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# Direct Sellers Hit by IRS Worker-Classification Audits: An Analysis of the Obscure Rules and Strategies Applicable to These Workers

*By Hale E. Sheppard*

Hale E. Sheppard examines how the IRS worker-classification can cause problems for unsuspecting direct sellers.

## **Introduction**

People are buying more and more online. Indeed, one cannot escape the holiday season nowadays without being bombarded with advertisements about Internet deals on so-called Cyber Monday. As the online phenomenon grows, many seem to forget about more traditional ways of moving product, such as door-to-door sales and home parties. People may not be gathered around the water cooler much these days discussing Tupperware parties and the like, but these types of events still occur with surprising regularity. According to a recent report by the IRS, “direct selling” is a significant industry, with annual sales of nearly \$30 billion dollars and salespersons surpassing 13 million in the United States alone.<sup>1</sup> The report also indicates that direct selling is pervasive, with more than 55 percent of the U.S. public having purchased items in this manner.<sup>2</sup>

These statistics seem positive for direct sellers, but another figure puts an immediate damper on things: 6,000. That is the number of random audits that the

IRS is conducting over a three-year period as part of its national research project on employment tax issues, including worker misclassification.<sup>3</sup> The IRS estimates that the “tax gap” (*i.e.*, the difference between what taxpayers should pay and what they actually pay) a few years ago was approximately \$345 billion, a significant percentage of which was attributable to worker misclassification and other employment tax noncompliance.<sup>4</sup> Thus, the IRS’s research likely will reveal that worker misclassification is widespread, and further audits will ensue.

Theoretically, these audits should cause little consternation for direct sellers, as they enjoy a special status under the Internal Revenue Code. The reality is that the IRS’s recent focus on worker-classification has caused problems for many direct sellers, particularly those who fail to appreciate their unique tax status and/or assert their rights. This article, aimed at both taxpayers and their advisors, is designed to alleviate these problems.

## **Overview of the Worker-Classification Issue**

Various categories of workers exist; they can be statutory employees, statutory nonemployees, common-law employees or independent contractors. The problem, aside from the hyper-technical definitions

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and tricky rules associated with each category, is that one worker might fall into *multiple* categories at once. This can generate turmoil, for taxpayers and the IRS alike. To appreciate this overlap and what it can mean in a tax dispute, one must have a basic understanding of worker categories.

Statutory employees are, like they sound, workers who are defined as employees in a statute. For instance, tax provisions explain that the term “employee” includes officers of corporations, as well as individuals who perform the following jobs for compensation: (i) agent-drivers or commission-drivers engaged in distributing particular products, (ii) full-time insurance salespersons, (iii) so-called homeworkers who perform work on materials or goods provided by their principals according to specifications set by the principals and then return the improved goods to the principals or a designated party, and (iv) traveling or city salespersons engaged on a full-time basis in soliciting for their principals orders from wholesalers, retailers, contractors or operators of hotels, restaurants or other similar establishments for merchandise for resale or supplies for use in their business operations.<sup>5</sup>

For their part, statutory nonemployees are, logically, workers who are specifically excluded from the definition of “employee” by a statute. Among the statutory nonemployees are direct sellers, who, according to a written contract and on a commission or other performance-driven basis, sell consumer products, personally or through others, in a home or in any other place that is not a permanent retail establishment.<sup>6</sup>

Unlike the preceding two categories, common-law employees are not identified in tax statutes; rather, as the name indicates, they are products of judicial evolution. The relevant regulations provide that one of the key factors in determining whether a particular worker should be considered a common-law employee is the degree of control that the service recipient possesses and/or exercises over the worker.<sup>7</sup> The regulations clarify that, in making a decision about common-law employee status, the IRS must consider “the particular facts of each case.”<sup>8</sup> The IRS released a list of 20 factors decades ago that serves as a guide in this analysis.<sup>9</sup>

Finally, independent contractors are those workers, characterized by flexibility in the time and manner

of performing their services, who do not fall into any of the preceding three categories.

A typical problem stems from the fact that one worker may seem to fall into several of the four categories identified above. Take, for instance, Willie Widget, who sells widgets, door-to-door, for one company, on a daily basis, according to specific instructions prepared by the company. Depending on the facts of the case, Willie Widget might be a statutory employee (*i.e.*, a traveling or city salesperson), a statutory nonemployee (*i.e.*, a direct seller) or a common-law employee (*i.e.*, a worker who meets many of the 20

factors identified by the IRS). The category in which Willie Widget ultimately belongs will have a significant economic impact on him and the company. How swiftly a case of this nature can be resolved will also have financial consequences, as defending a prolonged worker-classification dispute can be costly for businesses.

Most businesses would agree that the best result in the preceding example would be characterization of Willie Widget as a statutory nonemployee, *i.e.*, a direct seller. If this were the case, he would be treated as a nonemployee for purposes of federal income tax, the federal contributions insurance act (FICA), and the federal unemployment act (FUTA), thereby reducing the tax and compliance burdens of the business. The challenge, of course, is that countless tax practitioners (and too many IRS personnel) are completely unaware of the special rules for direct sellers found in Code Sec. 3508. Even if they are cognizant of the existence of such rules, they often lack familiarity with the unexpected ways in which the courts have interpreted certain requirements of Code Sec. 3508 that seem rather straightforward on their face. Finally, they frequently ignore or misunderstand the hierarchy of worker-classification rules; that is, they do not know what to argue first, how the regimes intertwine, which status trumps another, *etc.*

## Analysis of the Special Rules for Direct Sellers

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To solve the challenge described above, this article analyzes the category of workers called direct sellers and the relatively obscure rules that govern them. An adequate analysis requires us to start at the begin-

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ning, the legislative history to Code Sec. 3508, and progress from there.

## Legislative History

Congress enacted Code Sec. 3508 as part of the Tax Equity and Fiscal Responsibility Act of 1982. The Conference Report, though largely devoid of explanations as to why Congress felt compelled to act, contained a good description of this new tax provision. It stated the following:

Under this provision ... individuals who are direct sellers are treated for federal income and employment tax purposes as self-employed persons where substantially all the remuneration paid for their services as ... direct sellers is directly related to sales or other output and where such services are performed pursuant to a written contract providing that they will not be treated as employees for federal tax purposes. In defining direct sellers, the bill's reference to individuals engaged in the trade or business of selling or soliciting the sale of consumer products includes the activities of individuals who attempt to increase direct sales activities of their direct sellers and who realize remuneration dependent on the productivity of those direct sellers. These activities include providing motivation or encouragement, imparting skills, knowledge, or experience, or recruiting activities ... This provision applies to services performed after 1982.<sup>10</sup>

Like the Conference Report, the so-called Bluebook, prepared by the U.S. Joint Committee on Taxation, contains a solid description of the tax legislation. It also contains two additional items, the first of which is a clear outline of the three elements that must be met to satisfy the direct seller standard. It explains the following in this regard:

