Court Holds that Pre-Trial Win in Worker-Classification Dispute Thanks to Section 530 Does Not Trigger Automatic Fee Recovery Under Section 7430

*By Hale E. Sheppard**

Hale E. Sheppard examines fee recovery under Section 7430 using Nelly as a starting point

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I. Introduction

The IRS conducts a large number of employment tax audits each year, frequently arriving at the conclusion that workers, who were originally classified as independent contractors, should have been treated as employees instead. This often results in large assessments of back taxes, penalties, and interest against small companies, which are not sophisticated or economically strong enough to fend off the IRS. However, in certain situations, a company manages to prevail in a worker-classification attack thanks to so-called "Section 530." Then, fueled by this victory against the taxman, and staring at a large stack of legal, accounting, and other bills related to the fight, the company might file a motion with the relevant court seeking recoupment of fees and costs from the IRS under Code Sec. 7430. Beating the IRS is one thing, but beating the IRS and then convincing a court to make the IRS pay the taxpayer for the inconvenience is another. One recent case, *Nelly*, provides an opportunity to explore this issue.[1]

The specific question in *Nelly* is whether a company can recover the legal fees and costs that it incurred in defending itself against a worker-classification attack by the IRS when the company persuades the District Court that it is entitled to full relief under Section 530 (such that there is an employment tax liability of $0), before trial, through a Motion for Summary Judgment. In other words, if a company's argument that the IRS's position about worker-classification was not "substantially justified" is so compelling that a court upholds it without the need for a trial, does this assure the company of a fee award under Code Sec. 7430? This article analyzes this issue and related ones, using *Nelly* as a starting point.[2]

II. Overview of Employment Tax Relief Under Section 530

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.[3] 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.[4] 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.[5]

Congress introduced Section 530 nearly 40 years ago in an effort to counter aggressive IRS worker-classification audits on small businesses.[6] 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 (which the company did not withhold and remit to the IRS) for workers, even though such workers may have already paid their own income and self-employment taxes.[7]

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.[8]

Section 530 has remained in effect for nearly 40 years, despite these early thoughts about a temporary halt to overreaching by the IRS.

2. 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").[9]

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 private letter ruling, or a determination letter from the IRS pertaining the specific company in question ("Precedent Safe Harbor"), or
- 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"), or
- A longstanding recognized practice of a significant segment of the industry in which the worker is engaged ("Industry Practice Safe Harbor"), or
- Some other reasonable basis for treating the workers as independent contractors ("Other Reasonable Basis Safe Harbor").[10]

4. The Other 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.[11] 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.[12]

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 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.[13]

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."[14]

III. Analysis of the First Case—Fight over Section 530 Relief

A. Summary of the Facts[15]

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 non-medical 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," which 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, *like most tax cases, generates some interesting lessons, if you are willing to look beyond the surface.*

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 of work, 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, and 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 "home care 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 the Form 1040 for 2008, the IRS also began an employment tax audit of Nelly starting in 2011. The IRS concluded, as one would expect, 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 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 are 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, even if the Precedent Safe Harbor were irrelevant, and even if the District Court discounted the applicability of the Prior Audit Safe Harbor and the Industry Practice Safe Harbor, it should still reap the benefits of Section 530 thanks to the catch-all, the last resort, 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:

- 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.
- 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.
- Ms. Carney hired an attorney to prepare an independent contractor agreement.
- 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.
- 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 justifications 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.[16]

As Nelly demonstrates, a company can prevail on a worker-classification issue before trial, through a Motion for Summary Judgment, but this, alone, does not necessarily mean that the company will convince a court to make the U.S. government compensate the company for its trouble.

The District Court labeled the DOJ'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, 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 non-compete 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."

IV. Efforts to Recoup Professional Fees from the U.S. Government

A. Overview of the Rules for Making the Government Pay

Generally, the prevailing party in any administrative proceeding before the IRS or in any litigation that is brought by or against the U.S. government in connection with the determination, collection, or refund of any tax, interest, or penalty may be awarded reasonable administrative and/or litigation costs.[17] 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.[18] The litigation costs for which the taxpayer may seek reimbursement follow similar guidelines.[19]

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.[20] 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."[21] 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.[22] According to congressional reports, "the successful taxpayer will receive an award of attorney's fees unless the IRS satisfies its burden of proof."[23] 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.[24] 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.[25] 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.[26] 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.[27] This brand of stubborn litigiousness, say the reports, would place an undue burden on those taxpayers forced to dispute decided issues.[28]

