Taxpayer Delivers One-Two Punch to the IRS in Recent Worker-Classification Dispute: Victory under Section 530 and Potential Fee Recoupment

By Hale E. Sheppard

Hale E. Sheppard examines the eligibility criteria for Section 530, the details of Nelly, and theories for recovery of professional fees under Code Sec. 7430.

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I. Introduction

The IRS has traditionally conducted a large number of employment tax audits, frequently arriving at the conclusion that workers, who were originally classified as independent contractors, should have been treated as employees instead. This triggered assessments against small businesses for back taxes, penalties and interest charges. This is not newsworthy. What is remarkable, though, is when a taxpayer successfully defends itself in a worker-classification attack, thanks to so-called Section 530 and then pursues the IRS for fee recoupment for advancing a legal/tax position after it was no longer "substantially justified." This is precisely what happened in a case decided in May 2016, *Nelly*.[1] Given the scarcity of court decisions upholding taxpayer relief under Section 530, and given the IRS's upcoming increase in employment tax compliance efforts, many taxpayers might rely on this case and others with similar outcomes. Accordingly, the eligibility criteria for

Section 530, the details of *Nelly*, and theories for recovery of professional fees under Code Sec. 7430 are examined in this article.

II. Current Enforcement Environment

To grasp the importance and timeliness of *Nelly*, one must first have some context. Here are the highlights or lowlights, depending on your perspective: (i) The difference between what taxpayers should pay the IRS and what they actually pay is called the "tax gap." (ii) The tax gap reached a whopping $345 billion only a few years ago. (iii) A significant portion of the tax gap is attributable to noncompliance with employment tax laws, including worker-misclassification (*i.e.*, treating workers as independent contractors when they should really be employees). (iv) The IRS is close to concluding a three-year research project, which entailed 6,000 random employment tax audits. (v) This research is expected to show that worker-misclassification is rampant.[2]

Against this backdrop, the IRS announced in September 2011 a new voluntary classification settlement program (VCSP) that was designed to entice companies into reclassifying their workers from independent contractors to employees. Unlike the series of "offshore" voluntary disclosure programs that the IRS began introducing in 2009 to address unreported foreign income and assets (such as the Offshore Voluntary Disclosure Program, Streamline Domestic Offshore Procedure, Streamline Foreign Offshore Procedure and others), the VCSP has *not* enjoyed widespread participation. Indeed, after nearly four years in existence, only about 1,600 companies have applied for the VCSP, and approximately 10 percent of those never ended up resolving matters with the IRS through the VCSP.[3]

In light of an enormous tax gap, the perception of widespread worker-misclassification, the forthcoming report by the IRS that likely will validate this view and the reality (as demonstrated by the VCSP) that taxpayers are disinclined to pro-actively recharacterize workers as employees, one might anticipate that the IRS will deem it necessary to dedicate significantly more resources to enforcement of employment tax laws in the near future. This expectation has already come true to a certain extent, with the IRS recently announcing that it intends to hire as many as 700 individuals to fill a variety of enforcement positions.[4] As the IRS increases its pursuit of worker-classification issues, the concept of protection under Section 530, the central issue in *Nelly*, will take on renewed importance.

III. Section 530 Overview

A. Section 530 Relief

1. Brief History of Section 530

Section 530 is the Holy Grail of worker-classification cases, but it is not found in the Internal Revenue Code (the "Code"). Instead, it is a reference to "Section 530" of the Revenue Act of 1978. Confusion often results from the fact that this legislation has never been codified. The consequence is that those looking for Section 530 in the current version of the 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 (including federal income tax withholding, FICA taxes or FUTA taxes), penalties or interest charges against the company.[5] Second, and perhaps more importantly, the IRS cannot obligate the company to reclassify the workers in question 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.[6]

Given its importance in the employment tax arena, one could write entire books on the history, impact and nuances of Section 530. This is well beyond the scope of this article, though. Suffice it to understand a few key points.

Congress introduced Section 530 nearly 40 years ago, in the Revenue Act of 1978, in an effort to counter aggressive IRS worker-classification audits on small businesses.[7] 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 the forced 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.[8]

Congress initially contemplated a short-term reprieve for companies, the proverbial "time out," 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.[9]

Section 530 has remained in effect for nearly 40 years despite these early thoughts about a temporary reprieve.

