In Defense of Section 530

by

Coalition to Preserve Independent Contractor Status

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Executive Summary

Section 530 of the Revenue Act of 1978 ("Section 530")[1] is a safe-harbor provision of the federal tax law that is relied upon every day by many companies and self-employed service providers. Section 530 provides both parties to covered business relationships with absolute certainty that the independent-contractor status of their relationship will be respected for federal employment-tax purposes.

From a federal tax perspective, the government *should* be indifferent as to whether an individual performs services as an employee or independent contractor, *so long as* the compensation paid the individual is reported on Forms 1099-MISC. The FICA/SECA tax treatment of each is now substantially the same and their respective tax-compliance rates are within two percentage points of each other. Internal Revenue Service ("IRS") data estimate that the tax-compliance rate for recipients of Forms 1099 (independent contractors) is 97% compared to 99% for recipients of Forms W-2 (employees).

Bills introduced in the 110th Congress suggest that the Congress seeks to discourage companies from doing business with independent contractors. Such bills would dramatically reduce the federal employment-tax certainty of treating service providers as independent contractors and materially increase the financial consequences of misclassification. There are some indications that similar proposals will offered during the 111th Congress.

It is important to appreciate that self-employed service providers are a type of small business – one of the most vibrant sectors of our economy, supplying innovation, job creation, and economic growth. Over half of the employment in this country comes from firms with less than 500 employees, and all net new job creation comes from small business.

The certainty that Section 530 provides enables companies and self-employed service providers – the quintessential small business persons – to enter into business relationships that they know will be respected for federal employment-tax purposes. A certain and predictable regulatory environment for independent contractors inures to the benefit of

[1] By way of background, Section 530 protects a company against the IRS requiring it to reclassify as employees, for federal employment-tax purposes, workers whom the company treats as independent contractors ("covered workers"), provided that:

> (1) the company has always consistently treated the covered workers as independent contractors for federal employment-tax purposes, and for all periods beginning after December 31, 1977, the company and any predecessor have consistently treated all other workers holding a *substantially similar position* as independent contractors for federal employment-tax purposes[1] (the "substantive consistency" requirement);
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> (2) for the tax year at issue the company has complied with the Form 1099 reporting requirements with respect to the compensation paid to the covered workers[1] (the "Form 1099" requirement); and
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> (3) the company had a *reasonable basis* for treating the covered workers as independent contractors (the "reasonable basis" requirement).

independent contractors, the companies that purchase their services and our nation's economy.

I. Repealing Section 530 is an Ineffective Strategy for Reducing the Tax Gap

In recent years the Congress has become concerned about what is known as the *tax gap*, defined generally as "the difference between what taxpayers timely and accurately pay in taxes and what they should pay under the law." While sole proprietors do account for a material portion of the tax gap, all sole proprietors are not equal contributors. Those whose income is reported on Forms 1099 are *not* material contributors to the tax gap; the principal contributors are instead those whose income is not subject to information reporting.

It follows that any strategy for reducing the tax gap that targets sole proprietors whose income is currently reported on Forms 1099 – such as those covered by Section 530 – is misguided and even counterproductive, as it penalizes currently compliant taxpayers while leaving untouched the noncompliant. Because Form 1099 compliance is an essential condition of Section 530 eligibility, Section 530 operates as a powerful incentive for companies to comply with the Form 1099 reporting requirements that apply to payments made to independent contractors.

A repeal of Section 530 could result in companies that now qualify for Section 530 protection becoming less vigilant in ensuring compliance with the Form 1099 requirements, since the Section 530 benefits of fastidious compliance would no longer exist. Moreover, a repeal could also result in newly established companies electing to "fly under the radar" by not issuing any Forms 1099, since there no longer would be any Section 530 incentive to do so. Finally, if independent contractors were to react by establishing their own corporations, their fees would no longer be reportable on Forms 1099-MISC. It follows that a repeal of Section 530 would be a highly ineffective strategy for reducing the tax gap associated with independent contractors.

II. Preserving Section 530 is Critical for Business

There are many companies whose entire business model is predicated on their ability to enter into hundreds or thousands of engagements throughout a year with self-employed service providers. One common bond shared by many of these companies is their reliance on the protections provided by Section 530 to ensure that their relationships with independent contractors will be respected for federal employment-tax purposes.

These firms contract with independent contractors for reasons of business necessity, not tax planning. It is critical for these businesses that their relationships with self-employed service providers be respected over the long term, as they need this certainty:

- to appropriately plan for the future,
- to convince investors to provide the outside capital they need in order to fund their operations,
- to make capital investments that require several years of operations to become profitable, and
- to ultimately sell their company at a fair price.

For some companies, the elimination of the certainty that Section 530 provides would drive the company out of business, due to a drying up of essential outside capital, while for others the chronic day-to-day risk of one day having a viable business, and the next day not, would be intolerable and the principals themselves would decide to close down. For owners seeking to sell such a business, the value of their business would be materially reduced without the employment-tax certainty that Section 530 provides.

III. Preserving Section 530 is Critical for Self-Employed Service Providers

The certainty that Section 530 provides is at least as important to self-employed service providers, because the companies that need that certainty in order to do business with independent contractors are their clients! A very large percentage of entrepreneurs starting new businesses begin as independent contractors. Starting a new business is fraught with extraordinary risk. Placing another obstacle in the road to new business formation will further curtail a segment of the economy that could play a material role in extricating us from our current economic contraction.

It is important to appreciate that self-employed service providers often compete head-to-head for business with larger firms that operate in the form of a corporation, partnership or limited liability company. If the regulatory risk to potential clients of doing business with sole proprietors becomes too high, potential clients will become less willing to do business with sole proprietors. If that were to occur, sole proprietors will find it increasingly difficult to sell their services.

The principal losers of a repeal of Section 530 would be the individuals who currently offer their services as independent contractors. They would find fewer and fewer buyers for their services because their potential clients would no longer enjoy any certainty that their relationship will be respected for federal employment-tax purposes. In many cases, the victim will be an individual who has been pursuing his or her entrepreneurial dream but finds that dream taken away. The individual would be left to find a job at a time of rising national unemployment. When that person is trying to support a family, make mortgage payments and pay college tuition, the impact is especially devastating.

IV. The *Prospective* Protection of Section 530 is Vital

The principal value of Section 530 is its *prospective* protection: the certainty it provides a business that its contracts with independent contractors will *always* be respected for federal employment-tax purposes. Any company whose business model is predicated on independent-contractor relationships *needs* this certainty in order to plan effectively for the future and create long-term value. This need for prospective certainly is not merely theoretical. The IRS has a long institutional history of inconsistently applying the test for distinguishing employees from independent contractors.

There are too many instances of IRS first assuring a company that its treatment of workers as independent contractors is appropriate, only to later reverse itself and reclassify those workers to employee status. *E.g., Henry v. United States,* 793 F.2d 289, 1986 U.S. App. LEXIS 20095, 86-2 U.S. Tax Cas. ¶9512, 58 A.F.T.R.2d 5144 (Fed. Cir. App. 1986. Even after Section 530's enactment, the court in *In re Compass Marine Corporation,* 146 B.R. 138, 1992 Bankr. LEXIS 1290 (Bankr. E.D. Pa. 1992), expressed concern about the doctrinaire zeal with which IRS continued to pursue reclassifications of workers treated as independent contractors. In that case, the court offered the following observation:

> It is somewhat disturbing to us to observe the selective enforcement of the IRC requirements for classification of employees, which [IRS Agent John] Gilbert himself conceded in his admission that his own wife was probably improperly classified by her employer. We also were disturbed by the suggestion that Gilbert prides himself as somewhat of a *crusader on this issue*. It is perhaps in recognition of the harshness of enforcement of these IRC requirements on the unfortunate targets of IRS enforcement that Congress has enacted Section 530 as an "out" for certain employers.

146 B.R. at 155. (Emphasis added).

For many taxpayers, Section 530 provides the only certain protection against an IRS *crusader* on the worker-misclassification issue.

It is important to emphasize that there is no contention at this time that IRS is anything other than highly objective in its enforcement of the law governing worker-classification for federal tax purposes. In fact, that is one important argument in favor of preserving the *status quo*, as the existence of Section 530 might well be a significant influence on the IRS's approach to the issue. If Section 530 were repealed, there is a risk that taxpayers could find themselves, once again, in an environment of uncertainty, with no guarantee from one day to the next whether their business model will be viable. For companies whose business model is predicated on doing business with independent contractors, that risk is too high.