The Act also sets forth three conditions that must be satisfied in order for a person to qualify as a direct seller. First, the person either must be (1) engaged in the trade or business of selling (or soliciting the sale of) consumer products to any buyer on a buy-sell basis, a deposit-commission basis, or any similar basis prescribed by regulations, for resale (by the buyer or any other person) in the home or otherwise than in a permanent retail establishment, or (2) engaged in the trade or business of selling (or soliciting the sale of)

consumer products in the home or otherwise than in a permanent retail establishment. Second, substantially all the remuneration (whether or not paid in cash) for the performance of the direct selling services must be directly related to sales or other output (including the performance of services) rather than to the number of hours worked. Finally, the services performed by the person must be performed pursuant to a written contract between such person and the person for whom services are performed and the contract must provide that the person will not be treated as an employee, with respect to such services, for Federal tax purposes.<sup>11</sup>

The second important item in the Bluebook is the backstory, the supposed reasons why Congress was called to action back in 1982. The Bluebook states the following on this score:

A major portion of the employment tax status classification controversies that arose prior to the implementation of the interim relief provisions of the 1978 Act [*i.e.*, the Section 530 taxpayer-relief provisions] focused upon workers who were involved either in direct selling activities or real estate sales. Congress believed that it was these workers who were most in need of an immediate solution to the problem of proper employment tax status. Thus, the Act provides a statutory scheme for assuring the status of certain direct sellers and real estate sales persons as independent contractors.<sup>12</sup>

## The Internal Revenue Code and Underlying Regulations

Code Sec. 3508(a) establishes the general rule that, for all purposes of the Internal Revenue Code, in cases of services performed by a "direct seller," the individual performing the services shall *not* be treated as an employee, and the company for which the individual is performing the services shall *not* be treated as an employer.<sup>13</sup> In order for a worker to reach this favored status of direct seller, Code Sec. 3508(b) requires that he demonstrate that he meets three elements: type of activity, type of pay and written contract. Each of these elements is examined below.

### *Type of Activity*

The first element is that the worker must be engaged in the trade or business of (i) selling consumer

products to any buyer on a buy-sell basis, a deposit-commission basis, or any similar basis, for resale in the home or any other place that is not a permanent retail establishment or (ii) selling consumer products in the home or any other place that is not a permanent retail establishment.<sup>14</sup> This initial element is, as they say, a mouthful, even by convoluted tax standards. Therefore, it is beneficial to break down the requirements into manageable pieces.

**Consumer Goods.** Individuals must be selling “consumer products,” which, according to the regulations, encompass any *tangible* personal property that is distributed in commerce and normally used for personal, family or household purposes, including property designed to be attached to or installed in any real property.<sup>15</sup> Lest there be any doubt regarding what the IRS had in mind, the preamble to the regulations goes on to state that the term direct sellers “does not include door-to-door salespersons of *intangible* products (e.g., insurance, cable television subscriptions).”<sup>16</sup> The IRS turned to nontax law to create this limitation, noting that a narrow definition of “consumer products” is consistent with the consumer product safety regulations in Title 15 of the U.S. Code, the rules concerning criminal tampering with consumer products in Title 18 of the U.S. Code, and the energy-conservation requirements for consumer products in Title 42 of the U.S. Code.<sup>17</sup> As discussed later in this article, the IRS quickly changed its tune regarding what, exactly, a “consumer product” is for purposes of the direct seller rules after being heavily criticized by the courts.

**Products versus Services (or Some of Both).** The regulations also emphasize the distinction between selling products and providing services. The preamble to the regulations puts it rather bluntly, explaining that individuals who provide services that do not involve the use of a product (such as polltakers) and services that involve parts or materials that are merely incidental to providing services (such as painting, carpet cleaning, septic tank cleaning, lawn care, pest control services or appliance repair) are not direct sellers; they are service providers.<sup>18</sup> The regulations reflect a little more latitude, declaring that an individual is not engaged in the trade or business of selling consumer products if the sale of products is only an “incidental part” of the activity and the individual primarily renders services.<sup>19</sup> The regulations also explain that, in making this determination, the IRS must take into account all the facts and circumstances, including the cost of the product compared to the cost of the service.<sup>20</sup>

The regulations feature related, yet specialized, rules when it comes to the sale of products, followed by their installation. They state that where an individual is engaged in the business of selling consumer products and he also performs installation services in conjunction with such sales, the installation shall only be deemed part of the direct seller activity if the value of the installation is 10 percent or less of the sales price of the product (including installation).<sup>21</sup> The regulations contain two examples designed to elucidate this concept:

B is engaged in the trade or business of selling aluminum siding. B performs services as a direct seller pursuant to a written contract [specifying that he will not be treated as an employee for federal tax purposes]. All sales are made in the customer’s home and the purchase price includes installation. B installs all aluminum siding which he sells and receives a commission based upon the purchase price as compensation for his services with respect to both the sale and the installation. The value of such installation services exceeds 10 percent of the purchase price of the siding. [Therefore] B will be treated as a nonemployee under section 3508 only with respect to his services as a direct seller. Whether B is treated as an employee or as a self-employed individual with respect to services performed in installing the siding will be determined under common-law principles.<sup>22</sup>

The facts are the same as in [the preceding example] except that B sells and installs personal computers and that the value of the installation services performed by B is less than 10 percent of the purchase price of the computers including installation. B is treated as a nonemployee under section 3508 with respect to both his services in selling the computers and in installing them.<sup>23</sup>

The preamble to the regulations also reveals some flexibility when it comes to the installation issue, stating that direct sellers may, depending on the circumstances, include “door-to-door salespersons of not only products traditionally thought of as consumer products (e.g., personal toiletry items, vacuum cleaners, kitchen products) but also products which require installation or construction on the consumer’s property (e.g., residential swimming pools, aluminum siding, kitchen cabinets, storm windows, insulation, carpeting) and products not used in or around the home.”<sup>24</sup>

**Not a Permanent Establishment.** The first element mandates that the products are sold, personally or through others, in the home or any other place that is *not* a “permanent retail establishment.”<sup>25</sup> According to the regulations, a permanent retail establishment is any retail business that is operating in a structure or facility that remains stationary for a substantial period of time, such as grocery stores, hardware stores, clothing stores, hotels, restaurants, drug stores and newsstands.<sup>26</sup> The term also includes amusement areas, like sports arenas and amusement parks, where consumer products are sold.<sup>27</sup>

Ordinarily, portable or mobile structures, facilities, and equipment (such as street vendors and those selling from mobile carts or other vehicles) do not constitute permanent retail establishments.<sup>28</sup> There are exceptions to this general rule, though. For instance, the regulations clarify that a vendor who sells souvenirs or food items in the stands of a sports arena or on the grounds of an amusement park is deemed to be selling in a permanent retail establishment.<sup>29</sup> Moreover, a vendor who sells consumer products in a parking lot or other property that is near to and serves a sports or other amusement area pursuant to agreement that grants the vendor the right to sell such products is deemed to be selling in a permanent retail establishment, regardless of whether the products are sold inside a permanent structure.<sup>30</sup>

**Sales in Multi-Level Marketing Situations.** The first element mandates that direct sellers either sell products directly (to the end-users in a home or another place that is not a permanent retail establishment) or indirectly (to buyers who are not end-users, in a specific manner, for later resale to the end-users in a home or another place that is not a permanent retail establishment).<sup>31</sup>

A little background on direct selling companies helps to clarify this requirement. Generally, two types of direct selling companies exist: single-level marketing companies and multi-level marketing companies. The former compensates sales representatives via commissions or bonuses for their own personal sales activity, and they cannot take on other distributors or sales representatives.<sup>32</sup> By contrast, the latter has sales representatives who sponsor other distributors or sales representatives and receive commissions or bonuses based on the sales by such resellers.<sup>33</sup> The sellers at all levels are considered “direct sellers” for purposes of Code Sec. 3508, provided that the other elements are satisfied.