2. Overview of Three Criteria to Satisfy Section 530

The law generally provides that, if a company treated a worker as an independent contractor for certain tax periods, then the worker *shall* be deemed an independent contractor for such periods, as long as the company meets the following three criteria:

- The company filed information returns in a manner consistent with the worker's status as an independent contractor; that is, the company filed annual Forms 1099-MISC (Miscellaneous Income) with the IRS reporting all "non-employee compensation" paid to the worker ("Reporting Consistency").
- The company treated other workers holding substantially similar positions as independent contractors ("Substantive Consistency").
- The company had a "reasonable basis" for treating the worker as an independent contractor ("Reasonable Basis").[10]

3. What Does "Reasonable" Mean for Purposes of Section 530?

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

- Court decisions or published IRS rulings, regardless of whether they relate to the particular industry or business in which the company is engaged, as well as technical advice, a letter ruling or a determination letter from the IRS pertaining the specific company in question ("Precedent Safe Harbor")
- 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 currently at issue ("Prior Audit Safe Harbor")
- A longstanding recognized practice of a significant segment of the industry in which the worker is engaged ("Industry Practice Safe Harbor")
- Some other reasonable basis for treating the workers as independent contractors ("Other Reasonable Basis Safe Harbor")[11]

4. The Reasonable Basis Safe Harbor Is Flexible

The IRS has acknowledged that the last component (*i.e.*, the Other Reasonable Basis Safe Harbor) should be broadly interpreted to favor the company being subjected to the worker-classification audit.[12] Congress, for its part, has stated that reasonable reliance on a qualified, informed tax professional suffices:

> 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.[13]

The IRS has also expanded the reasonable-reliance defense in its own Internal Revenue Manual, stating that the tax professional dispensing the key advice is not even required to possess any expertise in employment taxes:

> 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.[14]

In addition to reasonably relying on a qualified tax professional, Congress has also recognized that a taxpayer can meet the Other Reasonable Basis Safe Harbor by showing that the company reviewed the common-law standards and concluded, albeit incorrectly, that the workers in question did not fall into the "employee" category. According to a 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."[15]

5. The IRS's Duty to Notify Taxpayers About Section 530

As indicated above, Section 530 has remained in effect for nearly 40 years. The law has been amended three times during this period, and each time the rights of those companies invoking Section 530 relief were strengthened.[16] For instance, both 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.[17] This statutory mandate is also found in a variety of other sources. Legislative history, for example, contains the following guidance on the IRS's obligation to notify taxpayers of their rights, particularly as they relate to Section 530 relief:

> [T]he Senate amendment provides that an officer or employee of the IRS must, at (or before) the commencement of an audit involving worker classification issues, provide the taxpayer with written notice of the provisions of Section 530.[18]
>
> The conferees wish to clarify the notice that the IRS must provide to taxpayers at (or before) the commencement of an audit inquiry involving worker classification issues. The conferees recognize that, in many cases, the portion of any audit involving worker classification issues will not arise until after the examination of the taxpayer begins. In that case, the notice need only be given at the time the worker classification issue is first raised with the taxpayer.[19]

Like the legislative history, the IRS's own Internal Revenue Manual features multiple entries mandating that the Section 530 analysis takes place at the beginning of the audit process. Relevant entries include the following:

> 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.[20]

The IRS's worker-classification training materials also indicate that "Section 530 is a relief provision that should be considered as the first step in any case involving worker classification."[21]

Finally, the IRS issued a news release way back in 1996 publicly committing itself to informing taxpayers of their rights and protections at the commencement of a worker-classification audit.[22] Revenue Agents were to implement this notification by supplying taxpayers under audit with IRS Publication 176, which is now called *Do You Qualify for Relief Under Section 530?* The news release was absolutely clear about the appropriate time for enlightening taxpayers, mandating that Revenue Agents "provide the new explanation of Section 530 relief requirements at the beginning of any inquiry into worker classification and will answer any questions about eligibility for this relief."[23]

IV. Analysis of the Case

A. Summary of the Facts[24]

Helen Carney established Nelly, LLC in 2004. She later organized its successor, Nelly Home Care, Inc., in 2009. The former was a single-member limited liability company, generally treated as a disregarded entity for federal tax purposes. Its income, deductions and related items were reported on Schedules C to joint Forms 1040 filed by Ms. Carney and her husband. The latter was a corporation wholly owned by Ms. Carney, which filed a separate income tax return.

