the assessment. However, the Third Notice clarifies that after correcting any "procedural defects," the IRS may issue the Notice of Determination or assess taxes, as appropriate, as long as the relevant assessment periods remain open.[88]

## V. Important Items Missing from IRS Guidance

Two important items, both favorable to taxpayers, are conspicuously absent from the First Notice, Second Notice, and Third Notice. Readers need to be aware of these.

### A. Chance to Shift Burden to the IRS

There was no mention of burden-shifting in the Tax Court disputes. If a company establishes a *prima facie* case that it was reasonable to treat the workers as independent contractors, and the company fully cooperated with reasonable requests from the IRS during the audit, then the burden of proof with respect to the classification issue shifts to the IRS.[89] Why did Congress insert this special procedural rule aiding taxpayers? It cited as inspiration the high incidence of worker-classification disputes, the fact that many such disputes involve small businesses without adequate resources to challenge the IRS, and the "costly litigation."[90]

### B. Chance to Recoup from the IRS

Congress explicitly commented when first enacting Code Sec. 7436 that taxpayers could seek reimbursement from the IRS under Code Sec. 7430 if they prevailed in the Tax Court and met other criteria.[91] The IRS neglected to mention that in the First Notice, Second Notice, or Third Notice. Therefore, some detail is in order.

The "prevailing party" in an administrative proceeding or litigation with the IRS might be awarded reasonable fees and costs.[92] Recoverable administrative costs can include charges imposed by the IRS; legal bills; expenses for expert witnesses; and costs of any study, analysis, report, test, or project necessary for the preparation of a case.[93] Litigation costs for which the taxpayer may seek reimbursement follow similar guidelines.[94]

The term prevailing party generally means the one that has substantially prevailed with respect to either the amount in controversy or the most significant issues presented, and has a net worth that does not exceed certain statutory thresholds.[95] Even if the taxpayer substantially prevails and meets the net worth requirement, the taxpayer will not be deemed the prevailing party if the IRS establishes that its position was "substantially justified."[96] Understanding what constitutes a substantial justification, therefore, is paramount.

There is a rebuttable presumption that the IRS's position is *not* substantially justified if the IRS failed to follow its own "published guidance" during a proceeding.[97] Such guidance includes regulations, revenue rulings, information releases, notices, and announcements.[98] 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.[99]

In deciding whether the position taken by the IRS was substantially justified, courts must consider whether the

IRS lost on similar issues in federal appeals courts.[100] The regulations further explain that the IRS's position is substantially justified only if it has a reasonable basis in both fact and law.[101]

Case law also 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 the stage at which the issue or litigation is resolved, opinions of other courts on the same underlying issues, clarity of the governing law, foreseeable length and complexity of the litigation, and consistency of the IRS's position.[102] Other courts have utilized a different approach, scrutinizing whether the position taken by the IRS was reasonable.[103] 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."[104] Still other courts rely on a different test, presenting the question as whether the IRS knew or should have known that its position was invalid at the time it took it.[105]

## VI. Conclusion

Because unpaid employment taxes constitute a major component of the tax gap, and because companies have serious financial incentives to treat workers as independent contractors, the safe bet is that the IRS will continue to aggressively audit employment tax issues, particularly worker classification. It is also logical that, when attacked by the IRS, companies will raise Section 530 relief as one of its primary defenses. The IRS, of course, is reluctant to accept defeat during an audit or administrative appeal, which leads to the Tax Court litigation. The rules applicable to the Tax Court litigation of worker classification and Section 530 relief cases have changed several times since their introduction in 1997, with the IRS announcing the most recent alterations in 2022. As this article indicates, the intermittent guidance from the IRS does not tell the whole story, downplaying or omitting certain items favorable to taxpayers. Therefore, when approached by the IRS regarding employment tax issues, taxpayers would be wise to retain professionals with a profound understanding of the ever-changing laws and procedures.

### ENDNOTES

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

2 Code Sec. 3508 and Proposed Reg. §31.3508-1.

3 Reg. §31.3401(c)-1(b). *See also* Reg. §31.3121(d)-1(c)(2).

4 Reg. §31.3401(c)-1(c).

5 Rev. Rul. 87-41, 1987-1 CB 296.

6 Public Law 95-600.

7 For purposes of this article, the term "employment taxes" refers to three items: (i) The federal income taxes that an employer is required to withhold from an employee; (ii) 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 (iii) Amounts under the Federal Unemployment Tax Act ("FUTA"), which are paid solely by the employer.

8 Section 530(a)(1).

9 P.L. 95-600 (1978), Section 530.

10 Senate Report No. 95-1263, 95th Cong. 2d Sess. (1978), p. 209–211.

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

12 *See* Revenue Act of 1978 (P.L. 95-600), Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248), Tax Reform Act of 1986 (P.L. 99-514), and Small Business Job Protection Act of 1996 (P.L. 104-188).