V. The Likely Market Reaction to Repeal of Section 530 is Not Appealing

It is submitted that the likely market reaction to a new paradigm in which the *prospective* protection of Section 530 no longer exists would be for client companies to cease doing business with self-employed service providers and instead encourage them to either become "employees" of a third-party firm or establish their own corporate identity.

A case study already exists of what happens when self-employed service providers are forced to become employees of third-party firms. The result has been immense tax-compliance problems for all affected parties. It also creates a new and permanent transaction charge on the services that independent contractors provide, which is imposed by the third-party firms that function as their "employer" of record.

From a tax-administration perspective, a new paradigm in which freelance service providers operate as *de facto* employees of third-party firms is *not* one the IRS should desire. While two-party relationships can present vexing federal employment-tax controversies, those controversies pale in complexity alongside three-party arrangements. In three-party arrangements, a long line of court decisions and IRS rulings have established that the mere fact that a third-party firm disburses "wages" to a worker does not necessarily mean that the third party, as opposed to the service recipient, is liable for the corresponding federal employment-taxes – because of the potential application of Internal Revenue Code section 3401(d)(1). A proliferation of these three-party relationship would overwhelm the IRS with disputes and litigation over which taxpayer is liable for unpaid employment taxes.

If self-employed service providers were to establish their own corporations, this outcome is no more desirable, as it would provide the parties far less employment-tax certainty than Section 530 and likely eliminate from the marketplace those individuals who offer their freelance services on a sporadic or part-time basis, because the added cost and administrative burden of establishing and maintaining a corporation would undermine the economic viability of those endeavors. The establishment of corporations would also lead to a reduction in tax compliance because payments made to corporations are not subject to information reporting and, as noted, IRS data indicate that the compliance rate for unreported payments is materially less than for reported payments. The net result of a repeal of Section 530 would be diminished economic activity, an increase in IRS disputes over which taxpayer (in three-party arrangements) is liable for unpaid employment taxes and a reduction in tax compliance.

VI. Section 530 Requirements are Demanding and Sufficiently Rigorous to Prevent Taxpayer Abuse

The Section 530 safe harbor was designed to protect only those companies that satisfy the provision's rigorous requirements. As a practical matter, most businesses that qualify for Section 530 protection are those that contract with independent contractors to perform a type of service that the business, itself, does not provide. This is because of Section 530's *substantive consistency* requirement, which provides generally that a taxpayer is ineligible for Section 530 protection with respect to workers if the taxpayer (or a predecessor) has treated as an employee for federal employment-tax purposes as much as one worker who holds a *substantially similar* position.

Also, the Form 1099 requirement of Section 530, which arguably is its most straightforward, will deny Section 530 protection to a taxpayer that fails to comply with the Form 1099 reporting requirements.

The reasonable basis requirement operates to deny Section 530 protection to taxpayers that lack a "reasonable basis" for treating workers as independent contractors. As is true with the *substantive consistency* requirement, courts have interpreted the reasonable basis requirement in a manner that jealously guards the safe harbor against abuse.

For example, if a taxpayer seeks to establish a reasonable basis by relying on legal precedent, the precedent must, among other things, be squarely on point, must apply the same or a comparable legal test as is followed for federal employment-tax purposes and must have been relied upon by the taxpayer when it treated the workers at issue as independent contractors. Moreover, if a taxpayer seeks to rely on a prior IRS audit commencing after December 31, 1996, the taxpayer generally must provide documentation establishing that during the prior audit IRS affirmatively considered the taxpayer's treatment for federal employment-tax purposes of workers whose positions are substantially similar to the workers at issue. The evidentiary burden that taxpayers need to meet in order to rely on an industry practice is especially demanding, as the taxpayer must, among other things, be able to establish the existence of an industry practice through a means other than personal experience, *e.g.,* by commissioning a third-party industry survey, and must specifically identify each of the other companies that allegedly follow the practice which the taxpayer asserts is the industry standard.

Often overlooked aspects of the reasonable-basis requirement are that a taxpayer's reliance on an asserted reasonable basis must be in *good faith*, and that the taxpayer must be

able to show that it does not retain a sufficient right of control over the worker at issue as to render *unreasonable* the taxpayer's reliance on an asserted reasonable basis. A requirement for establishing a reasonable basis that comes as a surprise to many is that a taxpayer must have *relied* on an asserted reasonable basis *at the time* the taxpayer treated the workers at issue as independent contractors.

As the foregoing reveals, any perception of Section 530 as a broad loophole, vulnerable to widespread taxpayer abuse, betrays a lack of understanding of how the provision has been interpreted and applied by IRS and the courts.

VII. Conclusion

The *prospective* protections that Section 530 provides have become essential to the continued viability of many companies. They enable such companies to plan for the future and attract the necessary capital to fund current operations and make prudent investments that might take years to become profitable. The benefits of Section 530 are in no sense limited to companies, however, as millions of self-employed service providers currently benefit from the certainty of Section 530; it enables them to compete when selling their services on a level playing field against competitors that are larger in size and operate out of legal entities.

The elimination of Section 530's prospective protection would have far-reaching ramifications that, in an economy as complex and interdependent as ours, cannot be meaningfully quantified. What is clear, however, is that the resulting chilling effect would lead to business closures and greatly diminished client opportunities for those self-employed service providers who are able to survive.

If independent contractors were to react to the resulting diminished client opportunities by offering their services through third-party employers of record, the cost for their services would be artificially inflated and their net earnings would likely decline. If they were to respond by forming corporations, many would simply cease operations due to the cost and administrative burden associated with operating out of a corporation. For those who can make the transition, IRS data suggest that their tax compliance would drop, since their fees would not longer be reportable on Forms 1099-MISC.

Section 530 has ample safeguards to protect its safe-harbor protections against taxpayer abuse. The scores of taxpayers that have asserted Section 530 protection and lost can attest to the efficacy of such safeguards. Moreover, the Form 1099 reporting requirement of Section 530 ensures that the tax compliance rate among self-employed providers who are covered by the protections will remain high.

It is respectfully submitted that Section 530, in its current form, is working as intended and should be retained. The certainty that Section 530 provides to the marketplace for freelance talent is precious. Any repeal of Section 530 – or its *prospective protection* – would be a grave mistake. The price exacted by such a mistake would be borne most heavily by the self-employed service providers who are already in an economically vulnerable position. Many are seeking to support their families by working as self-employed service providers while others are struggling to make ends meet by supplementing their income with freelance work on a part-time basis. A repeal of Section 530, which ensures a level playing field for freelance talent, would be a most cruel act of discrimination against the self-employed sector of our economy.

In Defense of Section 530

Section 530 of the Revenue Act of 1978 ("Section 530")[2] has become one of the venerable pillars of the federal tax law upon which many companies – and self-employed service providers – rely everyday as they conduct their business. Section 530 provides both parties to covered business relationships with absolute certainty that the independent-contractor status of their relationship will be respected for federal employment-tax purposes.

From a federal tax perspective, the government *should* be indifferent as to whether an individual performs services as an employee or independent contractor, *so long as* the compensation paid the individual is reported on Forms 1099-MISC. The FICA/SECA tax treatment of each is now substantially the same[3] and their respective tax-compliance rates are within two percentage points of each other. Internal Revenue Service ("IRS") data estimate that the tax-compliance rate for recipients of Forms 1099 (independent contractors) is 97% compared to 99% for recipients of Forms W-2 (employees).[4]

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[2] Section 530 was initially enacted as a temporary measure that would terminate at the end of 1979, but it was extended through the end of 1980 by P.L. 96-167, and through June 30, 1982, by P.L. 96-541. The provision was made permanent by §269 of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324, 552. Section 530 was subsequently amended by the Tax Reform Act of 1986, the Small Business Job Protection Act of 1996, and the Pension Protection Act of 2006. Section 530 was never codified.

By way of background, Section 530 protects a company against the IRS requiring it to reclassify as employees, for federal employment-tax purposes, workers whom the company treats as independent contractors ("covered workers"), provided that:

> (1) the company has always consistently treated the covered workers as independent contractors for federal employment-tax purposes, and for all periods beginning after December 31, 1977, the company and any predecessor have consistently treated all other workers holding a *substantially similar position* as independent contractors for federal employment-tax purposes[2] (the "substantive consistency" requirement);
>
> (2) for the tax year at issue the company has complied with the Form 1099 reporting requirements with respect to the compensation paid to the covered workers[2] (the "Form 1099" requirement); and
>
> (3) the company had a *reasonable basis* for treating the covered workers as independent contractors (the "reasonable basis" requirement).