Both companies, collectively referred to in this article as "Nelly," provide nonmedical homecare services to senior citizens, thereby allowing them to live independently and safely as long as possible. These services include, but are not limited to, assistance with hygiene, preparation of meals, medication reminders, light housekeeping, errands, shopping, companionship, transportation to appointments and relief for family caregivers. Nelly had approximately

70 workers by 2008, but that number has decreased to around 40 workers.

The majority of the customers live in retirement communities. Nelly does not supervise its workers, direct them in the performance of their duties, train them, meet with them on a regular basis, obligate them to accept any particular assignment, set a minimum or maximum number of workable hours, assign them a uniform or give specific instructions about how to care for the elderly customers. Additionally, the workers have scheduling freedom in that they can arrange for a substitute caregiver from Nelly, if necessary, or coordinate directly with the client to personally reschedule missed sessions. All workers sign an "Independent Contractor Service Agreement" that explains, among other things, that they will be treated as independent contractors for tax purposes. Nelly does not pay for health insurance, the requisite criminal background checks and vaccinations or other expenses incurred by workers, such as travel, parking, phones and meals.

Nelly obtains worker's compensation insurance for the workers, which is something businesses often do for employees, but not independent contractors. Moreover, in order to get paid, the workers provide Nelly with a weekly statement noting the dates worked, time spent and type of services performed. The workers are also required to call Nelly upon arriving at and departing from a job, because this procedure facilitates billing and avoids potential disagreements with clients or their family members regarding the amount of time spent by the workers.

Ms. Carney previously worked as a provider of homecare services to senior citizens. While doing this job, Ms. Carney met other workers, who indicated that they were functioning as independent contractors, too. Ms. Carney also contacted three other firms offering similar services, two of which indicated that they treated their workers as independent contractors. Ms. Carney later decided to start her own business, Nelly, treating workers as independent contractors. To clarify this stance, Ms. Carney hired an attorney to prepare an independent contractor agreement based on an existing contract used by one of the competing companies.

Ms. Carney continued to confirm the decision to treat workers as independent contractors after inception. For instance, she conducted a survey of companies offering homecare services, like Nelly, regarding how they characterized their workers. This survey revealed that seven out of 20 companies treated workers as independent contractors, though some of these companies were located outside the Philadelphia metropolitan area, where Nelly operated. In 2009, Ms. Carney attended a mandatory conference organized by the Pennsylvania Department of Health. She was again told at such event that so-called homecare registries, which was the manner in which Nelly was classified, were defined as businesses that supply, arrange and refer independent contractors to provide homecare services.

In 2007, the IRS audited Forms 1040 for 2004 and 2005 of Ms. Carney and her husband. One of the Information Document Requests (IDRs) issued by the Revenue Agent demanded (i) all books, journals, ledgers and workpapers used in determining the gross receipts shown on the Schedule C for Nelly, LLC; (ii) all documentation to support the deduction of contract labor on the Schedule C for Nelly, LLC; (iii) any and all workpapers used in preparing Schedule C; and (iv) copies of all contracts made with independent contractors. This first audit resulted in significant increases to the federal income tax liabilities, but no adjustments related to payments made to the homecare workers or to their treatment as independent contractors.

In 2011, the IRS audited Form 1040 for 2008 of Ms. Carney and her husband. As part of this second audit, the Revenue Agent issued IDRs seeking copies of all independent contractor agreements for Nelly, LLC and a checklist or test showing how Nelly, LLC determined that its workers should be treated as independent contractors instead of employees. The second audit ended with a "no change" letter from the IRS.

As a result of a referral by the Revenue Agent conducting the income tax audit of Form 1040 for 2008, the IRS also began an employment tax audit of Nelly starting in 2011. The IRS concluded that the workers in question should have been treated as employees instead of independent contractors.

Nelly, LLC paid the resulting employment taxes for 2008 and 2009 and immediately filed Forms 941-X (Adjusted Employer's Quarterly Federal Tax Return or Claim for Refund) for each of the relevant tax periods. Nelly Home Care, Inc. did the same for 2010, 2011 and 2012. The IRS never even responded to these claims for refund. Therefore, after waiting the required six months, Nelly, LLC and Nelly Home Care, Inc. each filed a lawsuit for refund with the proper District Court.