Armed with that additional context, the regulations related to what one might call “indirect direct sell-

ers” make somewhat more sense. They explain that services that fall within the confines of a direct seller include those designed to increase the productivity of others who are personally engaged in the act of selling, such as recruiting, training, motivating, and counseling such individuals.<sup>34</sup> The regulations also clarify the manner in which the indirect direct seller must transfer the consumer products to the direct seller. The first manner, transferring on a “buy-sell basis,” means that the buyer is entitled to a portion of the spread; that is, the buyer, as his compensation, retains part or all of the difference between the price at which he purchased the product and the price at which he ultimately sells the product.<sup>35</sup> The second acceptable approach, the “deposit-commission basis,” means that the buyer may keep, as his compensation, part or all of the purchase deposit paid by the consumer in connection with the transaction.<sup>36</sup>

### ***Type of Pay***

The second element is that substantially all the remuneration that the worker receives for performing the services is directly related to amount of sales or other output, rather than to the number of hours worked.<sup>37</sup> The regulations expand on this requirement, explaining that the phrase “substantially all the remuneration” means at least 90 percent of the total compensation earned by the worker from the company during the relevant calendar year.<sup>38</sup> The regulations also clarify the concept of services “directly related to sales or other output.” They generally indicate that compensation is adequately related for these purposes if, based on all the facts and circumstances, it is paid, awarded or credited to the worker on the basis of his services with respect to one or more specific sales transactions or tasks, rather than on the basis of the number of hours worked.<sup>39</sup> For those higher up the sales ladder, if you will, the regulations explain that compensation earned by an individual based on the sales or productivity of some other individual will be treated as sufficiently related if it is paid, awarded or credited because of the other individual’s sales transactions or other accomplishments.<sup>40</sup>

### ***Written Contract***

The third element is that the worker must perform the services pursuant to a written contract, which provides that the worker will not be treated as an employee with respect to such services for federal tax purposes.<sup>41</sup> The regulations emphasize two points here. First, they underscore that the contract must contain precise

language: With limited exceptions for contracts existing at the time the regulations were issued years ago, “a written contract that states that the individual will not be treated as an employee without specifically stating ‘for Federal tax purposes’ does not meet the written contract requirements.”<sup>42</sup> The preamble to the regulations, further seizing on the importance of this notion, indicates that “the written contract requirement is not met unless the contract specifically states that the individual will not be treated as an employee for Federal tax purposes [and] it is not sufficient that the contract merely states that the individual will not be treated as an employee.”<sup>43</sup> Tax practitioner groups warned the IRS from the outset that invalidating an individual’s status as a direct seller solely because the words “for federal tax purposes” were lacking in his contract constitutes a “pitfall for the unwary.”<sup>44</sup> Consistent with this prophecy, courts have rejected classification of individuals as direct sellers for lacking the four magic words in the contract.<sup>45</sup>

### Assorted Administrative Sources

Despite its relative obscurity to the general public (and to certain IRS personnel assigned to conduct employee tax audits), the protections offered to direct sellers under Code Sec. 3508 have been widely recognized by the IRS for years.

First, the IRS’s training manual for Revenue Agents on worker-classification issues contains a subchapter on statutory nonemployees, including direct sellers.<sup>46</sup>

Second, IRS Publication 15-A, entitled *Employer’s Supplemental Tax Guide*, also confirms that direct sellers are not employees for federal tax purposes.<sup>47</sup>

Third, the IRS has issued dozens of pronouncements over the years concluding that various workers are direct sellers under Code Sec. 3508. Take, for instance, FSA 20021315663 (determining that a sales representative selling prefabricated home kits was a direct seller), TAM 9530001 (finding that two types of salespersons in the home repair and improvement business, canvassers and closers, were direct sellers), LTR 9442005 (ruling that workers engaged in selling products to buyers on a buy-sell basis are direct sellers), TAM 8838002 (reasoning that workers selling products in homes, pursuant to a written agreement, and keeping as compensation the spread between the base price and the sales price, were direct sellers) and LTR 8723058 (ruling that salespersons for a company that installs fences are direct sellers). The IRS has also issued a remarkable number of rulings establishing that commission-based salespersons of

vacuum cleaners purchased from wholesale distributors are direct sellers.<sup>48</sup>

Fourth, the INTERNAL REVENUE MANUAL contains a significant amount of guidance regarding worker-classification issues in general and direct seller rules in particular. Among such information is the following:

Workers in three occupations will not be treated as employees for FICA, FUTA, or federal income tax withholding purposes provided that they meet certain qualifications. These workers are referred to as “statutory non-employees.” IRC § 3508 provides that, for all IRC purposes, qualified real estate agents and direct sellers are statutory non-employees.<sup>49</sup>

Fifth, IRS Publication 911, which is simply called *Direct Sellers*, is devoted entirely to this issue.<sup>50</sup> This comprehensive publication, consisting of 20 pages, provides information on all types of tax-related issues for direct sellers, not just instruction about the criteria that an individual must meet to belong in this category.

Sixth, the IRS’s Audit Technique Guide (ATG) for the Retail Industry contains a whole chapter on examination techniques related to direct sellers.<sup>51</sup> The ATG contains the following description of direct selling companies and their workers:

Direct selling companies market their products through person to person contact away from a fixed retail location through a network of independent sellers. Frequently these sales presentations are in the home, in the form of a sales “party,” or through door to door solicitations, or sometimes, as part of a get-together—one person to one person. In any case, these approaches are all considered direct sales.<sup>52</sup>

The ATG contains a subsection devoted to the specific issue of whether direct sellers should be treated as employees or independent contractors.<sup>53</sup> In this regard, it describes several sources that support nonemployee classification, including Rev. Rul. 85-63. Paraphrasing that IRS ruling, the ATG describes the following scenario and conclusion:

B, an individual, performs services selling consumer household products door-to-door for Y, a corporation. These services are performed

under a written agreement which provides that, for federal tax purposes, Y will not treat B as an employee. B is paid solely on a commission basis. B thus meets the description of a direct seller ... The direction and control that Y exercises over B in the performance of B's services would establish the relationship of employer and employee under applicable common-law rules. Thus, but for the application of section 3508(a) of the Code, B would be Y's employee [under the common law rules].<sup>54</sup>

## Major Court Decisions

Code Sec. 3508 has been in existence for some 30 years, but there have been just three major federal court decisions regarding direct sellers, all of which were favorable to the taxpayers. These court decisions are analyzed below.