A more detailed explanation of Section 530 is provided below in Section VIII.

[3] The Federal Insurance Contributions Act ("FICA") tax and Self Employment Contributions Act ("SECA") tax each impose social security and Medicare taxes on earnings. FICA imposes the tax on employees, where the employer and employee each pay one half of the tax, while SECA imposes the tax on independent contractors, where the independent contractor pays the entire amount. In *303 West 42nd Street Enterprises, Inc. v. Internal Revenue Service,* 916 F. Supp. 349, 1996 U.S. Dist. LEXIS 2274, 96-1 U.S. Tax Cas. ¶50,189, 79 A.F.T.R.2d 442 (S.D. N.Y. 1996), the court explained that:

> Prior to 1990, the employment tax structure significantly favored independent contractors over employees. Until 1983 the FICA tax rate on the employer and employee was higher than the SECA tax rate. In 1989, the tax rates were equalized; however, a self-employed person is still entitled to an income tax deduction for a portion of SECA taxes. Joint Committee print; JCX-27-92, *Present Law and Issues Relating to Misclassification of Employees and Independent Contractors for Federal Tax Purposes*.

[4] IRS data indicate that employees who receive Forms W-2 generally report 99 percent of the income appearing on those forms. *E.g.,* IRS National Headquarters Office of Research*, Interactive Tax Gap Map for Year* 2001, 22-23 (Feb. 24, 2004). With respect to Forms 1099, the Government Accountability Office testified that:

Bills introduced in the 110th Congress suggest that the Congress seeks to discourage companies from doing business with independent contractors. Specifically, the *Independent Contractor Proper Classification Act of 2007* (S. 2044)[5] and its companion bill the *Taxpayer Responsibility, Accountability, and Consistency Act of 2008*, (H.R. 5804)[6] would repeal the *prospective* protection that Section 530 currently provides and would tighten the provision's eligibility requirements so fewer companies would qualify. In addition, the bills would create a new procedure for individuals to obtain a determination from IRS as to their status as employees or independent contractors. The new procedure would permit an appeal *only* in cases where IRS concludes that the individual is an independent contractor; the bills are silent as to any appeal rights in cases where IRS concludes that the individual is an employee. Also, S. 2044 would award attorney fees and costs to an individual who obtains an IRS determination that reclassifies the individual from an independent contractor to an employee.

While not a tax bill, the *Employee Misclassification Prevention Act of 2008* (H.R. 6111)[7] is another bill that would make life unpleasant for companies that do business with independent contractors. It would allow successful individual plaintiffs claiming to have been misclassified as independent contractors and denied overtime and/or minimum wages under the Fair Labor Standards Act ("FLSA") to recover *triple damages*. The bill also would expose employers covered by the FLSA that are determined to have *repeatedly* or *willfully* misclassified workers as independent contractors to a civil penalty of up to $10,000 for each individual determined to have been misclassified.

The above-referenced bills would dramatically reduce the federal employment-tax certainty of treating service providers as independent contractors and materially increase the financial consequences of misclassification. The clear effect of these bills would be to discourage companies from doing business with independent contractors. There are indications that similar proposals will be offered during the 111th Congress.

While this paper is focused on preserving Section 530, this issue is only one facet of the larger debate concerning the preservation of independent-contractor status. Ultimately, the issue before the Congress and President Obama is whether our government should continue allowing individuals to work for themselves and offer their services as independent contractors.

While one certainly might frame the debate in terms of whether it is *fair* to deny an individual the full panoply of federal and state tax, labor, safety and employment laws – which were enacted with the *explicit* purpose of covering *only* employees – (hereinafter "employment laws"), it is important to recognize that this question avoids any consideration of individual choice. The question does not countenance the possibility that individuals might be willing to trade the protections conferred by employment laws in exchange for an

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> Past IRS data have shown that independent contractors report 97 percent of the income that appears on information returns, while contractors that do not receive these returns report only 83 percent of income.

GAO, *Making Significant Progress in Improving Tax Compliance Rests on Enhancing Current IRS Techniques and Adopting New Legislative Actions*, GAO-06-453T (Feb. 15, 2006); accord, GAO, *Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches*, GAO-06-1000T (Washington, D.C. July 26, 2006).

[5] Introduced on September 12, 2007, by Senator Barack Obama (D-Ill).

[6] Introduced on April 15, 2008, by Ways and Means Committee Member Jim McDermott (D-Wash).

[7] Introduced on May 22, 2008, by Representative Rob Andrews (D-NJ), Chairman of the Subcommittee on Health, Employment, Labor and Pensions of the House Committee on Education and Labor.

opportunity to pursue the development of their own business. Once the question is properly framed to take into account the individual-choice perspective, it becomes evident that the question of *fairness* is not one for the government, but rather is most appropriately answered by each individual when he or she decides whether to seek a job or pursue self-employment. An individual who eschews a job in favor of pursuing self employment has expressed a clear decision, namely, that the loss of employment-law protections is a *fair* price to pay for the freedom to build one's own business.

Finally, it is important to appreciate that self-employed service providers are a type of small business. Small business is one of the most vibrant sectors of our economy, supplying innovation, job creation, and economic growth. As economist Akbar Sadeghi recently observed:

> The role of entrepreneurs in the American economy is legendary. One of the unique characteristics of the U.S. economic system is the freedom to start a business relatively easily and quickly. Indeed, one of the engines of growth is the employment and wages generated by new businesses.[8]
>
> …
>
> New businesses go through difference phases. A new business often starts with an idea in the mind of an entrepreneur, then emerges in a home office setting with only the founder or founders as employees, and finally reaches the point at which it hires additional labor.[9]

Over half of the employment in the country comes from firms with less than 500 employees, according to the *2007 Report to the President*[10] by the Office of Advocacy for the Small Business Administration. In addition, all net new job creation comes from small business. By contrast, those businesses with over 500 employees are responsible for a net job loss.[11] That certainly continues to be true in our current recession. The following is taken from Office of Advocacy's report:

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[8] Akbar Sadeghi, *The births and deaths of business establishments in the United States*, Monthly Labor Review, Vol. 131, No. 12 (Dec. 2008) at p. 3.

[9] *Id.* at p. 5.

[10] *The Small Business Economy: A Report to the President,* Office of Advocacy of the U.S. Small Business Administration (December 2006) (hereinafter, the "2007 SBA Report").

[11] According to the 2007 SBA Report:

> In 2004, the most recent year for which firm size data are available, small firms with fewer than 500 employees accounted for all of the net new jobs. According to the U.S. Department of Commerce, Bureau of the Census, firms with fewer than 500 employees had a net gain of 1.86 million new jobs, while large firms with 500 or more employees had a net loss of 181,000 jobs. Small firms employed just over half of the private sector work force and generated more than half of nonfarm private gross domestic product. More than 99 percent of American businesses are small, and the average small employer had one location and 10 employees, compared with 62 locations and 3,313 employees in the average large business.

Id. at p. 1.

> First, Kathryn Kobe of Economic Consulting Services reconfirmed our knowledge that *small businesses account for half of private, nonfarm gross domestic product*. Second, Donald Bruce, John A. Deskins, Brian C. Hill, and Jonathon C. Rork find that *a state's ability to generate new establishments is the most important factor that leads to higher gross state product, state personal income, and total state employment*. Finally, Larry Plummer, a doctoral student at the University of Colorado at Boulder who served as a visiting research economist in this office, found that *new business entrants provide long-term benefits to the local economy*; the increased competition might be painful in the short term, but with time, collaborative efforts accrue to everyone's betterment.[12]

(Emphasis added.)

The certainty that Section 530 provides enables companies and self-employed service providers – the quintessential small business persons – to enter into business relationships that they know will be respected for federal employment-tax purposes. A certain and predictable regulatory environment for independent contractors inures to the benefit of self-employed service providers, the companies that purchase their services and our nation's economy overall.