13 Section 530(e)(1); Small Business Job Protection Act of 1996 (P.L. 104-188, §1122).

14 IRM 4.23.5.2.1 (Feb. 1, 2003) (emphasis added).

15 H.Rept. No 178 (95th Cong., 2nd Sess., 5 (1978); IRM 4.23.5.2.1 (Feb. 1, 2003).

16 Section 530(a)(1); Rev. Proc. 85-18, 1985-1 CB 518.

17 Section 530(a)(2); Rev. Proc. 85-18, 1985-1 CB 518.

18 Rev. Proc. 85-18 1985-1 CB 518, Section 3.01.

19 S. Rep. 104-281, 104th Cong., 2nd Sess., 24 (1996); IRM 4.23.5.2.2.7 (Feb. 1, 2003).

20 S. Rep. 104-281, 104th Cong., 2nd Sess., 24 (1996).

21 Reg. §31.3401(c)-1(a).

22 Reg. §31.3401(c)-1(b).

23 Reg. §31.3401(c)-1(c).

24 Rev. Rul. 87-41, 1987-1 CB 296.

25 *See* Code Sec. 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 Code Sec. 3401(c) and Reg. §31.3401(c)-1 (containing the definition of "employee" for federal income tax withholding purposes).

26 IRS News Release, 96-7 (Mar. 5, 1996).

27 IRS Notice 98-21, 1998-1 CB 849.

28 FS-96-5; IRM 4.23.6.

29 FS-96-5; IRM 4.23.6.11 (Mar. 1, 2003).

30 FS-96-5; IRM 4.23.6.13.1 (Oct. 30, 2009).

31 FS-96-5; IRM 4.23.6.13.1 (Oct. 30, 2009).

32 Senate Report 97-494(I), 97th Cong., 2d Sess. (1982), at p. 1103.

33 Senate Report 97-494(I), 97th Cong., 2d Sess. (1982), at p. 1104.

34 Code Sec. 3509(a); IRM 4.23.8.5.1 (Jun. 7, 2011).

35 Code Sec. 3509(b); IRM 4.23.8.5.1 (Jun. 7, 2011).

36 Code Sec. 6205; Reg. §31.6205-1.

37 Rev. Rul. 75-464, 1975-2 CB 474, obsoleted by Rev. Rul. 2009-39, IRB 2009-52 (Dec. 10, 2009).

38 Code Sec. 7442.

39 Taxpayer Relief Act of 1997, Public Law 105-34, Section 1454(a) (effective Aug. 5, 1997).

40 Code Sec. 7436(a) (as originally enacted).

41 Code Sec. 7436(a)(1).

42 Code Sec. 7436(e) (consisting of Code Secs. 3101 through 3512).

43 U.S. House of Representatives, Committee on the Budget, Revenue Reconciliation Act of 1997, 105th Congress, 1st Session, Report 105-148 (Jun. 24, 1997), p. 639; U.S. House of Representatives, Conference Report, Taxpayer Relief Act of 1997, 105th Congress, 1st Session, Report 105-220 (Jul. 10, 1997), p. 734.

44 U.S. House of Representatives, Committee on the Budget, Revenue Reconciliation Act of 1997, 105th Congress, 1st Session, Report 105-148 (Jun. 24, 1997), p. 639; U.S. House of Representatives, Conference Report, Taxpayer Relief Act of 1997, 105th Congress, 1st Session, Report 105-220 (Jul. 10, 1997), p. 734.

45 U.S. Joint Committee on Taxation, General Explanation of the Tax Legislation Enacted in1997, JCS-23-97 (Dec. 17, 1997), p. 428.

46 U.S. House of Representatives, Committee on the Budget, Revenue Reconciliation Act of 1997, 105th Congress, 1st Session, Report 105-148

(Jun. 24, 1997), p. 639; U.S. House of Representatives, Conference Report, Taxpayer Relief Act of 1997, 105th Congress, 1st Session, Report 105-220 (Jul. 10, 1997), p. 734.

[47] U.S. House of Representatives, Committee on the Budget, Revenue Reconciliation Act of 1997, 105th Congress, 1st Session, Report 105-148 (Jun. 24, 1997), p. 639.

[48] Notice 98-43, 1998-2 CB 211 (Jul. 31, 1998).

[49] Notice 98-43, 1998-2 CB 211 (Jul. 31, 1998).

[50] Notice 98-43, 1998-2 CB 211 (Jul. 31, 1998).

[51] Notice 98-43, 1998-2 CB 211 (Jul. 31, 1998).

[52] Notice 98-43, 1998-2 CB 211 (Jul. 31, 1998).

[53] *Henry Randolph Consulting*, 11 TC 1, Dec. 53,201 (Jan. 6, 1999); *See also Henry Randolph Consulting*, 113 TC 20, Dec. 53,588 (Oct. 19, 1999) (stating "we do not have jurisdiction to determine the amount of taxes owing").

[54] Code Sec. 7436(a) (as originally enacted).

[55] Community Renewal Tax Relief Act of 2000, Public Law 106-554, Section 314(f) (Dec. 21, 2000). This change had retroactive effect, making it applicable from the time that Section 7436 was originally enacted in 1997.

[56] Notice 2002-5, 2002-1 CB 320.