B. Reasoning of the Court

1. Focusing the Legal/Tax Issue

Nelly, LLC and Nelly Home Care, Inc. filed a Consolidated Motion for Summary Judgment in refund litigation against the U.S. Department of Justice (DOJ), asking the District Court to determine that these two companies are protected by Section 530 and thus are not required to pay employment taxes, penalties or interest to resolve past matters, and not obligated to now reclassify the workers as employees to address future matters. The DOJ stipulated that Nelly met two of the three criteria for Section 530; that is, there was no dispute that Nelly had Reporting Consistency and Substantive Consistency. The sole issue before the District Court, therefore, was whether Nelly met the third and final criteria, *i.e.*, did it have a Reasonable Basis for treating the workers as independent contractors? Nelly raised three arguments in support of its position that, yes, indeed, it had more than a Reasonable Basis for categorizing the relevant workers as independent contractors.

2. First Argument—District Court Rejects Prior Audit Safe Harbor

First, Nelly cited the Prior Audit Safe Harbor, claiming that it relied in good faith on the previous review by the IRS in 2007 of workers holding substantially similar positions, which resulted in no employment tax assessments. The District Court rejected this theory because (i) the earlier audit focused on Forms 1040 for 2004 and 2005 of Ms. Carney and her husband (*i.e.*, personal income tax audit), not on the types of workers involved in the current case (*i.e.*, business employment tax audit), and (ii) although the IRS requested copies of Forms 1099 during the personal income tax audit, it did so to analyze the questionable deductions and expenses on Forms 1040 related to Nelly, not to challenge the classification of Nelly's workers.

3. Second Argument—District Court Finds No Reliable Industry Practice

Second, Nelly maintained that it met the Industry Practice Safe Harbor. As proof thereof, Nelly pointed to the fact that Ms. Carney spoke with three companies offering similar homecare services before starting Nelly, two of which indicated that they treated their workers as independent contractors. The District Court spurned this evidence because the actions of merely two companies do not constitute a significant segment of the pertinent industry and because, even if such behavior were industrywide now, Nelly failed to show that such practice was "longstanding." In its quest to satisfy the Industry Practice Safe Harbor, Nelly also advanced the notion that it relied on its own survey of 20 companies in defining industry practice. The problem, stated the District Court, was that only seven of the companies treated workers as independent contractors and some of the companies were not indicative of the relevant industry because they were situated outside metropolitan Philadelphia, where Nelly is located.

4. Third Argument—District Court Embraces Other Reasonable Basis

Third, Nelly argued that it should still reap the benefits of Section 530, thanks to the catch-all, the last resort and the Hail Mary of worker-classification, *i.e.*, the Other Reasonable Basis Safe Harbor. The District Court accepted this premise from Nelly, concluding that it was entitled to protection under Section 530.

The District Court reasoned as follows in arriving at this Nelly-favorable decision: (i) Before forming Nelly, Ms. Carney had personally worked as a homecare service provider and confirmed that many of her coworkers were treated as independent contractors. (ii) Ms. Carney contacted three other firms offering similar services, two of which were treating their workers as independent contractors, and one of which offered her a copy of its independent contractor agreement. (iii) Ms. Carney hired an attorney to prepare an independent contractor agreement. (iv) Ms. Carney attended a mandatory conference organized by the Pennsylvania Department of Health in 2009, where they stated that "home care registries," like Nelly, were businesses that provide independent contractors for homecare services. (v) The IRS "said nothing" about the worker-classification issue for Nelly when it was auditing Forms 1040 from 2004 and 2005 of Ms. Carney and her husband in 2007. As the District Court saw things, "[g]iven that [the IRS] undertook an in-depth analysis of Nelly LLC's business practices, it was reasonable for Carney to interpret the IRS's silence on the independent contractor classification as acquiescence."