This paper seeks to explain why Section 530 – and especially the *prospective* protection it provides – is so critical to independent contractors and to the companies with which they do business, and how the Form 1099 reporting requirement of Section 530 operates to enhance tax compliance among covered service providers. It also discusses a likely market reaction to a repeal of Section 530 and how that reaction would create a far less favorable environment than the *status quo*. An overview of the legislative history accompanying the enactment of Section 530 demonstrates that the provision was not enacted precipitously, but only after considerable thought and deliberation. That overview is followed by a discussion of court decisions demonstrating that Section 530 contains ample safeguards to appropriately limit its safe-harbor protections to truly deserving taxpayers, and to protect the provision against taxpayer abuse. The paper concludes with an observation that Section 530 is achieving its intended purpose by creating tax certainty for deserving businesses and independent contractors, and that there is no justification for any change to Section 530 at this time.

I. Repealing Section 530 is an Ineffective Strategy for Reducing the Tax

In recent years the Congress has become increasingly concerned about what is known as the *tax gap*, defined generally as "the difference between what taxpayers timely and accurately pay in taxes and what they should pay under the law."[13] GAO studies estimate that the gross tax gap for tax year 2001 was $345 billion, and that $68 billion was represented by sole-proprietor income.[14] While sole proprietors appear to represent a material component

[12] Id. at p. iii.

[13] GAO, *Multiple Strategies, Better Compliance Data, and Long-Term Goals are needed to Improve Taxpayer Compliance,* GAO-06-208T (Washington, D.C.: Oct. 26, 2005).

[14] GAO, *Using Data from the Internal Revenue Service's National Research Program to Identify Potential Opportunities to Reduce the Tax Gap*, GAO-07-423R (Washington, D.C.: Mar. 15, 2007).

of the tax gap, another critical factor is the effect of information reporting on tax compliance. The GAO reported that in cases of *substantial information reporting and withholding*, 1.2% of net income is misreported, and in cases of *substantial information reporting* the percentage increases slightly to 4.5%, but where there is *little or no information reporting*, the percentage of net income misreported spikes to 53.9%.[15] Moreover, as noted above, the compliance rate for income reported on a Form 1099 is 97%.[16] These data suggest that while sole proprietors do account for a material portion of the tax gap, all sole proprietors are not equal contributors. Those whose income is reported on Forms 1099 are *not* material contributors to the tax gap; the principal contributors are instead those whose income is not reported.

It follows that any strategy for reducing the tax gap that targets sole proprietors whose income is currently reported on Forms 1099 – such as those covered by Section 530 – is misguided and even counterproductive, as it penalizes currently compliant taxpayers while leaving untouched the noncompliant. Because Form 1099 compliance is an essential condition of Section 530 eligibility, Section 530 operates as a powerful incentive for companies to comply with the Form 1099 reporting requirements that apply to payments made to independent contractors.

A repeal of Section 530 could result in companies that currently qualify for Section 530 protection becoming less vigilant in ensuring compliance with the Form 1099 requirements, since the Section 530 benefits of fastidious compliance would no longer exist. Moreover, a repeal could also result in newly established companies electing to "fly under the radar" by not issuing any Forms 1099, since there no longer would be any Section 530 incentive to do so. Finally, as discussed below in Section V, if independent contractors were to react by establishing their own corporations, their fees would no longer be reportable on Forms 1099-MISC.

The foregoing demonstrates that any asserted justification for repealing Section 530 that is premised on the *tax gap* is flatly belied by the government's own data. The independent contractors who would be affected are already 97% compliant. It follows that the likely effect on the tax gap of a repeal of Section 530 would be either negligible or possibly a widening of the gap due to the resulting decline in information reporting.

II. Preserving Section 530 is Critical for Business

Why is Section 530 so important? There are many companies whose entire business model is predicated on their ability to enter into hundreds, sometimes thousands or tens of thousands, of engagements throughout a year with self-employed service providers. Some of these firms outsource critical projects to persons with exceptional talents in narrow subject areas,[17] while others function as market facilitators that bring together buyers and freelance sellers of a certain type of service[18] or engage self-employed commissioned sales

[15] GAO, *Opportunities Exist to Reduce the Tax Gap Using a Variety of Approaches,* GAO-06-1000T (Washington, D.C.: July 26, 2006).

[16] *See,* above, note 4.

[17] In many cases, these service providers insist on working freelance because they do not want to work exclusively for any company. They need exposure to a wide array of clients in order to keep their skills sharp. Likewise, the client company may have only a very discrete need for the services of such a professional and it would make no business sense for the company to hire an employee for such a limited purpose.

[18] Market facilitators, commonly known as brokers or registries, represent self-employed service providers and help match them with potential client opportunities. These firms generally conduct a background-screening and

professionals to solicit sales of the company's products and services.[19] One common bond shared by many of these companies is that they rely on the protections provided by Section 530 to ensure that their relationships with independent contractors will be respected for federal employment-tax purposes.

While these are only a few examples of the types of businesses that rely on the certainty that Section 530 provides, they exemplify the large numbers of businesses that have very legitimate needs for entering into independent-contractor relationships. These firms contract with independent contractors for reasons of business necessity, not tax planning. It is critical for these businesses that their relationships with self-employed service providers be respected over the long term, as they need this certainly to appropriately plan for the future. The viability of their business model might depend on their ability to contract with certain types of freelance service providers, and they might need the certainly that those relationships will be respected for federal employment-tax purposes in order to convince investors to provide the outside capital they require to fund their operations. Likewise, if the owners of these companies hope to one day sell their company, the prospective buyers will want to know how certain the company is that its independent-contractor relationships will be respected. The degree of certainty on this issue can materially affect the sales price for these types of businesses.

Section 530 also enables these businesses to make capital investments that are premised on future viability. For example, these businesses are willing to invest substantial amounts in computer technologies and personnel that require several years of operations for the investment to be profitable. If such firms were exposed to an ongoing risk that IRS at any time could reclassify the independent contractors to employees of the firm, substantial capital investments would seldom be prudent because of the looming uncertainty as to whether the business would be able to continue operating for the requisite number of years for the investment to be pay off.

For example, consider what actually happened to one firm that functions as a registry/broker for self-employed service providers and relies on outside capital to finance its current operations. Shortly after the introduction of S. 2044[20] in the 110th Congress, the firm, which enjoys Section 530 protection, was advised by its principal lender that it would cease

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credential-verification protocol for all service providers before agreeing to represent them, but remain in all respects detached from the actual delivery of services. All service-delivery issues are strictly between the service provider and the service recipient.

19 The decision whether to operate with sales professionals who are employees or independent contractors is generally a philosophical one, in that a company that believes it knows the best way to sell will operate with employees, so the company can train the sales professionals to sell in a manner that the company believes is most effective; while a company that believes the best way to get its products sold is to unleash the entrepreneurial zeal of motivated sales professionals will operate with independent contractors. The independent-contractor sales professionals are typically compensated purely on commissions; they "eat what they kill."

20 The *Independent Contractor Proper Classification Act of 2007* (S. 2044), was introduced on September 12, 2007, by Sen. Barack Obama (D-Ill). Initial cosponsors include fellow Illinois Senator Richard Durbin (D-Ill) and Senators Ted Kennedy (D-Mass) and Patty Murray (D-Wash). The bill would tighten the eligibility criteria for Section 530 and completely eliminate any *prospective* protection that Section 530 currently provides. This change would expose a taxpayer to the threat of a prospective reclassification of covered workers to employee status for federal employment-tax purposes – at any time, and regardless of whether the IRS has previously audited the taxpayer on the specific issue of worker classification. A companion bill, H.R. 5804, the *Taxpayer Responsibility, Accountability, and Consistency Act of 2008* was introduced in the House of Representatives, on April 15, 2008, by Ways and Means Committee Member Jim McDermott (D-WA).

lending any funds if S. 2044 were enacted. The lender explained that it was concerned that the bill would eliminate the current-law certainty that the firm's business model will remain viable in the future, and it needs that prospective certainty in order to have a reasonable assurance that the loans will be repaid. This particular firm reported that if it lost that funding it would go out of business. The firm happens to be one of the largest firms of its type in the region in which it operates. One could properly infer from this real-life incident what a repeal of Section 530, or its *prospective protections*, would mean to the firm's smaller competitors and other types of firms whose business models are predicated on independent-contractor relationship and rely on outside capital to finance their operations.