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.[29] 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.[30] Such guidance includes regulations (final or temporary), revenue rulings, information releases, notices, and announcements.[31] 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.[32] 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.[33]

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.[34] A significant factor in making this determination is whether the taxpayer presented all the relevant information under his control to the appropriate IRS personnel.[35] 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 non-exhaustive 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.[36] Other courts have utilized a different approach, scrutinizing whether the position taken by the IRS was reasonable.[37] 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."[38] 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.[39]

V. Analysis of the Second Case—Possibly Making the Government Pay

The Opinion issued by the District Court in *Nelly* 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. In doing so, the District Court referenced "attorney's fees to be determined at a later date." Consistent with this notion, but showing greater reserve, footnote 7 of the Opinion 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."[40] Based on this triumph on the substantive employment tax issue, and the fact Nelly achieved it *via* a Consolidated Motion for Summary Judgment (without the need to even go to trial to present evidence), one assumes that Nelly was optimistic about its chances of forcing the U.S. government to cover at least a portion of its litigation fees and costs. These high spirits were deflated quickly.

The attorneys for Nelly filed a motion with the District Court seeking reimbursement of legal fees under Code Sec. 7430. They asked for total recovery of just over $100,000.[41] Despite the earlier victory on the worker-classification issue, the District Court, this time led by a different judge, determined that Nelly should receive $0 for fees because the U.S. government's position (initially advanced by the IRS during the audit and later carried on by the DOJ during the refund litigation) was "substantially justified."

The District Court began its analysis by providing an abbreviated explanation of the legal standards applicable to Code Sec. 7430, as described earlier in this article. It placed emphasis on the notion that, in deciding whether the U.S. government's position is "substantially justified," the courts must examine "objective indicia" regarding the strength of the position, and if this is inconclusive, then the court is free to make its own assessment. According to the District Court, the "objective indicia" in *Nelly* were "inconclusive," so it applied its own perspective.

The District Court began by flatly stating that "[b]ecause the case was decided on summary judgment does not [necessarily] mean that the government's position was not substantially justified."[42] It then went on to underscore the following: (i) Nelly did not succeed in proving to the District Court in the earlier case that the workers in question were independent contractors and not employees, but rather it persuaded the District Court that it was shielded from this analysis thanks to Section 530; (ii) The rationale for a decision/opinion by a court is the most powerful indicator of whether the U.S. government's position was "substantially justified," and the fact that the U.S. government ultimately lost on the merits is not determinative; (iii) Nelly previously convinced the District Court that Section 530 applied because it had a "reasonable basis" for classifying the workers as independent contractors, and this question is "fact-specific," "subject to varying interpretations of the facts and circumstances of the case," and "could have gone either way"; (iv) It was not unreasonable for the U.S. government to challenge Nelly's argument that it relied on the conduct of other healthcare companies, particularly when the survey performed by Nelly revealed that only seven out of 20 companies treated their workers as independent contractors; (v) Nelly did not seek advice about worker-classification issues beforehand from attorneys or accountants; (vi) Nelly provided worker's compensation insurance to its workers, which generally indicates employee status; and (vii) No contrary legal precedent existed.

The District Court, anchored in these factors, fully denied fee recovery for Nelly. Thus, while Nelly managed to escape payment of employment taxes, penalties, and interest charges, and while it was legally permitted to continue treating the relevant workers as independent contractors in future years, the encounter with the IRS had cost the company lots of time (with the audits starting in 2007 and the litigation concluding a decade later, in 2017) and lots of money (including, but not limited to, approximately $100,000 in legal fees).

VI. Interesting Points—Some Takeaways

Nelly, like most tax cases, generates some interesting lessons, if you are willing to look beyond the surface. Below are some of those lessons.