The DOJ argued that the Other Reasonable Safe Harbor could not safeguard Nelly because, generally speaking, there can be no after-the-fact justification by companies for employment decisions. Here is how the DOJ put it in its legal brief opposing summary judgment:

> [T]he 2004 and 2005 income tax audit of the Carneys took place in 2007. Nelly, LLC was formed in 2004 and it began treating its workers as independent contractors in 2004. Therefore, an income tax audit which occurred three years after Nelly, LLC was already treating its workers as independent contractors cannot be a basis for reasonable reliance for treating the workers as independent contractors. Section 530 is not available based on ex post facto reliance.
>
> [P]rior to the commencement of the audit in 2011 of the 2008 federal income tax returns of the Carneys, Nelly LLC and Nelly Home Care, Inc. has been treating its workers as independent contractors since 2004. A

six year ex post facto reliance is not reasonable. At the time of the audit in 2011, Nelly LLC was no longer in existence. At the time of the audit in 2011, Nelly Home Care, Inc. was already treating its workers as independent contractors. Even assuming that the six year period is not applicable to Nelly Home Care, Inc., the audit [of the 2011 Form 1040 of the Carneys] occurred one year after Nelly Home Care, Inc. was already treating the workers as independent contractors.[25]

The District Court labeled the IRS's line of thinking "misplaced" because Ms. Carney's decision to treat the workers as independent contractors was based on "extensive research" in both 2004 and 2010, and the subsequent IRS audits and the conference by the Pennsylvania Department of Health served to confirm her earlier decision. Moreover, added the District Court, Ms. Carney did not make just one decision about classifying the workers, she made a separate decision each tax year that Nelly was in operation.

The DOJ, in its brief challenging summary judgment, argued that the homecare workers should be considered employees under the 20 common-law factors because the "Independent Contractor Service Agreement" contained a noncompete clause, the workers had to contact Nelly upon arriving at and leaving a job, Nelly kept a time sheet for each worker, Nelly paid worker's compensation insurance of each worker and Nelly created and gave competency tests to the workers.

The District Court, after yielding such a positive interpretation of the facts for Nelly, effectively ignored the claims by the DOJ regarding the common-law factors. It explicitly limited the scope of its ruling in response to the Motion for Summary Judgment. The District Court emphasized that it was not required to determine whether Nelly was correct when it classified the workers as independent contractors, since it resolved the initial issue (*i.e.*, does Section 530 relief apply) in favor of Nelly. Lest any doubt remain about the substance of its decision, the District Court ended by stating that "[t]o be sure, our decision today in no way endorses Nelly's classification of its workers as independent contractors."

V. Recouping Professional Fees from the U.S. Government

A. Overview of the Rules for Making the U.S. Government Pay

Generally, the prevailing party in any administrative proceeding before the IRS or in any litigation that is brought by or against the federal government in connection with the determination, collection or refund of any tax, interest or penalty may be awarded reasonable administrative and/or litigation costs.[26] 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.[27] The litigation costs for which the taxpayer may seek reimbursement follow similar guidelines.[28]

The term "prevailing party" generally means a party in any tax-related administrative proceeding or litigation that (i) has substantially prevailed with respect to either the amount in controversy or the most significant issue(s) presented and (ii) has a net worth that does not exceed certain statutory thresholds.[29] 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."[30] In other words, if the government manages to prove that the position it took during the administrative dispute or litigation was substantially justified, then 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.[31] According to congressional reports, "the successful taxpayer will receive an award of attorney's fees unless the IRS satisfies its burden of proof."[32] 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.[33] If it fails 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.[34] 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.[35] 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.[36] This brand of stubborn litigiousness, say the reports, would place an undue burden on those taxpayers forced to dispute decided issues.[37]

The legislative modifications discussed above have been incorporated into the 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.[38] 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.[39] Such guidance includes regulations (final or temporary), revenue rulings, information releases, notices and announcements.[40] 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.[41] 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.[42]

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.[43] A significant factor in making this determination is whether the taxpayer presented all the relevant information under his control to the appropriate IRS personnel.[44] 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 substantial justification. Certain courts have developed a framework, a nonexhaustive list of factors to be considered. Among these factors are (i) the stage at which the issue or litigation is resolved, (ii) the opinions of other courts on the same underlying issues, (iii) the legal merits of the government's position, (iv) the clarity of the governing law, (v) the foreseeable length and complexity of the litigation and (vi) the consistency of the government's position.[45] Other courts have utilized a different approach, scrutinizing whether the position taken by the IRS was reasonable.[46] 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."[47] 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.[48]