Also, consider the founder of such a firm that devotes his or her life's passion into building a solid business, only to remain in constant fear that any day the IRS could show up at the company and destroy the business model by reclassifying all of the service providers with whom the company does business as company employees. If Section 530 were repealed, or its *prospective* protection eliminated, the company would be exposed to this continuing threat each and every day of its existence, and regardless of whether IRS had previously advised the company that the service providers are properly classified as independent contractors.[21] This is not merely a theoretical risk, as repetitive IRS examinations of the same companies on worker-classification issues are precisely what led the Congress to enact Section 530.[22]

The elimination of employment-tax certainty that Section 530 provides could have far-reaching adverse consequences to companies that currently rely on that certainty. For some, the elimination of that certainty would drive the company out of business, due to a drying up of essential outside capital, while for others the chronic day-to-day risk of one day having a viable business, and the next day not, would be intolerable and the principals themselves would decide to close down. For owners seeking to sell such a business, the value of their business would be materially reduced without the employment-tax certainty that Section 530 provides.

An option for companies whose business model is not predicated on independent contractors is to simply stop doing business with self-employed service providers.[23]

III. Preserving Section 530 is Critical for Self-Employed Service Providers

The certainty that Section 530 provides is at least as important to self-employed service providers, because the companies that need that certainty in order to do business with independent contractors are their clients! A very large percentage of entrepreneurs starting new businesses begin as independent contractors. Starting a new business is fraught with extraordinary risk as evidenced by the high percentage of failure.[24] Placing another obstacle in the road to new business formation will further curtail a segment of the economy that could play a material role in extricating us from our current economic contraction.

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[21] Both S. 2044 and H.R. 5804 would permit the IRS to *prospectively* reclassify workers to employee status even if the IRS had previously examined the workers and affirmed their proper classification as independent contractors.

[22] See, below, the discussion in Part IV.

[23] A discussion of how companies would likely accomplish this is provided below in Section V.

[24] Bureau of Labor Statistics data indicate that for new business formations during the second quarter 1988, 34% failed within two years and 56% failed within four years. *See,* Amy Knaup, *Survival and longevity in the Business Employment Dynamics data*, Monthly Labor Review, 51, 52 (May 2005).

When large companies reduce their operations and lay off seasoned and experienced workers[25] the only alternative for many is self employment. These people may have liabilities that make it very difficult to find an employment position. Because of age, health issues, income history, family situation or a narrow field of expertise, these workers often find themselves unemployable. These circumstances are often the unstated reasons why finding employment is difficult for this population of workers. Working as an independent contractor can provide the only viable alternative for these highly skilled, yet economically vulnerable, members of our society that find themselves without a job as large corporations downsize.

In light of our current economy we should be looking for ways to make it easier for these individuals to start and operate businesses. Repealing the protections offered by Section 530 would do the opposite; it would exacerbate the problems these individuals face in finding service opportunities.

It is important to appreciate that self-employed service providers often compete head-to-head for business with larger firms that operate in the form of a corporation, partnership or limited liability company. If the regulatory risk to potential clients of doing business with sole proprietors becomes too high, potential clients will become less willing to do business with sole proprietors. If that were to occur, sole proprietors would find it increasingly difficult to sell their services.

Consider, for example, a renowned financial expert in an esoteric subject matter who recently lost her high-paying job because the large bank where she worked closed her department. After applying for jobs at various firms with no success, she decides to strike out on her own as an independent financial consultant. Because of her reputation in the industry, she receives many leads to potential service opportunities. If she were to submit a proposal for a project that requires her specialized knowledge, and discover that a financial consulting firm has also submitted a proposal for that same project, she would appropriately expect the two proposals to be evaluated on their merits. That would not occur if the potential client were overly concerned about her being reclassified as its employee. If the potential client qualifies for Section 530 protection with respect to her, it would have no such concerns and could evaluate the two proposals strictly on merit.[26] If that Section 530 protection were lost, she would be materially disadvantaged.

An overview of the dynamics of another industry illustrates why individuals even in lower-paying industries also cherish their right to offer their services as independent contractors, and how an abridgement of that right, *e.g.,* by scaring away companies from doing business with independent contractors, can inflict serious damage on their financial

[25] The Bureau of Labor Statistics reported on February 6, 2009, that nonfarm payroll employment in January fell by 598,000 and that the unemployment rate reached 7.6 percent. *See*, www.bls.gov/news.release/pdf/empsit.pdf.

[26] When a company has Section 530 protection, self-employed service providers are on a level playing field with a larger incorporated business when offering their services to the company, because a Section 530 protected company has zero risk that IRS will re-characterize self-employed service provides as its employees and hold it liable for federal employment taxes with respect to the fees it paid such service provider. When a company does not have Section 530 protection, the risk is almost always higher than zero, even in cases of overwhelming evidence of an independent-contractor relationship. Also, for a Section 530 protected company, the expense and burden of defending against an IRS inquiry into the status of service providers is far preferable because of the Section 530 requirements are more objective and less subject to debate than the twenty factor common-law test, so it generally is much more efficient to prevail quicker in an IRS inquiry when a company can demonstrate Section 530 protection.

livelihood as well. The industry is home care; the individuals are home-care providers. In this industry, the independent-contractor model offers home-care providers an escape from an otherwise bleak economic circumstance.

Home care providers have three fundamental service opportunities, namely, working as an employee of a facility, working as an employee of a home-care agency or marketing their services to consumers directly as freelance, independent-contractor care providers. For each of these options, the demand for home-care providers exceeds the supply.[27] It is an industry in which home-care providers truly exercise their individual choice by selecting the context in which they wish to work. For those who choose not to work at a facility, their options are to work either as an employee of a home-care agency or as a freelance care provider. Freelance care providers commonly market their services to consumers directly and/or through a caregiver registry.[28] Most commonly, they market their services through caregiver registries, because the consumers who seek home care are disaggregated and difficult to identify.[29]

For the past several years, employee-based home-care agencies have been engaged in letter-writing campaigns to the IRS complaining that a caregiver registry that helps freelance care providers market their services to consumers should be treated as the care providers' employer. These agencies also have pursued legislative campaigns aimed at convincing state legislatures to enact laws that effectively regulate caregiver registries out of business. The agencies argue that they seek a "level playing field."

Why do home-care agencies do this? It appears that they do this because they dislike the competition of independent-contractor care providers. The "level playing field" they appear to seek is one from which all competition has been eliminated. The home-care agencies understand that it is extremely difficult for freelance care providers to effectively market their services to consumers while also performing services for their existing clients, and that without caregiver registries the freelance option for many care providers would be infeasible. If home-care providers were denied the independent-contractor option, their only remaining option – other than working at a facility – would be to work as an employee of a home-care agency. The reality is that freelance, independent contractors commonly charge consumers less than home-care agencies and the independent-contractor care providers make

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[27] *E.g., A Workforce to Care for Our Aging*, Genworth Financial (April. 29, 2008) http://www.genworth.com/content/etc/medialib/genworth/us/en/Long_Term_Care.Par.85289.File.dat/45452_Workforce.pdf ("There is a gap between those who need and will need [long-term] care and those who are and will be available to provide it.") at p. 3 ("There is a shortage of long term caregivers; we need to recruit 200,000 new direct-care workers each year to meet future demand.") at p. 4.

[28] A caregiver registry operates strictly as a broker; it creates a marketplace that brings together buyers and sellers of home-care services, were the buyers are consumers or facilities and the sellers are self-employed home-care providers. The self-employed home-care provider performs services for the buyer and is paid by the buyer. The registry is neither a provider nor a recipient of any home care services; nor is it the payor of any compensation to the care provider.

[29] A registry makes the market for home care operate more efficiently by creating a marketplace through which consumers can be introduced to pre-background-screened, pre-credential-verified freelance care providers who meet the criteria that a consumer specifies. Without a registry, freelance care providers would need to devote an inordinate amount of time to marketing, trying to identify consumers who seek their services. Because the time spent marketing is not remunerative, a caregiver's earnings can be much higher by engaging a registry to identify client opportunities and devoting all available time to performing remunerative client service.

more money than their colleagues who work as employees of agencies (because registries typically charge a relatively nominal fee for their services).[30]

If the independent-contractor option for home-care providers were eliminated, the employee-based home-care agencies would be the clear "winners," as they could then increase their profits by raising prices to consumers and paying care providers less. The "losers" would be the consumers who would be forced to pay higher prices for home care, and the care providers whose earnings would be dictated by their agency employer. Because care providers would no longer have the option of offering their services as independent contractors, they would no longer have any avenue of escape from the wages offered by an agency. The microcosm of home care illustrates how denying an individual the opportunity to work as an independent contractor can inflict serious economic damage even on self-employed service providers in lower-paid industries.