A. Unique Strategies in Worker-Classification Cases

In ordinary income tax audits, taxpayers and their advisors, whether or not they openly acknowledge this, have certain incentives to slow the process, provide minimal information and documentation to the Revenue Agent, and drive the dispute to a head, hoping to achieve a more favorable resolution with the Appeals Office or the Tax Court. Things are different in worker-classification cases, though, because presenting all evidence to the Revenue Agent as soon as possible that the company meets Section 530 often has the effect of persuading the IRS to drop the issue and, if not, it helps the company establish when, exactly, the IRS's position was no longer "substantially justified." For this reason, tax professionals seasoned in worker-classification disputes frequently present all supporting evidence to the Revenue Agent at the outset, sometimes before the Revenue Agent has solicited it through IDRs, along with a cover letter summarizing the company's positions. Set forth below is a sample of the positions that a company might present to the IRS early in the audit process and throughout the entire tax dispute, as necessary and appropriate:

> As demonstrated by all the documentation and information provided by the Company to the IRS thus far during the audit, the Company meets all the requirements of Section 530. Therefore, the IRS should immediately discontinue its worker-classification examination, and the Company should be allowed to continue treating the workers as independent contractors. Moreover, the Company has established a prima facie case that it was reasonable to treat the workers at issue as independent contractors, and the Company and its representatives have fully cooperated with reasonable requests from the IRS during the audit. Accordingly, under Section 530(e)(4)(A), the burden of proof with respect to the worker-classification issue has now shifted to the IRS. Even if the Company somehow fails to qualify for Section 530 relief, the Company would nonetheless not be subject to any employment taxes, 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. We hereby notify you that, if the IRS declines to grant the Company protection under Section 530 during the audit, the Company is forced to incur fees and costs to defend itself with the Appeals Office, the Tax Court, and/or the Court of Appeals, and the Company ultimately prevails, the Company intends to seek reimbursement from the IRS of all relevant fees and costs under Section 7430. Fee and cost recovery will be warranted under Section 7430 because based on information and documentation already provided to the IRS as part of the audit, the IRS's position that the relevant workers are not independent contractors and/or that the Company failed to meet the standards of Section 530 cannot be considered "substantially justified."

It appears that the issue of potential fee and cost reimbursement from the IRS was not raised in *Nelly* until the District Court litigation.

B. Relative Scarcity of Cases

The number of worker-classifications cases, like *Nelly*, that are forced to court is relatively small, particularly considering that nearly all businesses have at least some workers treated as independent contractors and that the IRS has aggressively audited worker-classification issues for years. There are a few reasons for this, one of which is highlighted by *Nelly*. It shows that many issues are, or should be, dispensed with swiftly, in favor of the company, when the supporting facts and evidence are strong, and the tax professional representing the company understands how to effectively utilize Section 530. Another reason, which was not raised in *Nelly*, is the availability of the classification settlement program ("CSP").

1. Description of the CSP

In 1996, the IRS issued a news release announcing the so-called CSP and identifying it as a two-year trial.[43] 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 any early stage.[44] Details about the CSP are somewhat challenging to find because they derive primarily from a Field Service Advisory issued in 1996, as restated and expanded in the Internal Revenue Manual.[45] The description of the CSP, below, comes from these sources.

In cases where it appears that a business may have misclassified a worker, the Revenue Agent must fully develop the issue and determine, among other things, whether the business is eligible for Section 530 relief, and, if not, whether the business is entitled to a CSP offer.[46] 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 business had Reporting Consistency, but clearly lacked either Substantive Consistency or a Reasonable Basis, the CSP offer entails assessment of 100 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-100-Percent Offer"). The second offer is better for businesses. In cases where the business had Reporting Consistency and has a "colorable argument" that it also had Substantive Consistency or a 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").[47] Under both scenarios, the business must agree to reclassify the workers as employees going forward.[48] To grasp the benefit of the two CSP offers, one must look beyond the Internal Revenue Manual to two obscure tax provisions: Code Sec. 3509 and Code Sec. 6205.

2. Reduced Tax Rates Under Code Sec. 3509

In 1982, Congress realized that three "major problems" existed with forcing a business to reclassify its workers as employees: (i) The business could be assessed income taxes, FICA taxes, and FUTA taxes for all years still open under the statute of limitations; (ii) Overpayments of federal income taxes might occur if the business were obligated to pay these amounts in situations where workers personally paid them earlier *via* estimated tax payments or with their individual income tax returns; and (iii) Overpayments of FICA taxes could occur, too, if the business were required to pay these amounts in cases where the workers already did so through self-employment taxes.[49] Congress understood that, in the case of a forced reclassification, the IRS generally would adjust/lower assessments against a company, to the extent that it could furnish certificates, signed by those workers who were reclassified, showing that they had personally paid the taxes.[50] 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" in cases where workers were numerous, uncooperative, and/or poor record-keepers.[51]

In light of this reality, Congress enacted Code Sec. 3509, which was welcomed as a new procedure in worker-classification cases designed to substantially simplify the law, reduce burdens on businesses, approximate the tax liability of a business after assuming certain levels of tax compliance by individual workers who were reclassified, and punish the business for its violations.[52]