### *Cleveland Institute of Electronics, Inc.*<sup>55</sup>

The taxpayer, Cleveland Institute of Electronics (CIE), sold home study educational courses to students in two manners, one of which was by commissioned salespersons. These individuals received compensation solely on the basis of their sales performance, they solicited sales by meeting with prospective students at locations that were not permanent retail establishments (including homes, shopping malls and military posts), and they signed a contract with CIE acknowledging, among other things, that they would not be treated as employees for federal tax purposes. Nevertheless, the IRS took the position that the salespersons were employees.

The court pointed out that Congress enacted Code Sec. 3508 in response to problems arising from increased worker-classification disputes, Congress intended to "create a shelter" for workers who meet certain criteria, and Congress specifically protected direct sellers because they were most in need of an urgent solution to the worker-classification problem. In this case, the IRS conceded that the workers met the second element of Code Sec. 3508, the type of pay, because they were compensated solely on sales performance, not the number of hours worked. The

IRS also forfeited the third element of Code Sec. 3508, the written contract, because the agreement between CIE and the workers expressly stated that they would not be treated as employees "for federal tax purposes." The sole issue, therefore, was whether the works met the first element of Code Sec. 3508, the type of activity.

The IRS argued that the items sold by the workers, educational courses, were not "consumer products," as required by Code Sec. 3508 and the underlying regulations, but rather "intangible services." CIE made two counterarguments. First, it contended that Congress did not intend to limit the term "consumer products" to tangible items, notwithstanding what the IRS's proposed regulations state. Second, it maintained that, even if the definition of "consumer goods" was restricted to tangible items, the workers were selling tangible items (*i.e.*, books and equipment), not intangible items (*i.e.*, educational courses).

The court first noted that the term "consumer product" is not defined in Code Sec. 3508. To determine its meaning, therefore, the court turned to three sources: legislative history to Code Sec. 3508; the definition of "consumer products" in four other federal statutes; and the proposed regulations under Code Sec. 3508. As seen below, the court was critical of all three.

The court stated the following with respect to the legislative history to Code Sec. 3508:

**The problem, aside from the hyper-technical definitions and tricky rules associated with each category, is that one worker might fall into *multiple* categories at once.**

In sum, the legislative history behind [Code Sec. 3508] provides no clue as to exactly what Congress meant when it used the term "consumer products," and certainly gives no indication whether CIE's educational courses qualify as consumer products. At

best, the legislative history demonstrates that the purposes behind the statute are to reduce the number of controversies regarding employment tax status and to improve tax compliance on the part of independent contractors.

The court seemed equally unimpressed by the four federal statutes, other than Code Sec. 3508, in which Congress had narrowly defined the term "consumer products" only to apply to tangible goods. After examining the four statutes, the court stated the following:

The government, of course, is right—under any of these other statutes, CIE’s educational courses probably would not qualify as consumer products. However, the Court is not interpreting these other statutes, and indeed, they are inapposite. These statutes address, respectively, ensuring the safety of consumer products, ensuring the adequacy of warranties on consumer products, preventing criminal tampering with consumer products, and improving the energy efficiency of consumer products. These statutes have nothing to do with tax employment status or direct selling activity. Moreover, the fact that each statute has a different definition for the same term argues *against* using any one of these definitions in the context of [Code Sec. 3508]. It is clear that Congress has treated the meaning of the phrase “consumer products” as malleable, changing its significance to meet the purpose of the statute in which the term is employed. In fact, Congress has defined “consumer products” differently every time it has used the term—except once. The exception is [Code Sec. 3508], when Congress failed to provide any definition at all. Thus, searching for the meaning of “consumer products” as used in [Code Sec. 3508] by examining other federal legislation is fruitless. Congress’s past use of this term does not provide the Court with any meaningful guidance.

Like the legislative history to Code Sec. 3508 and the four federal statutes defining “consumer products” in different contexts, the proposed regulations under Code Sec. 3508 did not constitute guidance on which the court was willing to rely. The court explained the following about the significance of proposed regulations:

These regulations, if accepted by the Court as controlling, would settle the issue at hand ... Because the regulations are merely proposed and not adopted, however, they must be construed as having been published for the limited purpose of giving the public notice that the regulations are under consideration. In fact, at public hearings on these proposed regulations, testimony was heard criticizing the suggested definition of consumer products. Furthermore, there are other factors that give the Court reason not to adopt the definition of “consumer products” as set forth in the proposed regulations. The proposed regulations were published in 1986. Six years later, they have

still not been adopted in final form. This delay might indicate that the IRS itself has not determined whether the proposed regulations should be ratified. Thus, the Court is not persuaded by the proposed federal regulations that CIE’s educational courses fail to qualify as “consumer products.” The proposed regulations define the term “consumer products” by drawing a distinction between tangible and intangible products. Introductory remarks to the proposed regulations rely on this distinction to state that a door-to-door sales person selling vacuum cleaners may be considered a direct seller of consumer products, but that a door-to-door sales person selling cable television subscriptions may not. The Court does not find support for this distinction in the statute itself, nor in the statute’s legislative history, nor in language used in other federal statutes. The meaning of the term “consumer products,” as Congress used this term in [Code Sec. 3508], must come from another source.<sup>56</sup>

Thus dispensing with those three potential sources of guidance, the court indicated that it must rely on two things to determine the meaning of “consumer products” within Code Sec. 3508: the plain meaning of the term, and the underlying purposes of the statute. With respect to the former, the court, seemingly vexed at this point, concluded that no plain meaning of the term exists. Accordingly, it turned to the former, the purposes of Code Sec. 3508. The court explained that, based on legislative history, Congress intended to (i) reduce the number of controversies concerning employment tax status, and (ii) improve tax compliance on the part of independent contractors. It then concluded that these two goals are best advanced by broadly construing the term “consumer products” to include both “tangible consumer products and intangible consumer services.” Based on this interpretation, the court held that salespersons for CIE were statutory nonemployees, *i.e.*, direct sellers under Code Sec. 3508.

### ***The R Corporation***<sup>57</sup>

The direct sales division of The R Corporation (“R Corp”) was engaged in the business of door-to-door sales of cable television subscriptions and other items. The contract executed by all salespersons stated that they were independent contractors, and the salespersons were paid exclusively on the amount of sales they generated. From the court’s perspec-



tive, the broader question raised in this case was “whether intangible services are encompassed within the meaning of ‘consumer products’ as defined in Section 3508.”

R Corp took the position that cable television subscriptions fall within the definition of “consumer products” because the plain meaning of the term covers both tangible and intangible property and because precedent, *Cleveland Institute of Electronics, Inc.*, already held that intangible services qualify as “consumer products” for purposes of Code Sec. 3508. The IRS, for its part, urged the court to adopt the definition of “consumer products” in the proposed regulations, which restrict the definition to tangible goods. The IRS further asked the court to disregard the previous holding in *Cleveland Institute of Electronics, Inc.* because, in the IRS’s opinion, it was unduly narrow and contrary to congressional intent.