A repeal of the tax certainty that Section 530 provides would cause unimaginable market disruption for self-employed service providers of all types. To be sure, the principal losers would be the individuals who currently offer their services as independent contractors. They would find fewer and fewer potential buyers for their services. In many cases, the victim will be an individual who has been pursuing his or her entrepreneurial dream but finds that dream taken away. The individual would be left to find a job at a time of rising national unemployment. When that person is trying to support a family, make mortgage payments and pay college tuition, the impact is especially devastating.

IV. The *Prospective* Protection of Section 530 is Vital

The principal value of Section 530 is its *prospective* protection: the certainty it provides a business that its contracts with independent contractors will *always* be respected for federal employment-tax purposes. Any company whose business model is predicated on independent-contractor relationships *needs* this certainty in order to plan effectively for the future and create long-term value. This need for prospective certainly is not merely theoretical. The IRS has a long institutional history of inconsistently applying the test for distinguishing employees from independent contractors.

There are too many instances of IRS first assuring a company that its treatment of workers as independent contractors is appropriate, only to later reverse itself and reclassify those workers to employee status. In this regard, the court in *Institute for Resource Management, Inc. v. United States*, 22 Cl. Ct. 114, 90-2 U.S. Tax Cas. ¶50,586; 66 A.F.T.R.2d 5957, 1990 U.S. Cl. Ct. LEXIS 464 (Cl. Ct. 1990), observed that:

> Many employers who had previously successfully treated their workers as independent contractors were suddenly told by IRS that these workers were in fact employees, resulting in unanticipated assessments that the taxpayers were often unable to meet. *See* Staff of Joint Committee on Taxation, 95th Cong.,

[30] The existence of independent-contractor home-care providers increases competition, by imposing downward pressure on prices charged to consumers for home care and upward pressure on wages an agency must pay caregivers, in order to compete with the fees a caregiver can earn by working as an independent-contractor.

> 2d Sess., General Explanation of the Revenue Act of 1978, at 300 (Comm. Print 1979).[31]

Similarly, in *Henry v. United States,* 793 F.2d 289, 1986 U.S. App. LEXIS 20095, 86-2 U.S. Tax Cas. ¶9512, 58 A.F.T.R.2d 5144 (Fed. Cir. App. 1986) – which involves facts that predate the enactment of Section 530 – the court found that in April 1974, an IRS representative informed the taxpayer that it need not pay FICA or FUTA payroll taxes on the workers it brokered, because they were independent contractors. Relying on that IRS advice, the taxpayer continued treating the workers as independent contractors and reporting their compensation on Forms 1099.

In mid-1975, the IRS conducted a payroll-tax audit of that same taxpayer and, this time, reclassified the workers as employees and assessed FICA and FUTA taxes against the taxpayer. Because the failure to pay the taxes was in reliance the prior IRS determination, IRS did not impose a penalty. The taxpayer paid the taxes, ceased doing business and sold its assets. Thus, the denouement for this company – after conflicting IRS determinations ultimately repudiated its business model – was to cease operations. If S. 2044 or H.R. 5804 were enacted, this could happen again, as both those bills would eliminate any *prospective* protection under Section 530.

It is submitted that a regulatory environment in which companies operate with constant fear of their relationships with self-employed service providers being repudiated at any time – irrespective of whether the IRS had previously found such relationships to be proper – is not desirable and certainly does not promote economic efficiency. Companies seeking to comply with the law should be able to conduct their business operations with a reasonable degree of certainty that the operations are legally compliant. Section 530 was enacted to achieve that regulatory certainty.

Even after Section 530's enactment, the court in *In re Compass Marine Corporation* 146 B.R. 138, 1992 Bankr. LEXIS 1290 (Bankr. E.D. Pa. 1992), expressed concern about the doctrinaire zeal with which IRS continued to pursue reclassifications of workers treated as independent contractors. In that case, the court offered the following observation:

> It is somewhat disturbing to us to observe the selective enforcement of the IRC requirements for classification of employees, which [IRS Agent John] Gilbert himself conceded in his admission that his own wife was probably improperly classified by her employer. We also were disturbed by the suggestion that Gilbert prides himself as somewhat of a *crusader on this issue*. It is perhaps in recognition of the harshness of enforcement of these IRC requirements on the

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[31] See, also, *Ridgewell's, Inc. v. United States*, 228 Ct. Cl. 393, 655 F.2d 1098, 1981 U.S. Ct. Cl. LEXIS 407, 81-2 U.S. Tax Cas. ¶ 9583, 48 A.F.T.R.2d 5673 (Ct. Cl. 1981), wherein the court explained that:

> Section 530 was aimed at controversies between taxpayers and the IRS as to whether certain individuals had the status of employees of the taxpayers. In the late 1960's, the IRS increased its enforcement of the employment tax laws. This led to many controversies with taxpayers when IRS proposed to reclassify individuals from independent contractor status to employee status and the taxpayers complained that *the reclassifications involved changes in IRS's position on how the common law rules applied to particular individuals*. (Emphasis added.)

> unfortunate targets of IRS enforcement that Congress has enacted Section 530 as an "out" for certain employers.

146 B.R. at 155. (Emphasis added).

For many taxpayers, Section 530 provides the only certain protection against an IRS *crusader* on the worker-misclassification issue. And, Section 530 is not the only safe-harbor protection that exists. Congress has enacted several safe-harbor provisions[32] that provide affected companies with similar certainty in their treatment of individuals as independent contractors. All of these safe-harbor provisions were enacted for the same purpose, namely, to enable eligible companies to operate their respective business models with a view toward the long term, with confidence that their business model will remain viable on a permanent basis.[33]

It is important to emphasize that there is no contention at this time that IRS is anything other than highly objective in its enforcement of the law governing worker-classification for federal tax purposes. In fact, that is one important argument in favor of preserving the *status quo*, as the existence of Section 530 might well be a significant influence on the IRS's approach to the issue. If Section 530 were repealed, there is a risk that taxpayers could find themselves, once again, in an environment of uncertainty, with no guarantee from one day to the next whether their business model will be viable. For companies whose business model is predicated on doing business with independent contractors, that risk is too high.

Another dimension to the value of the *prospective* certainty that Section 530 provides is the reduced cost and administrative burden a company derives by being able to defend against repeated IRS challenges by relying on Section 530 protection. Without Section 530, a company needs to separately defend against each and every IRS challenge based on the common-law test, which is both subjective and fact specific and – as demonstrated by the decision in *Henry* – is vulnerable to inconsistent determinations. The time, burden and cost of asserting a separate common-law defense against each successive IRS examination can be substantial. By contrast, a company that qualifies for Section 530 protection need only demonstrate that it satisfies the Section 530 criteria.

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[32] *See,* Internal Revenue Code section 3508, protecting certain Realtors, direct sellers and newspaper distributors, and Internal Revenue Code section 3506 protecting certain companion sitting placement businesses.

[33] There is little reason to believe that IRS enforcement of worker-classifications issues would not revert to the pre-Section 530 era if Section 530 were repealed or otherwise eviscerated. While currently IRS is highly objective and evenhanded in its approach to worker-classification matters, it is submitted that the existence of Section 530 might well be a significant reason for that. To be sure, recent evidence suggests some degree of pent up energy at IRS to reclassify. In November 2007, the Internal Revenue Service announced in IR-2007-184, *IRS and States to Share Employment Tax Examination Results* (Nov. 6, 2007) and FS-2007-25, *Information on the Questionable Employment Tax Practices Memorandum of Understanding* (November 2007), a "collaborative, nationwide program" – with the National Association of State Workforce Agencies, the U.S. Department of Labor, the Federation of Tax Administrators and the state workforce agencies for 29 states – to focus on *Questionable Employment Tax Practices* ("QETP"). One of the explicit goals of this program is to seek consistent classifications of workers, as employees or independent contractors, for purposes of federal employment taxes and state unemployment taxes, even though the test for employee status for purposes of state unemployment taxes is significantly broader in scope than the federal test. Other stated goals of this program are equally distressing, *e.g.,* of pursuing a "nationwide standardization" and creating a "level playing field," as these objectives appear aimed at denying businesses the opportunity to outsource a type of services if a competitor provides a similar type of service with its own employees.

As the foregoing demonstrates, the *prospective* protection that Section 530 offers is the essence of Section 530. Without that protection, the value of Section 530 is negligible. As the *Henry* decision illustrates, the business model under which a company operates is the very essence of the company. Once that business model is repudiated, as happened in *Henry,* the company no longer operates the same business, and in many cases it will react by closing down. The *prospective* protection of Section 530 is what enables a company whose operations are predicated on an independent-contractor-based business model to plan for the future, raise essential outside capital and create long-term value.