Code Sec. 3509 functions in the following manner. As mentioned above, both the One-Year-100-Percent Offer and the One-Year-25-Percent Offer indicate that the liability for the year in question might be calculated under the special rates found in Code Sec. 3509. When a business incorrectly treats an employee as an independent contractor, it is liable for the employee's federal income tax withholding and the employee's share of FICA taxes, not to mention the business's share of the FICA taxes and its FUTA taxes.[53] Assuming that the business did not intentionally disregard its duty to withhold, Code Sec. 3509(a) sets the following level of payback to the IRS: In situations where the business filed annual Forms 1099 for the workers, the company is only obligated to pay (i) federal income tax withholding calculated as 1.5 percent of the worker's total wages, (ii) 20 percent of the employee's share of FICA, and (iii) 100 percent of the company's share of FICA.[54]

3. Interest-Free Payments Under Code Sec. 6205

As explained above, a business 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 tax rates under Code Sec. 3509. Settling under the CSP could trigger one more benefit for a business, 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.[55] These rules have been liberally interpreted by the IRS, such that most businesses that concede worker-classification cases under the CSP avoid interest charges.[56]

C. Applicable yet Uncited Precedent

Analyzing cases after the fact, the quintessential Monday-morning-quarterbacking is easy. With that acknowledged, it is interesting to note that the materials submitted to the District Court in *Nelly* on the issue of fee recoupment under Code Sec. 7430, and consequently the Opinion issued by the District Court, lack meaningful review of numerous cases that would seem relevant. Such cases, like *Nelly*, deal with situations in which the government ultimately agreed that the company was entitled to relief under Section 530, and the company, fortified by this victory, filed a motion for fees and costs under Code Sec. 7430.

Some of the cases further address the idea of whether a win by a company on the substantive issue *before* the need for a full trial strengthens the argument that the government's position was not "substantially justified." This most often occurs in situations where an Appeals Officer or a government attorney concedes a case, or where a court, like the District Court in *Nelly*, holds in favor of a company in response to a Motion for Summary Judgment on the Section 530 issue. As one Tax Court case described it, "[t]he fact that the [government] eventually loses or concedes a case does not by itself establish that the position taken is unreasonable. However, it is a factor that may be considered."[57] A District Court has expressed a comparable thought, explaining that "[a]lthough a loss in itself does not subject the [government] to a fee award, a total loss at the summary judgment stage does reveal something regarding the merits of the government's position."[58] Similar stances are discussed in the precedent summarized below:

- *Images in Motion of El Paso, Inc.*[59] The IRS conducted an audit, the Revenue Agent issued a Notice of Determination of Worker Classification alleging that the relevant workers were employees, the company filed a Petition with Tax Court, and the case was automatically routed back to the Appeals Office for potential pre-trial resolution. The Appeals Officer then fully conceded the worker-classification issue, and the IRS attorney and company filed a Decision Document dispensing with the case. Shortly thereafter, the company filed a motion for reasonable litigation costs under Code Sec. 7430. The Tax Court found that the IRS's position about worker-classification was not "substantially justified" and awarded fees and costs to the company.
- *Cinema Art Theatre of Springfield, Inc.*[60] In September 1996, the IRS claimed that the workers were employees and assessed corresponding employment taxes. The company countered by arguing that the workers were independent contractors and, in all events, it was entitled to Section 530 relief. The company paid the requisite amount of employment taxes, filed a claim for refund, the IRS disallowed the refund, and District Court litigation ensued. Thereafter, several District Courts held that taxpayers with similarly-situated workers were entitled to Section 530 relief, and the company alerted the DOJ to these judicial precedents. Approximately one-and-a-half years after the refund suit started, the government conceded that the company was entitled to Section 530 relief and agreed to a Consent Judgment in favor of the company. Later,

the company filed a motion seeking attorney fees under Code Sec. 7430. The government argued that it was "substantially justified" in denying Section 530 relief because the company failed to file all necessary Forms 1099, while the company maintained that no Forms 1099 were due because it did not make any "payments" to the workers. The District Court held that the government's position regarding "payments" was unreasonable (particularly in light of a Revenue Ruling from over 30 years earlier that was seemingly on point and favorable to the company) and thus the government was not "substantially justified" in denying Section 530 relief based on a supposed lack of Reporting Consistency.