The court first underscored that *Cleveland Institute of Electronics* was the only reported case construing Code Sec. 3508. It then reviewed the legal analysis in *Cleveland Institute of Electronics* and noted that the facts in that case were “strikingly similar” to those in the present case. The only issue, therefore, was whether cable subscriptions are considered “consumer products,” such that the protection of Code Sec. 3508 applies to the salespersons. The court left no ambiguity in determining that the subscription sales allowed the salespersons to be categorized as direct sellers: “[T]here is no question that the cable subscriptions sold by The R Corporation salespersons were intangible services, which are deemed ‘consumer products’ under Section 3508 as a matter of law.”<sup>58</sup>

### ***Smoky Mountain Secrets, Inc.*<sup>59</sup>**

The taxpayer, Smoky Mountain Secrets (SMS), sold gourmet foods and condiments to consumers. The majority of the sales were solicited through telephone calls made by SMS’s telemarketers, who worked out of various offices around the country. They did not close the deals alone, though. The delivery drivers frequently needed to consummate sales, particularly when a customer had changed his mind, forgotten or misunderstood the terms of the sale, or refused to accept the package without first checking with the spouse who placed the order. Before starting work at SMS (and each year thereafter), all telemarketers and delivery drivers were obligated to sign a written contract, which provided that compensation was based solely on the number of sales delivered and fully paid, and the workers would not be treated as

employees for federal tax purposes. The IRS argued that, under these circumstances, the workers should be treated as employees.

The court strongly rejected the IRS’s argument and held that both the telemarketers and delivery drivers were “direct sellers.” In reaching this conclusion, the court addressed each of the three elements of Code Sec. 3508. Regarding the first element, the type of activity, the court noted that the delivery persons closed sales on a regular basis and constituted an “indispensable part” of the SMS selling apparatus. With respect to the second element, type of pay, the court recognized that the telemarketers and drivers received commission-pay only, which was contingent upon the successful delivery of, and receipt of payment for, the product. Thus, substantially all of their remuneration was directly related to the amount of sales or other output, rather than the number of hours they worked. Finally, concerning the third element, written contract, the court held that the workers had performed the services pursuant to an appropriate written contract, even though SMS was unable to produce the original contracts or executed copies thereof at trial. The court explained that the federal rules of evidence permitted the use of “copies of form contracts” where the originals had been lost or destroyed. In concluding that the telemarketers and delivery drivers were properly treated as “direct sellers,” the court cited the legislative purpose underlying Code Sec. 3508; that is, to reduce the number of controversies regarding the status of direct sellers. It noted that the court “must interpret the requirements of Section 3508 in a fashion which will further the statute’s purpose.”

## **Lesser-Known Aspects of Code Sec. 3508**

If all goes as planned, the preceding section of this article supplied the reader valuable, new information about the legislative history behind Code Sec. 3508, the three statutory elements, the IRS’s interpretation of the elements as found in the proposed regulations, numerous administrative sources that can be consulted to strengthen a direct seller case, and the taxpayer-favorable decisions by various federal courts. These items, while important, are not the whole story. In fact, some of the lesser-known aspects of Code Sec. 3508, set forth below, may prove to be more prized by taxpayers who find themselves in a worker-classification dispute.

## What Trumps What and Why It Matters

Normal income tax audits are characterized by lots of waiting, particularly by taxpayers. Their hope many times is that the Revenue Agent tires of asking for materials, gets busy with different cases, or identifies reasons to conclude a case without reviewing all the materials and issues. This attitude may be acceptable for certain income tax audits, but the unique rules associated with worker-classification audits make immediate action the better strategy. This is particularly true when the workers at issue arguably fall into the direct seller camp.

When one does battle with the IRS, it is critical to grasp which rules trump others. Our example earlier in this article focused on Willie Widget, who, depending on the circumstances and perhaps the experience level of the Revenue Agent conducting the audit, might be seen as a statutory employee (*i.e.*, a traveling or city salesperson), a statutory nonemployee (*i.e.*, a direct seller) or a common-law employee (*i.e.*, a worker who meets many of the 20 factors identified by the IRS). The preferred status, from the perspective of companies, is that Willie Widget is treated as a direct seller. Unbeknownst to many practitioners, developing and presenting a strong Code Sec. 3508 position to the IRS at the early stages of an audit should increase the likelihood of achieving this status. This is clear from the advisories issued to IRS field personnel, which state the direct seller rules supplant classification of workers as common-law employees.

Only if the Section 3508 test is not met should there be further consideration to determine if the salesperson is a common-law employee or independent contractor. Indeed, even if it is clear that a salesperson would be classified as an employee under the common law test ... the service recipient may not treat that salesperson as an employee if he is selling consumer products door-to-door, paid on a basis tied to sales, and has a contract described in Section 3508(b)(2)(C).<sup>60</sup>

Expanding on this notion, the regulations establish the hierarchy of worker classifications. They explain that classification of workers as direct sellers trumps application of the statutory employee rules:

A statutory employee ... who meets the requirements ... for classification ... as a direct seller shall be treated as a nonemployee for Federal income tax, Federal Insurance Contribution Act (FICA), and Federal Unemployment Tax Act (FUTA) purposes with respect to services performed ... as a direct seller ... .<sup>61</sup>

The preamble to the regulations dispels any remaining ambiguity on this issue. It provides the following explanation:

The proposed regulations make clear that a statutory employee ... who also qualifies as a non-employee [*i.e.*, direct seller] under Section 3508 will be treated as a nonemployee for FICA, FUTA, and Federal income tax withholding purposes with respect to services described in Section 3508. For example, an agent-driver (statutory employee) who qualifies as a direct seller (statutory nonemployee) will be treated as a nonemployee for FICA, FUTA, and income tax withholding purposes with respect to services performed as a direct seller.<sup>62</sup>

In summary, various administrative sources, taken together, provide unequivocal guidance as to which worker status dominates (*i.e.*, direct seller under Code Sec. 3508) and thus which argument should be raised first during an employment tax audit, if applicable.