Several cases involve demands for recoupment of professional fees after the taxpayer successfully shielded itself with Section 530. One example is *Smokey Mountain Secrets, Inc.*[49] In that case, after winning on the issue of whether workers at issue were "direct sellers" under Code Sec. 3508, the company initiated a separate suit seeking legal fees and costs.[50] The court refused to make the government reimburse the taxpayer on the direct seller issue because it was a case of first impression: "[T]he fact remains that no case law existed before this matter was decided addressing the issue of whether telemarketers and delivery persons were actually direct sellers."[51] This was not the end of the matter, though. The taxpayer in *Smokey Mountain Secrets, Inc.* had raised two alternative arguments at trial. The taxpayer first contended that the workers were direct sellers under Code Sec. 3508. Its second position was that, even if the workers were employees, the taxpayer was not required to treat them as such because it met all the criteria for protection under Section 530. The court agreed that the taxpayer presented a strong Section 530 defense, yet the IRS persisted. The court, therefore, granted partial fee reimbursement to the taxpayer, finding that the IRS's position was "wholly without merit" and "borders on the disingenuous," and the IRS had all the relevant information before trial but "[n]evertheless it put [the taxpayer] through the cost of a trial even though the IRS's position was not substantially justified in fact or in law."[52]

B. Optimism About Fee Recovery in *Nelly*

The Opinion issued by the District Court in *Nelly* dated May 10, 2016, confirmed victory for both Nelly, LLC and Nelly Home Care, Inc., granting the Consolidated Motion for Summary Judgment on grounds that the companies should be protected under Section 530. Additionally, the District Court stated that they were entitled to "attorney's fees to be determined at a later date." Consistent with this notion, but featuring greater reserve, footnote 7 of the Opinion in *Nelly* states the following: "Nelly also requests that we award reasonable costs and attorney's fees. We will rule on this issue only after a formal motion or affidavit from Nelly requesting a specific amount and after considering any potential response in opposition from the Government."[53] The attorneys for Nelly indicated their intention of filing the appropriate documents with the District Court to seek reimbursement of legal fees from the U.S. government under Code Sec. 7430. It will be interesting to see when, exactly, the District Court determines that the U.S. government's case lacked substantial justification, as this will dictate the size of the fee recoupment.

VI. Conclusion

The sky might not be falling, but the situation for small businesses with potential worker-misclassification issues is undeniably bleak: The tax gap is huge, many count employment tax noncompliance among the largest culprits, the multi-year IRS research project is expected to soon conclude that worker-classification is pervasive and the IRS is hiring and training a significant number of new Revenue Agents to address this and other issues. Under these circumstances, rare cases like *Nelly*, involving taxpayer triumph under Section 530 and potential fee recovery under Code Sec. 7430, will assume additional importance for companies that find themselves subject to IRS scrutiny in the coming years.

ENDNOTES

1 *Nelly,* DC-PA, 117 AFTR2d 2016-XXXX (May 10, 2016); No. 2:15-cv-00439.

2 Michael Joe, *IRS to Audit 6,000 Companies for Employment Tax Compliance*, 2009 Tax Notes Today 183–184 (Sept. 24, 2009); Wesley Elmore, *Employment Tax Audit Program to Begin in Next Two Months, IRS Official Says*, 2010 Tax Notes Today 15-18 (Jan. 25, 2010); Laura Davison, *Employment Tax Study to Guide IRS Audit Selection Next Year*, 35 BNA Tax Management Weekly Report 388 (2016); 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 (Feb. 4, 2009), at 8.

3 Matthew R. Madara, *IRS Sees Success in Voluntary Classification Settlement Program*, 2015 Tax Notes Today 132–138 (July 10, 2015).

4 *IRS to Hire Additional Enforcement Staff*, 2016 Tax Notes Today 86–121 (May 4, 2016).

5 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.

6 Section 530(a)(1).

7 Act Sec. 530 of the Revenue Act of 1978 (P.L. 95-600).

8 Senate Report No. 95-1263, 95th Cong., 2nd Sess. (1978), at 209–211.

9 Senate Report No. 95-1263, 95th Cong., 2nd Sess. (1978), at 201 (emphasis added).

10 Section 530(a)(1); Rev. Proc. 85-18, 1985-1 CB 518. For more information about Reporting Consistency, please see the following article by the same author: *Must Taxpayers File "Timely" Forms 1099 to Obtain Section 530 Relief? Unexpected Answers from a Recent Worker-Classification Case*, Taxes, May 2013, at 55, selected for republication in J. Tax Practice & Procedure, Apr.–May 2013, at 39.