- *Déjà vu-Lynnwood, Inc.*[61] The Court of Appeals determined that the company was entitled to Section 530 relief and that the government's position regarding worker-classification was not "substantially justified." The District Court granted fees and costs under Code Sec. 7430, on remand.
- *RI Unlimited, Inc.*[62] The workers at issue in this case were medical transcriptionists. The IRS conducted an audit, issued an unfavorable Examination Report on the worker-classification issue, the company filed a Protest Letter arguing that the workers were independent contractors and Section 530 applied anyway, the Appeals Officer rejected these positions and offered a settlement under the CSP, the company declined the CSP offer, the IRS issued a Notice of Determination of Worker Classification, and the company elevated the matter to the Tax Court by filing a Petition. After the initial pleadings in the Tax Court had finished, the attorneys engaged in discovery, as a part of which the company's attorney gave the IRS attorney several credible affidavits supporting the position that the company was entitled to Section 530 relief. After receiving the affidavits, the IRS attorney interviewed the relevant individuals and then agreed to concede the case. The parties concluded matters by filing with the Tax Court a Stipulation of Settled Issues, but the company's motion for fees under Code Sec. 7430 remained. The Tax Court, noting that "a position that was reasonable when first taken may become unreasonable in the light of changed facts and circumstances," held that the IRS's position was no longer "substantially justified" after it received from the company the responses to the discovery requests. In rendering this decision, the Tax Court indicated the following: "[S]oon after reviewing the declarations and other materials [the company] submitted on August 4, 2008, [the IRS] agreed to fully concede the case … Although [the IRS's] concession does not establish that [its] position was not substantially justified, it is a factor to be considered."
- *Concerned Care, Inc.*[63] This was an employment tax refund case in District Court. Before trial, the parties resolved matters by filing a Stipulation and Order of Dismissal of Action, which preserved the right of the company to seek fee recoupment under Code Sec. 7430. It exercised this right. The DOJ attorneys responded by conceding that the company deserved relief under Section 530 but argued that it was not entitled to fees under Code Sec. 7430 because the government's position on the worker-classification issue was "substantially justified." The company pointed out to the District Court that, early in the audit, it had told the IRS that it had a reasonable basis for its position because it was relying on judicial precedent, *Critical Care Register Nursing, Inc.*[64] The District Court held in favor of the company on the Code Sec. 7430 issue, emphasizing that more than three years before the DOJ finally conceded the Section 530 issue, the company had presented its position to the Revenue Agent. The IRS had effectively discounted this, stating that it did not "acquiesce" in the decision of *Critical Care Register Nursing, Inc.*, it intended to continue fighting the issues raised in that case, and, therefore, such case could not constitute judicial precedent on which the company could rely for purposes of Section 530. The District Court swiftly rejected the government's line of reasoning, explaining that "[t]axpayers may not be denied the safe harbor provisions explicitly provided by Congress to protect them from long and costly battles with the IRS simply because the IRS does not 'acquiesce' in decisions favorable to taxpayers." The District Court also recognized that the company had reasonably relied on the advice of its accountant with respect to the worker-classification issue.
- *P.D. McClellan*.[65] This case reached the District Court after the normal dance involving an audit, administrative appeal, assessment of taxes, refund claim, and refund disallowance. After the discovery process, the company filed a Motion for Summary Judgment and demanded fees under Code Sec. 7430. In response, the DOJ attorneys conceded that the company did not owe employment taxes thanks to Section 530, but opposed fee recovery on the predictable grounds that the government's position was "substantially justified." Apparently, the company provided the Appeals Office a self-prepared survey of 41 companies located in the same area and engaged in the same business, which revealed that 40 of these competitors treated the same

type of workers as independent contractors, not employees. This, suggested the company, demonstrated that it could rely on the Industry Practice Safe Harbor. The Appeals Officer rejected the survey on grounds that it "lacked credibility." The District Court, clearly aggravated with the government, stated that the Appeals Officer placed an "unrealistic burden" on the company to provide detailed verification of the survey results, the failure of the Appeals Officer to take any steps to investigate was "clearly without justification," and "the IRS response here borders on bureaucratic arrogance and bad faith." The District Court granted the company's motion for fee recoupment under Code Sec. 7430, concluding that the government's position, as of the time it received the survey, was no longer "substantially justified."