[57] Notice 2002-5, 2002-1 CB 320. The Second Notice refers to additions to tax, additional amounts, and penalties, which the author has consolidated into "penalties" for the sake of clarity.

[58] Notice 2002-5, 2002-1 CB 320.

[59] *SECC Corporation*, 142 TC 225, Dec. 59,870 (2014).

[60] *SECC Corporation*, 142 TC 225, 228, Dec. 59,870 (2014).

[61] *SECC Corporation*, 142 TC 225, 229, Dec. 59,870 (2014).

[62] *SECC Corporation*, 142 TC 225, 232-233, Dec. 59,870 (2014).

[63] *SECC Corporation*, 142 TC 225, 234, Dec. 59,870 (2014).

[64] *American Airlines, Inc.*, 144 TC 24, Dec. 60,212 (2015).

[65] *American Airlines, Inc.*, 144 TC 24, 30, Dec. 60,212 (2015).

[66] *American Airlines, Inc.*, 144 TC 24, 33, Dec. 60,212 (2015).

[67] *American Airlines, Inc.*, 144 TC 24, 33, Dec. 60,212 (2015).

[68] *American Airlines, Inc.*, 144 TC 24, 36, Dec. 60,212 (2015).

[69] *American Airlines, Inc.*, 144 TC 24, 34, 36, Dec. 60,212 (2015).

[70] *American Airlines, Inc.*, 144 TC 24, 33-34, Dec. 60,212 (2015).

[71] Rev. Proc. 2022-13; *See also Guidance Clarifies Tax Court Review of Worker Reclassification*, 2022 TAX NOTES TODAY FEDERAL 13–16 (Jan. 19, 2022).

[72] Rev. Proc. 2022-13, IRB 2022-6, January 19, 2022, Section 2.03.

[73] Rev. Proc. 2022-13, IRB 2022-6, January 19, 2022, Section 2.04.

[74] Rev. Proc. 2022-13, IRB 2022-6, January 19, 2022, Section 2.05.

[75] Rev. Proc. 2022-13, IRB 2022-6, January 19, 2022, Section 3.02(1).

[76] Rev. Proc. 2022-13, IRB 2022-6, January 19, 2022, Section 3.02(1).

[77] Rev. Proc. 2022-13, IRB 2022-6, January 19, 2022, Section 3.02(2).

[78] Rev. Proc. 2022-13, IRB 2022-6, January 19, 2022, Section 3.02(3).

[79] Rev. Proc. 2022-13, IRB 2022-6, January 19, 2022, Section 3.03(1).

[80] Rev. Proc. 2022-13, IRB 2022-6, January 19, 2022, Section 3.03(4).

[81] Rev. Proc. 2022-13, IRB 2022-6, January 19, 2022, Section 3.03(4).

[82] Rev. Proc. 2022-13, IRB 2022-6, January 19, 2022, Section 3.04.

[83] Rev. Proc. 2022-13, IRB 2022-6, January 19, 2022, Section 3.04(2).

[84] Rev. Proc. 2022-13, IRB 2022-6, January 19, 2022, Section 3.05(1).

[85] Rev. Proc. 2022-13, IRB 2022-6, January 19, 2022, Section 3.05(1).

[86] Rev. Proc. 2022-13, IRB 2022-6, January 19, 2022, Section 3.05(2).

[87] Rev. Proc. 2022-13, IRB 2022-6, January 19, 2022, Section 4.03.

[88] Rev. Proc. 2022-13, IRB 2022-6, January 19, 2022, Section 9.02.

[89] Section 530(e)(4)(A).

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

[91] U.S. House of Representatives, Committee on the Budget, Revenue Reconciliation Act of 1997, 105th Congress, 1st Session, Report 105-148 (June 24, 1997), p. 639.

[92] Code Sec. 7430(a).

[93] Code Sec. 7430(c)(2).

[94] Code Sec. 7430(c)(1).

[95] Code Sec. 7430(c)(4)(A).

[96] Code Sec. 7430(c)(4)(B)(i).

[97] Code Sec. 7430(c)(4)(B)(ii).

[98] Code Sec. 7430(c)(4)(B)(iv)(I); Reg. §301.7430-5(c)(3).

[99] Code Sec. 7430(c)(4)(B)(iv)(II); Reg. §301.7430-5(c)(3).

[100] Code Sec. 7430(c)(4)(B)(iii).

[101] Reg. §301.7430-5(c)(1).

[102] *National Fed'n of Republican Assemblies*, CA-11, 2004-1 USTC ¶50,111, 353 F3d 1357, 263 FSupp2d 1372, 1378 (SD Ala. 2003).

[103] *See, e.g., Kennedy*, 89 TC 98, Dec. 44,046 (1987) (holding that the IRS' position was unreasonable where it acted contrary to its own regulations and case law, and without factual support).

[104] *Wilkes*, CA-11, 2002-1 USTC ¶60,438, 289 F3d 684, 688.

[105] *See, e.g., Downing*, 89 TCM 1009, Dec. 55,983(M), TC Memo. 2005-73.

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