V. The Likely Market Reaction to Repeal of Section 530 is Not Appealing

It is submitted that the likely market reaction to a paradigm in which the *prospective* protection of Section 530 no longer exists would be for many client companies to cease doing business with self-employed service providers and instead encourage them to either become "employees" of a third-party firm or establish their own corporate identity.

A case study already exists of what happens when self-employed service providers are forced to become employees of third-party firms. That is precisely what occurred in the market for government-funded home-care services in the aftermath of the federal government advising state agencies that administer federally funded home-care programs that home-care providers should not be allowed to operate as independent contractors for federal employment-tax purposes. The advice resulted in many government-funded home-care programs requiring home-care providers to be treated as employees of either a third-party firm or the elderly or infirm individuals who receive their care.

The National Taxpayer Advocate reported in her *2007 Annual Report to Congress* that the government-funded programs that have forced freelance home-care providers into "employment" relationships for federal-tax purposes with third-party firms have been disastrous for all concerned.[34] The model has produced immense tax-compliance problems for all affected parties. It also created a new permanent and unnecessary transaction charge that diverts finite program funds away from their intended purpose, in this case, of providing home care for a vulnerable population so they can remain independent. The transaction charge is imposed by a burgeoning cottage industry of third-party firms that function as the "employer" of record for home-care providers. The fees these firms charge have the effect of increasing the unit cost of home-care delivery with no corresponding increase in the amount or quality of care.

Extrapolating this experience to the broad national economy paints a bleak picture. If self-employed service providers are forced to operate as "employees" of third-party firms, the cost of their services to potential clients will necessarily increase, due to the administrative fees the third-party firms charge to administer the arrangements. This necessarily would make the self-employed service providers more expensive and less competitive, while their

[34] The effect of the advice in some states has been to force all parties to Medicaid-funded home-care arrangements into artificial and arbitrarily established employment relationships. Theretofore self-employed care providers were required to work as employees of the care recipient or of an intermediary service organization ("ISO") in order to participate in government-funded programs. The National Taxpayer Advocate ("NTA") describes in its *2007 Annual Report to Congress*, rampant confusion and mistakes by ISOs that have resulted in care recipients being assessed back taxes and interest and having tax liens filed against them and collection actions asserted against their assets – for employment taxes owed with respect to the remuneration paid to care providers by government programs. *See, National Taxpayer Advocate 2007 Annual Report to Congress,* at pp. 359 – 363.

net earnings would remain the same or decline. The principal beneficiaries would be the third-party firms that administer the arrangements. These firms provide the client company no added value except protection against a regulatory risk. The end result would be to make the market even less efficient for affected service providers – an especially ill-advised objective during the current economic conditions.

From a tax-administration perspective, a new paradigm in which freelance service providers operate as *de facto* employees of third-party firms is *not* one the IRS should desire. While two-party relationships can present vexing federal employment-tax controversies, those controversies pale in complexity alongside three-party arrangements, to which Internal Revenue Code section 3401(d)(1) can apply.[35] In three-party arrangements, the establishment of a common-law employment relationship is only a threshold inquiry. The next inquiry can be even more factually complex and legally uncertain, namely, determining whether the service recipient or the third-party firm is statutorily liable for the employment taxes at issue. A long line of court decisions and IRS rulings have firmly established that the mere fact that a third party disburses "wages" to a worker does not necessarily mean that the third party, as opposed to the service recipient, is liable for the corresponding federal employment-taxes.[36] It follows that if independent contractors were to enter into relationships with "third-party employers" the government could well find itself immersed in a tsunami of disputes and litigation over which party – in a three-party arrangement – is liable for unpaid or delinquent employment taxes and corresponding penalties and interest.

The other likely consequence of Section 530's repeal is that self-employed service providers would establish corporations. This outcome is no more desirable, as it would provide the parties far less employment-tax certainty than Section 530,[37] and would likely

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[35] The application of Internal Revenue Code section 3401(d)(1) is illustrated by the following example. If a worker performs services for business X as a common-law employee of business X, but business Y is determined to have *control of the payment* of wages to the worker, the federal employment-tax obligations that apply to the wages paid the worker are imposed on business Y, not the common-law employer, business X. *See, e.g.*, Priv. Ltr. Rul. 8328104 (April 15, 1983) (wherein an employee leasing firm was determined to be the employer, for purposes of FICA and FUTA taxes and federal income-tax withholding, with respect to workers who the leasing firm hired to perform services for its clients).

[36] *See, e.g.,* Chief Counsel Advice ("CCA") 200415008 (April 9, 2004), wherein IRS's Office of Chief Counsel stated that for purposes of determining whether a PEO (or employee leasing firm) is the statutory employer of the leased employees under Code section 3401(d)(1), the IRS position is that a PEO is not in *control of a payment* of wages if its payment of the wages is contingent upon, or proximately related to, it having first received the funds to effect the payment. In G.C.A. 199932002 (August 13, 1999), IRS concluded that a PEO could not be liable for failing to deposit employment taxes on a timely basis with respect to leased employees, because the leasing firm was not the workers' employer for federal employment-tax purposes. The ruling involved an employee leasing firm that specialized in supplying small and medium-sized employers with comprehensive human resource, insurance and other related services. The firm paid and withheld applicable payroll taxes on all wages paid the workers under its own employer identification number. According to the ruling, the leasing firm neglected to deposit the taxes on a timely basis, which resulted in the IRS assessing a penalty against the firm for such failures. The IRS National Office concluded that the penalties could not be imposed on the leasing firm because it was not the workers' employer. It reasoned that the leasing firm was not the common-law employer of the workers and did not *control the payment* of the workers' wages under Code section 3401(d)(1). In Priv. Ltr. Rul. 9340029 (July 2, 1993) the IRS considered a worker who performed services for a university while being paid by another firm. The IRS ruled that the worker was an employee of the university under the common law test. IRS also ruled, however, that because the worker was required to submit to the other business a time report each month, and was paid an hourly wage by the other business, the other business had *control of the payment* of wages to the worker. Consequently, the IRS determined that the other business was responsible for the employments taxes owed with respect to the wages paid the worker.

[37] The efficacy of a corporation for protecting a client company against potential federal employment-tax liabilities with respect to fees paid to incorporated service providers depends upon the specific facts. *See., e.g.,*

eliminate from the marketplace those individuals who would otherwise offer their freelance services on a sporadic or part-time basis, because the added cost and administrative burden of establishing and maintaining a corporation would undermine the economic viability of those endeavors. This reaction also would lead to a reduction in tax compliance because payments made to corporations are not subject to information reporting[38] and, as noted, IRS data indicate that the compliance rate for unreported payments is materially less than for reported payments.[39]

The net result of a repeal of Section 530 would be diminished economic activity, an increase in IRS disputes over which taxpayer (in three-party arrangements) is liable for unpaid employment taxes and a reduction in tax compliance. For those independent contractors who opt to become *de facto* employees of third-party firms, the cost for their services would increase, their own net earnings would likely decrease and the IRS would find itself in constant litigation over whether the third-party firm or the service recipient is statutorily liable for unpaid employment taxes. The repeal would also produce the tragic outcome of many part-time or seasonal self-employed service providers closing their business and giving up the family vacation or monthly dinner out that their former freelance activities made possible. To compound the problem, federal tax revenues would likely decline due both to the resulting reduction in economic activity and the reduction in tax compliance associated with payments to those who establish corporations and become exempt from the Form 1099-MISC reporting requirements.[40]

VI. Section 530 Was Enacted After Thoughtful Debate and Deliberation

Section 530 became law following an exhaustive study of a vexing problem for taxpayers created by IRS repeatedly auditing the same taxpayers on worker-classification issues and reaching inconsistent determinations. No company was safe. A company could be audited by IRS for one year and be advised that its treatment of workers as independent contractors was correct, only to find itself audited by IRS again for a subsequent year and the workers reclassified as employees. The fact that IRS had previously determined that the workers were classified properly offered the company no defense. The Congress rightfully determined that such a regulatory environment is not tolerable.