- *J&J Cab Service, Inc.*[66] In this refund litigation, the company filed a Motion for Summary Judgment, contending, among other things, that it was deserving of relief under Section 530 with respect to the classification of the taxicab drivers as independent contractors. The Magistrate Judge held that the company was entitled to Section 530 relief because of its reliance on a widespread industry standard (based on a survey of 24 cab companies conducted by an independent, professional company) and reliance on technical advice from its accountant. The Magistrate Judge ended by stating that "[i]n light of the overwhelming evidence of record, [the government] cannot, in good faith, argue that [taxpayer] had no reasonable basis for not treating the cab drivers as employees." The case was remanded back to the District Court Judge, who came to the same result, but was far less forgiving of the government's conduct during the worker-classification dispute. *See J&J Cab Service, Inc.*[67] Paraphrasing statements by a court often suffices, yet sometimes there is no substitute for the actual, pointed language. The District Court Judge made the following observations and comments:

As evidenced by the language used in this Court's opinion, it was clear to this Court, based upon uncontested facts and the applicable law, that [the company] was at all times entitled to the safe harbor provisions of Section 530, which was specifically enacted as a remedial statute to protect taxpayers from arbitrary action of the IRS which had been evidenced in the past. Instead of analyzing and applying Section 530 in a manner consistent with its purpose and case authority, the government bombarded the [company], and then this Court, with strained, unsupported arguments, and ignored the relevant case authority repeatedly cited by [the company]. This Court has no hesitation in finding that the government's position, during both the administrative proceedings and in this litigation, was not justified to a degree that could satisfy a reasonable person, and, therefore, such position did not demonstrate a reasonable basis in law and fact … Accordingly, the Court finds that [the company] has met its burden of demonstrating that the government's position in this case was not substantially justified, and that it is, therefore, entitled to an award of its reasonable litigation costs.

- *Howard's Yellow Cabs, Inc.*[68] This decision affirms the earlier one by a Magistrate Judge that the company, a taxicab business like the one that was in the IRS's crosshairs in *J&J Cab Service, Inc.*, warranted relief under Section 530. The motion for fee recoupment under Code Sec. 7430 was handled separately, in *Howard's Yellow Cabs, Inc.*[69] In this second Opinion, the Magistrate Judge held that there was "substantial evidence" that the cab drivers were independent contractors, there was "compelling evidence" that the company took its position in good faith, and the IRS "showed scant interest in this evidence, giving instead the appearance … of being on a 'crusade.'" Later, the District Court Judge, reviewing and affirming the earlier determination by the Magistrate Judge regarding fee recoupment, issued an Opinion, nearly identical to the one he published in *J&J Cab Service, Inc.*, harshly criticizing the conduct of the government.[70]
- *Marlar, Inc.*[71] This case involved refund litigation in District Court, which wrangled with the issue of how to properly treat nude dancers for employment tax purposes. The company filed a Motion for Summary Judgment, arguing that the workers were not employees, and even if they were, the company does not need to change paths because it was shielded by Section 530. The District Court held in favor of the company with respect to Section 530, finding that it was protected by the Industry Practice Safe Harbor. According to the District Court, "virtually the entire industry treats dancers as lessees" and "it is undisputed that the industry treats dancers as lessees [and] a lessor/lessee relationship does not require filing of a Form 1099." This decision was later upheld by the Court of Appeals.[72] On remand, the District Court was tasked with deciding the related issue of whether the company was entitled to fee recovery under Code Sec. 7430. In *Marlar, Inc.*,[73] the District Court concluded that the company's reliance on widespread industry standard was reasonable (and thus the IRS's position was not "substantially justified") because (i) the local industry had operated under lessor/lessee agreements

for a number of years without challenge by the IRS, (ii) the IRS had audited competitors of the company and had not demanded recharacterization of the dancers as employees, and (iii) the facts were similar to those at issue in a Revenue Ruling from 1969, which held that the workers were independent contractors.

- *Smokey Mountain Secrets, Inc.*[74] In this case, the company triumphed during trial on its positions that the workers were statutory non-employees (*i.e.*, so-called "direct sellers") under Code Sec. 3508, and, even if that were not the case, the company should still avoid any repercussions thanks to Section 530. With regard to latter, the District Court found that the company reasonably relied on the advice of its two accountants in classifying the telemarketers and delivery persons as independent contractors. The fee recovery issue under Code Sec. 7430 was addressed separately, in response to a post-victory motion filed by the company.[75] The District Court was not humored by the government's attempts to discredit the reliance by the company on worker-classification advice from its two accountants:

The IRS responds that [the company] could not have relied in good faith on the advice of its accountants because they did not possess the requisite qualifications or experience in the area of employment taxation necessary to render competent advice. The IRS's position on this issue is wholly without merit. Based on its position in this court, it is readily apparent that the IRS would require a battery of accountants or lawyers, perhaps even a bevy of specialists from a Big Six firm, to render advice before a taxpayer is entitled to the protection of Section 530. This position borders on the disingenuous.