### Using the Definition of “Consumer Products” to One’s Advantage

As explained above, two of the three major cases concerning Code Sec. 3508, *Cleveland Institute of Electronics* and *The R Corporation*, focused primarily on the proper interpretation of the term “consumer products.” To the IRS’s chagrin, the courts ruled that persons selling both tangible consumer products and intangible consumer services could qualify for the protections reserved for direct sellers. Experience dictates that most practitioners are unaware of these taxpayer-favorable court decisions and, even if they are, it is doubtful they know that the IRS has essentially conceded the issue. When the IRS officially acknowledges that it will no longer advance a particular position, it normally does so through the publication of an Action-on-Decision. No such formal announcement was made in the context of Code Sec. 3508, but the IRS has otherwise advised its personnel against challenging the point further. This is clear from its official worker-classification training manual, which contains the following instructions:

Based on the litigation cited above [*i.e.*, *Cleveland Institute of Electronics* and *The R Corporation*] and pending finalization of the regulations [which never occurred] and further consideration of this issue in that context, cases should *not* be developed based on a distinction between tangible and intangible products; *i.e.*, both types of products will qualify [for relief under Code Sec. 3508].<sup>63</sup>

## Alternative Arguments to Direct Seller Position

This article focuses on how and when to raise a direct seller argument during a worker-classification dispute. While this argument, where applicable, is often the first defense for a number of strategic reasons, taxpayers also have various alternative arguments at their disposal. For instance, Section 530 of the Revenue Act of 1978 (P.L. 95-600) (hereafter, Act Sec. 530) is the Holy Grail of worker-classification cases; the company that satisfies all the criteria to warrant so-called “Act Sec. 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. Second, and perhaps more importantly, the IRS cannot obligate the company to reclassify the workers in question as employees, regardless of the fact that the law and facts support reclassification. The company gets a free pass, if you will, for past *and* future behavior. It looks innocuous enough, but the general rule of Act Sec. 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.<sup>64</sup>

If the direct seller and Act Sec. 530 arguments are shunned by the IRS, taxpayers may also consider

broaching the IRS's standard classification settlement program (CSP). Many people have at least heard of Act Sec. 530, but general unawareness of the CSP seems to be the norm. This is probably attributable to the obscure materials in which details about the CSP appear. In 1996, the IRS issued a news release announcing the CSP and identifying it as a two-year trial program.<sup>65</sup> 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.<sup>66</sup> Details about the CSP are somewhat challenging to find because they derive primarily from a field service advisory in 1996, as restated and expanded in the INTERNAL REVENUE MANUAL.<sup>67</sup>

In cases where it appears that a company may have misclassified a worker, the Revenue Agent must fully develop the issue and determine, among other things, whether a misclassification occurred under applicable law, whether the company is eligible for Act Sec. 530 relief, and, if not, whether the company is entitled to a CSP offer.<sup>68</sup> 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. Depending on the facts, the IRS may extend a CSP offer entailing assessment of 100 percent of the employment tax liability due for the one tax year under audit, computed using the special rates under Code Sec. 3509, if applicable. The other CSP offer contemplates assessment of just 25 percent of the employment tax liability due for the one tax year under audit, computed using the special rates under Code Sec. 3509, if applicable.<sup>69</sup> Under either CSP offer, the company must agree to reclassify the workers in question as employees going forward, starting the first day of the quarter following the date of the Closing Agreement.<sup>70</sup>

Arguments and strategies in worker-classification cases abound, and a thorough analysis of these items far exceeds the scope of this article.<sup>71</sup> The key for those handling a case involving direct seller issues is awareness of the options and the prudent selection thereof. Case in point, the taxpayer in *Smokey Mountain Secrets, Inc.* successfully raised the direct seller and Act Sec. 530 positions at trial. This dual defense led not only to a victory, but also partial recoupment of legal fees and costs from the IRS, as explained further below.

## Taxpayers Might Recoup Fees from the IRS

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.<sup>72</sup> Recoverable administrative costs may include charges imposed by the IRS, reasonable attorneys' fees, reasonable expenses for expert witnesses and reasonable costs of any study, analysis, report, test or project necessary for the preparation of the taxpayer's case.<sup>73</sup> The litigation costs for which the taxpayer may seek reimbursement follow similar guidelines.<sup>74</sup>

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 or set of issues presented, and (ii) has a net worth that does not exceed certain statutory thresholds.<sup>75</sup> 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."<sup>76</sup> 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 his 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.<sup>77</sup> According to congressional reports, "the successful taxpayer will receive an award of attorney's fees unless the IRS satisfies its burden of proof."<sup>78</sup> 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.<sup>79</sup> 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 the taxpayers in 1998 with the passage of the Taxpayer Bill of Rights 3.<sup>80</sup> This legislation empowered the courts to take into account whether the govern-

ment has lost on similar issues in appellate courts for other circuits in determining if the government's position is substantially justified.<sup>81</sup> 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.<sup>82</sup> Such stubborn litigiousness would, say the reports, place an undue burden on those taxpayers forced to dispute decided issues.<sup>83</sup>

The legislative modifications discussed above have been incorporated into the Internal Revenue Code and corresponding regulations. The general rule still stands that a taxpayer will not be considered a "prevailing party," and thus will not be entitled to reimbursement, if the government's position was substantially justified.<sup>84</sup> 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.<sup>85</sup> Such guidance includes regulations (final or temporary), revenue rulings, information releases, notices and announcements.<sup>86</sup> 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.<sup>87</sup> 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.<sup>88</sup>

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.<sup>89</sup> A significant factor in making this determination is whether the taxpayer presented all of the relevant information under his control to the appropriate IRS personnel.<sup>90</sup> 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 her 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.<sup>91</sup> Other courts have utilized a different approach, scrutinizing whether the position taken by the IRS was reasonable.<sup>92</sup> 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."<sup>93</sup> 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.<sup>94</sup>

As explained earlier in this article, it generally behooves a taxpayer, where applicable, to develop and present a strong written argument to the IRS about direct seller characterization at the earliest stages of the audit. Doing so might limit the issues to Code Sec. 3508 and successfully terminate the audit near its inception. It might also allow the taxpayer to recoup certain fees from the IRS if it insists on further pressing the worker-classification issue, despite a strong direct seller case.

Two examples are helpful in fleshing out this concept. After winning the direct seller case, the taxpayer in *The R Corporation* filed suit seeking legal fees and costs from the government on grounds that the IRS's position in the earlier tax case was not "substantially justified."<sup>95</sup> The court declined to award the requested fees and costs to the taxpayer because only one prior case had addressed the specific issue and the issue was a "close question" of statutory construction.<sup>96</sup> Likewise, the taxpayer in *Smokey Mountain Secrets, Inc.*, after prevailing on the direct seller issue, initiated a separate suit seeking legal fees and costs.<sup>97</sup> The court refused to make the government reimburse the taxpayer on the direct seller issue because it was a case of first impression: "the 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."<sup>98</sup> This was not the end of the matter, though. The taxpayer in *Smokey Mountain Secrets, Inc.* 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 Act Sec. 530. The court agreed that the taxpayer presented a strong Act Sec. 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 of 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."<sup>99</sup>

## Conclusion

Tax practitioners who handle employment tax issues, particularly worker-classification disputes, must be well-versed in the direct seller rules for obvious reasons. However, it is equally important that many others understand these obscure rules given that the direct selling industry in the United States has more than 13 million salespersons, a significant portion of the \$345 billion "tax gap" is attributable to worker misclassification, the IRS is currently conducting 6,000 additional employment tax audits, the IRS is likely to institute even more classification audits in the coming years, and many IRS personnel have limited knowledge about the special rules for direct sellers under Code Sec. 3508. This article is designed to raise awareness for taxpayers and their advisors of certain direct seller issues, but it is not a complete treatise on the matter by any means. The smart play, when a business finds itself facing a worker-classification situation involving direct sellers, is to consult a practitioner steeped in these matters.