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

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

13 Senate Report 104-281, 104th Cong., 2nd Sess., 24 (1996).

14 IRM §4.23.5.2.2.7 (Feb. 1, 2003).

15 Senate Report 104-281, 104th Cong., 2nd Sess., 24 (1996).

16 *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).

17 Section 530(e)(1); Act Sec. 1122 of the Small Business Job Protection Act of 1996 (P.L. 104-188).

18 H. Conf. R. 104-737, 104th Cong., 2nd Sess., 203 (1996).

19 H. Conf. R. 104-737, 104th Cong., 2nd Sess., 204 (1996).

20 IRM §4.23.5.2.1 (Feb. 1, 2003) (emphasis in original).

21 Internal Revenue Service. Independent Contractor or Employee? Training Materials. Training 3320-102 (1996), at 1–5.

22 IRS News Release, IR-96-44, Oct. 30, 1996.

23 IRS News Release, IR-96-44, Oct. 30, 1996.

24 The facts in this case are derived from the following documents, all of which are in the author's possession: Complaint in *Nelly, LLC* dated January 29, 2015, Answer in *Nelly, LLC* dated April 6, 2015, Complaint in *Nelly Home Care, Inc.* dated January 29, 2015, Answer in *Nelly Home Care, Inc.* dated April 6, 2015, Consolidated Motion for Summary Judgment dated November 4, 2015, Memorandum of Law in Support of Consolidated Motion for Summary Judgment dated November 4, 2015, Opposition by United States to Consolidated Motion for Summary Judgment dated December 18, 2015, Opinion dated May 10, 2016, Judgment dated May 10, 2016.

25 Opposition by United States to Consolidated Motion for Summary Judgment filed December 18, 2015, at 17–18.

26 Code Sec. 7430(a).

27 Code Sec. 7430(c)(2).

28 Code Sec. 7430(c)(1).

29 Code Sec. 7430(c)(4)(A).

30 Code Sec. 7430(c)(4)(B)(i).

31 Taxpayer Bill of Rights 2 (P.L. 104-168).

32 H.R. Rept. 104-506, 104th Cong., 2nd Sess. 1996, at 37.

33 Act Sec. 701 of the Taxpayer Bill of Rights 2 (P.L. 104-168); H.R. Rept. 104-506, 104th Cong., 2nd Sess. 1996, at 36–37.

34 Taxpayer Bill of Rights 3 (P.L. 105-206).

35 Act Sec. 3101 of the Taxpayer Bill of Rights 3 (P.L. 105-206), codified as Code Sec. 7430(c)(4)(B)(iii).

36 H.R. Rept. 105-364, 105th Cong., 1st Sess. 1997, at 58; Sen. Rept. 105-174, 105th Cong., 2nd Sess. 1998, at 48.

37 H.R. Rept. 105-364, 105th Cong., 1st Sess. 1997, at 58; Sen. Rept. 105-174, 105th Cong., 2nd Sess. 1998, at 48.

38 Code Sec. 7430(c)(4)(B)(i).

39 Code Sec. 7430(c)(4)(B)(ii).

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

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

42 Code Sec. 7430(c)(4)(B)(iii).

43 Reg. §301.7430-5(c)(1).

44 Reg. §301.7430-5(c)(1); Reg. §301.7430-5(h), Ex. 1.

45 *National Fed'n of Republican Assemblies*, DC-AL, 263 FSupp2d 1372, 1378 (2003).

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

47 *N.R. Wilkes, Jr.,* CA-11, 2002-1 ustc ¶60,438, 289 F3d 684, 688 (2002).

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

49 *Smokey Mountain Secrets, Inc.*, DC-TN, 1996 WL 774554, 78 AFTR2d 96-7603 (1996).

50 *Smokey Mountain Secrets, Inc.*, DC-TN, 1996 WL 774554, 78 AFTR2d 96-7603 (1996).

51 *Smokey Mountain Secrets, Inc.*, DC-TN, 1996 WL 774554, 78 AFTR2d 96-7603 (1996), at *2.

52 *Smokey Mountain Secrets, Inc.*, DC-TN, 1996 WL 774554, 78 AFTR2d 96-7603 (1996), at *3.

53 Opinion dated May 10, 2016, footnote 7.