VII. Conclusion

As *Nelly* demonstrates, a company can prevail on a worker-classification issue before trial, through a Motion for Summary Judgment, but this, alone, does not necessarily mean that the company will convince a court to make the U.S. government compensate the company for its trouble. Defeating the U.S. government in a worker-classification dispute is laudable, a feat achieved when a company has strong facts, good evidence, positive precedent on point, a strong grasp of the most effective use of Section 530, and, yes, a healthy dose of good luck. However, to reach the pinnacle (*i.e.*, Section 530 relief plus fee recoupment from the U.S. government), a company needs at least one more thing, tax attorneys who understand the strategies and other issues unique to Code Sec. 7430.

ENDNOTES

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1 *Nelly*, 119 AFTR 2d 2017-XXXX (E.D. PA April 19, 2017); Civil Action No. 2:15-cv-00444.

2 This current article is the second by the author about *Nelly*. The earlier article, focused on the litigation surrounding the applicability of Section 530, is the following. Hale E. Sheppard, *Taxpayer Delivers One-Two Punch to IRS in Recent Worker-Classification Dispute: Victory under Section 530 and Fee Recoupment*, J. Tax Practice & Procedure, June–July 2016, at 33.

3 "Section 530" of the Revenue Act of 1978 (P.L. 95-600).

4 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.

5 Section 530(a)(1).

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

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

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

9 Section 530(a)(1); Rev. Proc. 85-18. 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—The Tax Magazine, April 2013, at 55–68, selected for republication in J. Tax Practice & Procedure, Apr.–May 2013, at 39–52.

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

11 Rev. Proc. 85-18, Section 3.01.

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

13 IRM pt. 4.23.5.2.2.7 (Feb. 1, 2003).

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

15 The facts in this case are derived from the following documents: 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, and the Opinion published at 185 FSupp3d 653; 117 AFTR 2d 2016-1500 (E.D. PA 2016).

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

17 Code Sec. 7430(a).

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

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

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

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

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

23 H.R. Rept. 104-506, 104th Cong., 2d Sess. 1996, at 37.

24 Act Sec. 701 of P.L. 104-168; H.R. Rept. 104-506, 104th Cong., 2d Sess. 1996, at 36–37.

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

26 Act Sec. 3101 of P.L. 105-206, codified as Code Sec. 7430(c)(4)(B)(iii).

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

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

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

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

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

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

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

[34] Reg. §301.7430-5(c)(1).

[35] Reg. §301.7430-5(c)(1); Reg. §301.7430-5(h) Ex. 1.

[36] *National Fed'n of Republican Assemblies*, DC-AL, 2003-1 USTC ¶50,249, 263 FSupp2d 1372, 1378.

[37] *See, e.g., R.C. Kennedy, Sr.*, 89 TC 98 (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).

[38] *N.R. Wilkes, Jr.*, CA-11, 2002-1 USTC ¶60,438, 289 F3d 684, 688.

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

[40] Opinion dated May 10, 2016, Footnote 7.

[41] The information about the fee-recoupment aspect of this case was derived from the following documents in *Nelly LLC and Nelly Home Care, Inc.*, District Court for Eastern District of Pennsylvania, Civil Action No. 2:15-cv-00444: Plaintiffs' Consolidated Motion for an Award of Attorneys' Fees and Costs Pursuant to Code Sec. 7430 filed May 24, 2016; U.S.' Opposition to Plaintiffs' Motion for Attorneys' Fees, filed June 14, 2016; Reply Memorandum of Law in Support of Plaintiffs' Consolidated Motion for an Award of Attorneys' Fees and Costs Pursuant to Code Sec. 7430 filed January 5, 2017; and Opinion dated April 19, 2017.