## ENDNOTES

<sup>1</sup> IRS, RETAIL INDUSTRY AUDIT TECHNIQUE GUIDE, *Examination Techniques for Specific Industries (Direct Sellers)*, Cat. No. 47515G (Rev. Feb. 2009), at 3-98 and 3-99.

<sup>2</sup> *Id.*

<sup>3</sup> Michael Joe, *IRS to Audit 6,000 Companies for Employment Tax Compliance*, 2009 TNT 183-4 (Sept. 24, 2009).

<sup>4</sup> 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.

<sup>5</sup> See Code Sec. 3121(d) and Reg. §31.3121(d)-1 (containing the definition of

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

<sup>6</sup> Code Sec. 3508 and Proposed Reg. §31.3508-1.

- <sup>7</sup> Reg. §31.3401(c)-1(b). See also Reg. §31.313121(d)-1(c)(2).
- <sup>8</sup> Reg. §31.3401(c)-1(c).
- <sup>9</sup> Rev. Rul. 87-41, 1987-1 CB 296.
- <sup>10</sup> H.R. CONF. REP. NO. 97-760, 97th Cong., 2nd Sess. 1982, at 1421.
- <sup>11</sup> U.S. Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982*, JCS-38-82 (Dec. 31, 1982), at 383.
- <sup>12</sup> *Id.*, at 382.
- <sup>13</sup> Proposed Reg. §31.3508-1(a).
- <sup>14</sup> Code Sec. 3508(b)(2)(A). Workers delivering or distributing newspapers or shopping news are also part of this category, though not discussed in this article.
- <sup>15</sup> Proposed Reg. §31.3508-1(g)(3).
- <sup>16</sup> Preamble to Proposed Regulations, 51 FR 4 (Jan. 7, 1986).
- <sup>17</sup> *Id.*
- <sup>18</sup> *Id.*
- <sup>19</sup> Proposed Reg. §31.3508-1(f).
- <sup>20</sup> Proposed Reg. §31.3508-1(f).
- <sup>21</sup> Proposed Reg. §31.3508-1(c)(2)(ii).
- <sup>22</sup> Proposed Reg. §31.3508-1(j)(2) Example 2.
- <sup>23</sup> Proposed Reg. §31.3508-1(j)(2) Example 3.
- <sup>24</sup> Preamble to Proposed Regulations, 51 FR 4 (Jan. 7, 1986).
- <sup>25</sup> Code Sec. 3508(b)(2)(A). Workers delivering or distributing newspapers or shopping news are also part of this category, though not discussed in this article.
- <sup>26</sup> Proposed Reg. §31.3508-1(g)(4).
- <sup>27</sup> Proposed Reg. §31.3508-1(g)(4).
- <sup>28</sup> Proposed Reg. §31.3508-1(g)(4).
- <sup>29</sup> Proposed Reg. §31.3508-1(g)(4).
- <sup>30</sup> Proposed Reg. §31.3508-1(g)(4).
- <sup>31</sup> Code Sec. 3508(b)(2)(A).
- <sup>32</sup> IRS, RETAIL INDUSTRY AUDIT TECHNIQUE GUIDE, *Examination Techniques for Specific Industries (Direct Sellers)*, Cat. No. 47515G (Rev. Feb. 2009), at 3-98 and 3-99.
- <sup>33</sup> *Id.*
- <sup>34</sup> Proposed Reg. §31.3508-1(c)(2)(i).
- <sup>35</sup> Proposed Reg. §31.3508-1(g)(1).
- <sup>36</sup> Proposed Reg. §31.3508-1(g)(2).
- <sup>37</sup> Code Sec. 3508(b)(2)(B).
- <sup>38</sup> Proposed Reg. §31.3508-1(d)(1)(i). Special rules exist with respect to repayment of advances or draws. See Proposed Reg. §31.3508-1(d)(1)(ii).
- <sup>39</sup> Proposed Reg. §31.3508-1(d)(2)(i).
- <sup>40</sup> Proposed Reg. §31.3508-1(d)(2)(ii).
- <sup>41</sup> Code Sec. 3508(b)(2)(C).
- <sup>42</sup> Proposed Reg. §31.3508-1(e)(1).
- <sup>43</sup> Preamble to Proposed Regulations, 51 FR 4 (Jan. 7, 1986).
- <sup>44</sup> Sam Goodley, *IRS Hears Testimony on Qualified Real Estate Agents and Direct Seller Regulations*, TAX NOTES, June 23, 1986, at 1163-65.
- <sup>45</sup> See, e.g., *D.J. Kraus*, 85 TCM 750, Dec. 55,011(M), TC Memo. 2003-10 (ruling that the worker was not a direct seller because the union contract governing his relationship with the company “did not provide that he was not to be treated as an employee with respect to those services for Federal tax purposes”).
- <sup>46</sup> IRS, *Independent Contractor or Employee? Training Materials*, Training 3320-102 (Oct. 1996), at 3-17 to 3-19 (available at [www.irs.gov/pub/irs-utl/emporind.pdf](http://www.irs.gov/pub/irs-utl/emporind.pdf)).
- <sup>47</sup> IRS Publication 15-A, *Employer’s Supplemental Tax Guide*, Cat. No. 21453T (2010), at 3-8.
- <sup>48</sup> LTR 9132035 (May 9, 1991); LTR 8926017 (Mar. 29, 1989); LTR 8926018 (Mar. 29, 1989); LTR 8925071 (Mar. 29, 1989); LTR 8925072 (Mar. 29, 1989); LTR 8922026 (Mar. 1, 1989); LTR 8920038 (Feb. 16, 1989); LTR 8918039 (Feb. 3, 1989); LTR 8918040 (Feb. 3, 1989); LTR 8918041 (Feb. 3, 1989); LTR 8904047 (Nov. 1, 1988); LTR 8903072 (Oct. 26, 1988); LTR 8848012 (Aug. 29, 1988); LTR 8844059 (Aug. 10, 1988); LTR 8842028 (July 25, 1988); LTR 8840013 (July 7, 1988); LTR 8840014 (July 7, 1988); LTR 8838054 (June 28, 1988); LTR 8836012 (June 10, 1988); LTR 8836013 (June 13, 1988); LTR 8835022 (June 7, 1988); LTR 8835023 (June 6, 1988); LTR 8835025 (June 6, 1988); LTR 8835027 (June 7, 1988); LTR 8835036 (June 7, 1988); LTR 8835043 (June 7, 1988); LTR 8835058 (June 10, 1988); LTR 8822017 (Mar. 1, 1988); LTR 8822038 (Mar. 3, 1988); LTR 8822040 (Mar. 3, 1988); LTR 8822042 (Mar. 3, 1988); LTR 8822044 (Mar. 3, 1988); LTR 8820024 (Feb. 12, 1988); LTR 8816011 (Jan. 7, 1988); LTR 8829031 (Apr. 21, 1988); LTR 8829026 (Apr. 20, 1988); LTR 8813016 (Dec. 24, 1987); LTR 8813017 (Dec. 24, 1987); LTR 8813018 (Dec. 24, 1987); LTR 8813020 (Dec. 24, 1987); LTR 8813043 (Jan. 4, 1988); LTR 8812014 (Dec. 14, 1987); LTR 8810036 (Dec. 11, 1987); LTR 8808055 (Dec. 1, 1987); LTR 8809017 (Dec. 1, 1987); LTR 8805018 (Nov. 4, 1987); LTR 8753020 (Oct. 2, 1987); LTR 8750074 (Sept. 17, 1987); LTR 8748011 (Aug. 27, 1987); LTR 8747036 (Aug. 25, 1987); LTR 8747037 (Aug. 25, 1987); LTR 8746084 (Aug. 21, 1987); LTR 8744044 (Aug. 5, 1987); LTR 8744046 (Aug. 5, 1987); LTR 8744047 (Aug. 5, 1987); LTR 8742063 (July 23, 1987); LTR 8742060 (July 23, 1987); LTR 8740048 (July 9, 1987); LTR 8737067 (June 17, 1987); LTR 8736066 (June 11, 1987); LTR 8735063 (June 4, 1987); LTR 8734051 (May 28, 1987); LTR 8734052 (May 28, 1987); LTR 8731035 (May 5, 1987); LTR 8729043 (Apr. 21, 1987); LTR 8727021 (Apr. 2, 1987); LTR 8724053 (Mar. 18, 1987); LTR 8724018 (Mar. 12, 1987); LTR 8721067 (Feb. 24, 1987); LTR 8721025 (Feb. 18, 1987); LTR 8720022 (Feb. 12, 1987); LTR 8720026 (Feb. 12, 1987); LTR 8716045 (Jan. 16, 1987); LTR 8711088 (Dec. 17, 1986); LTR 8703008 (Oct. 10, 1986).
- <sup>49</sup> IRM §4.23.5.6.5 (Feb. 1, 2003); see also IRM §4.23.5.6.7 (Feb. 1, 2003).
- <sup>50</sup> IRS Publication 911, *Direct Sellers* (Cat. No. 60031B).
- <sup>51</sup> *IRS Audit Technique Guide for Retail Industry* (Cat. No. 47515G) (Rev. Feb. 2009).
- <sup>52</sup> *Id.*, at 3-98.
- <sup>53</sup> *Id.*, at 3-109.
- <sup>54</sup> *Id.*, at 3-111.
- <sup>55</sup> *Cleveland Institute of Electronics, Inc.*, DC-OH, 92-1 USTC ¶50,182, 787 F.Supp. 741 (1992).
- <sup>56</sup> *Id.* (internal citations omitted).
- <sup>57</sup> *The R Corporation*, DC-FL, 94-2 USTC ¶50,380 (1994).
- <sup>58</sup> *Id.*
- <sup>59</sup> *Smoky Mountain Secrets, Inc.*, DC-TN, 95-2 USTC ¶50,573, 910 F.Supp. 1316 (1995).
- <sup>60</sup> See FSA 33107175 (Dec. 1, 1997) and FSA 33314303 (Dec. 1, 1997).
- <sup>61</sup> Proposed Reg. §31.3508-1(i).
- <sup>62</sup> Preamble to Proposed Regulations, 51 FR 4 (Jan. 7, 1986).
- <sup>63</sup> Training 3320-102 (Oct. 1996), *supra* note 46, at 3-18 (emphasis added); See also CCA 199940006 (June 11, 1999).
- <sup>64</sup> Section 530 (a)(1) of the Revenue Act of 1978 (P.L. 95-600).
- <sup>65</sup> IRS News Release 96-7 (Mar. 5, 1996).
- <sup>66</sup> Notice 98-21, 1998-1 CB 849.
- <sup>67</sup> FS-96-5; IRM §4.23.6.
- <sup>68</sup> FS-96-5; IRM §4.23.6.11 (Mar. 1, 2003).
- <sup>69</sup> FS-96-5; IRM §4.23.6.13.1 (Oct. 30, 2009).
- <sup>70</sup> *Id.*
- <sup>71</sup> For a detailed analysis of the options available to taxpayers facing a potential or actual worker-classification dispute, see Hale E. Sheppard, *IRS Introduces New Settlement Program for Worker-Classification Issues: Putting the Latest Employment Tax Offer into Perspective*, TAXES, Feb. 2012, at 53.
- <sup>72</sup> Code Sec. 7430(a).
- <sup>73</sup> Code Sec. 7430(c)(2).
- <sup>74</sup> Code Sec. 7430(c)(1).
- <sup>75</sup> Code Sec. 7430(c)(4)(A).
- <sup>76</sup> Code Sec. 7430(c)(4)(B)(i).
- <sup>77</sup> P.L. 104-168.
- <sup>78</sup> H.R. REPT. 104-506, 104th Cong., 2d Sess. 1996, at 37.
- <sup>79</sup> Act Sec. 701 of P.L. 104-168; H.R. REPT. 104-506, 104th Cong., 2d Sess. 1996, at 36-37.
- <sup>80</sup> P.L. 105-206.
- <sup>81</sup> Act Sec. 3101 of P.L. 105-206, codified as Code Sec. 7430(c)(4)(B)(iii).
- <sup>82</sup> H.R. REPT. 105-364, 105th Cong., 1st Sess. 1997, at 58; SEN. REPT. 105-174, 105th Cong., 2d Sess., 1998, at 48.
- <sup>83</sup> *Id.*
- <sup>84</sup> Code Sec. 7430(c)(4)(B)(i).
- <sup>85</sup> Code Sec. 7430(c)(4)(B)(ii).
- <sup>86</sup> Code Sec. 7430(c)(4)(B)(iv)(I); Reg. §301.7430-5(c)(3).

<sup>87</sup> Code Sec. 7430(c)(4)(B)(iv)(II); Reg. §301.7430-5(c)(3).  
<sup>88</sup> Code Sec. 7430(c)(4)(B)(iii).  
<sup>89</sup> Reg. §301.7430-5(c)(1).  
<sup>90</sup> Reg. §301.7430-5(c)(1); Reg. §301.7430-5(h), Example 1.  
<sup>91</sup> *National Fed'n of Republican Assemblies*, DC-AL, 2003-1 USTC ¶50,249, 263 FSupp2d

1372, 1378 (2003).  
<sup>92</sup> *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).  
<sup>93</sup> *N.R. Wilkes, Jr.*, CA-11, 2002-1 USTC ¶60,438, 289 F3d 684, 688 (2002).

<sup>94</sup> *See, e.g., M.J. Downing, Jr.*, 89 TCM 1009, Dec. 55,983(M), TC Memo. 2005-73.  
<sup>95</sup> *The R Corporation*, *supra* note 57.  
<sup>96</sup> *Id.*  
<sup>97</sup> *Smokey Mountain Secrets, Inc.*, *supra* note 59  
<sup>98</sup> *Id.*  
<sup>99</sup> *Id.*

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