[42] In making this broad statement, the District Court cited only one case, *V. Wiertzema*, 90-1 USTC ¶50,068, 747 FSupp 1363 (1989) (the substantive case in which the District Court held in favor of the taxpayer on summary judgment) and *Wiertzema*, DC-ND, 747 FSupp 1365 (1990) (the subsequent case resulting from the taxpayer's request for fee reimbursement under Code Sec. 7430). *Wiertzema* is distinct from *Nelly* in several important ways, including that (i) it did not involve a worker-classification dispute, (ii) it did not concern Section 530, and (iii) it addressed a specific legal/tax issue with no clear answer—District Courts had issued inconsistent decisions and the relevant Appeals Court had not yet ruled on the specific issue.

[43] IRS News Release, IR-96-7, Mar. 5, 1996.

[44] Notice 98-21.

[45] FS-96-5; IRM pt. 4.23.6.

[46] FS-96-5; IRM pt. 4.23.6.11 (Mar. 1, 2003).

[47] FS-96-5; IRM pt. 4.23.6.13.1 (Oct. 30, 2009).

[48] FS-96-5; IRM pt. 4.23.6.13.1 (Oct. 30, 2009).

[49] Senate Report 97-494(I), 97th Cong., 2d Sess. (1982), at 1103.

[50] Senate Report 97-494(I), 97th Cong., 2d Sess. (1982), at 1104.

[51] Senate Report 97-494(I), 97th Cong., 2d Sess. (1982), at 1103–1104.

[52] Senate Report 97-494(I), 97th Cong., 2d Sess. (1982), at 1104.

[53] The legislative history leaves no doubt that, even if the company is entitled to the reduced rates under Code Sec. 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 1105.

[54] Code Sec. 3509(a); IRM pt. 4.23.8.5.1 (June 7, 2011).

[55] Code Sec. 6205; Reg. §31.6205-1.

[56] Rev. Rul. 75-464, 1975-2 CB 474, obsoleted by Rev. Rul. 2009-39, IRB 2009-52. The regulations and IRS pronouncements clarify that a company that refuses to accept the CSP offer can still have an "interest-free adjustment," provided that it makes a cash bond deposit before receiving a Notice of Determination. *See* Reg. §31.6205-1(a)(6)(ii) and Rev. Rul. 2009-39.

[57] *Maggie Management Co.*, 108 TC 430, 444, Dec. 52,080 (1997).

[58] *J&J Cab Service, Inc.*, 81 AFTR 2d 98-1656 (W.D. NC 1998).

[59] *Images in Motion of El Paso, Inc.*, 91 TCM 716, Dec. 56,425(M), TC Memo. 2006-19.

[60] *Cinema Art Theatre of Springfield, Inc.*, DC-IL, 99-1 USTC ¶50,424, 46 FSupp2d 812, 83 AFTR 2d 99-1743.

[61] *Déjà vu-Lynnwood, Inc.*, DC-WA, 89 AFTR 2002-1811 (2002).

[62] *RI Unlimited, Inc.*, 100 TCM 262, Dec. 58,338(M), TC Memo. 2010-205.

[63] *Concerned Care, Inc.*, 80 AFTR 2d 97-7569 (W.D. PA 1997).

[64] *Critical Care Register Nursing, Inc.*, DC-PA, 91-2 USTC ¶50,481, 776 FSupp 1025.

[65] *P.D. McClellan*, DC-MI, 95-2 USTC ¶50,559, 900 FSupp 101.

[66] *J&J Cab Service, Inc.*, 75 AFTR 2d 95-618 (W.D. NC 1995).

[67] *See J&J Cab Service, Inc.*, 81 AFTR 2d 98-1656 (W.D. NC 1998).

[68] *Howard's Yellow Cabs, Inc.*, 79 AFTR 2d 97-2945 (W.D. NC 1997).

[69] *Howard's Yellow Cabs, Inc.*, 80 AFTR 2d 97-8261 (W.D. NC 1997).

[70] *See Howard's Yellow Cabs, Inc.*, 81 AFTR 2d 98-1417 (W.D. NC 1998).

[71] *Marlar, Inc.*, DC-WA, 96-2 USTC ¶50,463, 934 FSupp 1204.

[72] *See* Marlar, Inc., CA-9, 98-2 USTC ¶50,619, 151 F3d 962.

[73] *Marlar, Inc.*, 83 AFTR 2d 99-2859 (W.D. WA 1999).

[74] *Smokey Mountain Secrets, Inc.*, DC-TN, 95-2 USTC ¶50,573, 910 FSupp 1316.

[75] *See Smokey Mountain Secrets, Inc.*, DC-TN, 95-2 USTC ¶50,573, 910 FSupp 1316.