The enactment of Section 530 followed years of study by Congress. As early as 1976, Congress had identified the IRS's handling of worker-classification matters as problematic and asked the IRS to suspend audits pending further study on the matter. The United States Court of Claims, in *Ridgewell's, Inc. v. United States,* 655 F.2d 1098, 1101 (Ct.Cl.1981), offered the following account:

Sargent v. Commissioner, 929 F.2d 1252 (8th Cir. 1991)(corporation effectively protected professional hockey team against potential federal employment-tax liabilities associated with amounts paid to corporation formed by professional hockey player). *Cf., Leavell v. Commissioner,* 104 T.C. 140 (1995) (corporation ignored when payments made to corporation formed by professional basketball player). For a detailed discussion of the long line of court decisions addressing this issue, *see,* Russell A. Hollrah, *Alternate Staffing* at ¶3040 (PJC Publishing, LLC).

[38] *E.g.,* Fact Sheet 2006-23, 2006 IRB LEXIS 463 (Sept. 1, 2006).

[39] *See, supra*, note 3.

[40] It is worth noting that the information reporting dilemma is not easily cured by merely requiring information reporting of all payments made to corporations, as such a requirement would overwhelm IRS with Forms 1099. Developing an appropriately targeted information reporting requirement for corporate payees has thus far proved elusive, as evidenced by the numerous proposals that have been considered and rejected.

> In the late 1960's, the IRS increased its enforcement of the employment tax laws. This led to many controversies with taxpayers when IRS proposed to reclassify individuals from independent contractor status to employee status and the taxpayers complained that the reclassifications involved changes in IRS's position on how the common law rules applied to particular individuals. During the 1976 Tax Reform Act conference, House and Senate conferees requested that IRS "not apply any changed position or any newly stated position in this general subject area to past, as opposed to future taxable years" until the Joint Committee on Taxation had a chance to study the problem.

Subsequently, the Comptroller General of the United States conducted a study involving a sample of over 250 employment-tax cases from the IRS. As a result of the study, a number of recommendations were developed and presented in a report (including the recommendation that safe-harbor legislation would be appropriate) that was circulated among the Department of the Treasury, the Department of Labor and the Department of Justice, all of which had an opportunity to review and comment on the draft report. The report, entitled *Tax Treatment of Employees and Self-Employed Persons by The Internal Revenue Service: Problems and Solutions* (GGD-77-88), was then presented to the Joint Committee on Internal Revenue Taxation on November 21, 1977.

The solution Congress devised, *i.e.,* Section 530, was included in a Senate amendment to a House bill that later became a Conference Agreement that was enacted by the 95th Congress. Even before its inclusion in the Revenue Act of 1978, its safe-harbor provisions had been discussed, studied and vetted by multiple federal agencies.

The House of Representatives passed its version of the bill on August 10, 1978. The bill was then sent to the Senate, where it was the subject of hearings before the Senate Finance Committee. The Revenue Act of 1978 (H.R. 13511 P.L. 95-600) was passed by the Congress on October 15, 1978, and signed into law on November 6, 1978.

VII. Section 530 Requirements are Demanding and Limit Access to Only Deserving Taxpayers

The Section 530 safe harbor was designed to protect only those companies that satisfy the provision's rigorous requirements. By way of background, Section 530 protects a company against the IRS requiring it to reclassify as employees, for federal employment-tax purposes, workers whom the company treats as independent contractors ("covered workers"), provided that:

(1) the company has always consistently treated the covered workers as independent contractors for federal employment-tax purposes,[41] and for all periods beginning after December 31, 1977, the company and any predecessor have consistently treated all other workers holding a *substantially similar position* as independent contractors for federal employment-tax purposes[42] (the "substantive consistency" requirement);

[41] Section 530(a)(1)(A).

[42] Section 530(a)(3).

(2) for the tax year at issue the company has complied with the Form 1099 reporting requirements with respect to the compensation paid to the covered workers[43] (the "Form 1099" requirement); and

(3) the company had a *reasonable basis* for treating the covered workers as independent contractors[44] (the "reasonable basis" requirement).

For these purposes, a *reasonable basis* for treating a covered worker as an independent contractor can be established in any of four ways, namely:

(i) reasonable reliance on specified legal precedent;[45]

(ii) reasonable reliance on a past IRS audit;[46]

(iii) reasonable reliance on a long-standing industry practice;[47] or

(iv) reasonable reliance on a reasonable basis established in some other manner.[48]

An important limitation on the scope of Section 530 was enacted as section 1706 of the Tax Reform Act of 1986.[49] This law added a new subsection (d) to section 530**,** which denies the application of Section 530 with respect to an individual who, pursuant to an arrangement between the taxpayer and another person, provides services for such other person as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work.[50] Section 530(d) applies with respect to remuneration paid and services rendered after December 31, 1986.

As a practical matter, most businesses that qualify for Section 530 protection are those that contract with independent contractors to perform a service that the business, itself, does not provide. This is because of Section 530's *substantive consistency* requirement,[51] which provides generally that a taxpayer cannot qualify for Section 530 protection with respect to workers unless those workers[52] and all other workers who hold a *substantially similar*

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43 Section 530(a)(1)(B).

44 Section 530(a)(1).

45 Section 530(a)(2)(A).

46 Section 530(a)(2)(B).

47 Section 530(a)(2)(C).

48 The legislative history accompanying the enactment of Section 530 and Rev. Proc. 85-18, 1985-1 C.B. 518, makes clear that reasonable basis also can be demonstrated "in some other manner."

49 The provision is colloquially known simply as section 1706, because it was enacted as section 1706 of the Tax Reform Act of 1986.

50 Section 530(d) does not affect the determination of whether the affected workers are employees under the common law rules. Rather, it merely denies Section 530 protection that would otherwise be available to a taxpayer with respect to those workers. *See, e.g.,* Private Letter Ruling 91310106 (Apr. 30, 1991), in which a computer software developer was ruled to be an independent contractor under the common law test; and Private Letter Ruling 91310109 (Aug. 12, 1991), in which a software "debugger" was determined to be an independent contractor.

51 The *substantive consistency* requirement is discussed in detail below in Section VIII.A.

52 The *substantive consistency* requirement with respect to the workers for whom Section 530 protection is claimed must be satisfied for all tax years. Section 530(a)(2)(A).

position[53] have been treated as independent contractors for federal employment-tax purposes. This requirement generally operates to deny a business Section 530 protection with respect to workers who either perform the same types of services that its own employees perform or hold a position that is substantially the same as the positions held by its employees.[54]

Consequently, the *substantive consistency* requirement of Section 530 has the effect of limiting the types of business arrangements that can qualify for Section 530 protection to the following.

- Brokers that (i) introduce self-employed service providers to potential clients, and (ii) provide the logistics and administrative support that enables the service providers to focus exclusively on service delivery. Brokers commonly operate in industries in which the clients and/or the service providers are highly disaggregated and/or geographically dispersed. The broker adds efficiency to these industries by creating a marketplace through which buyers and sellers of a particular type of service can locate each other.

- What once were referred to as "see-through" businesses, which develop ideas and/or concepts and then contract with manufacturers or self-employed service providers to implement and execute the ideas and/or concepts that the business develops. These firms are in the businesses of designing products, developing marketing campaigns or public relations campaigns and creating other types of ideas and/or concepts. Such firms contract with third-party firms or independent contractors to build or manufacture the products or implement or execute the campaigns.

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53 The *substantive consistency* requirement with respect to the other workers who hold a *substantially similar* position must be satisfied for all tax years beginning after 1977. Section 530(a)(3).

54 For tax years beginning after December 31, 1996, the Small Business Job Protection Act of 1996 ("1996 Act") provides that in determining whether workers hold *substantially similar* positions "the relationship of the parties" (*i.e.,* the relationship between the business and the worker) *must* be one of the factors taken into account. The legislative history accompanying the 1996 Act states that the degree of a business's supervision and control of a worker is one consideration to be taken into account in comparing the relationships of a business and workers.

The *IRS Training Guidelines* interpret the 1996 Act changes as follows:

> A *substantially similar* position exists if the job functions, duties, and responsibilities are substantially similar and the control and supervision of those duties and responsibilities are substantially similar.
>
> In addition, section 530(e)(6), added by the Small Business Job Protection Act, states that the determination of whether workers hold *substantially similar* positions requires consideration of the relationship between the taxpayers and those individuals. This includes, but is not limited to, the degree of supervision and control. This statutory change appears to be designed to enable differences in managerial responsibilities and differences in reporting requirements to be taken into account, along with differences in job duties. Presumably, the contractual relationship and the provision of employee benefits are also entitled to some weight.
>
> The determination of what is *substantially similar* work rests on analysis of the facts. The day-to-day services that workers perform, and the methods by which they perform those services, are relevant in determining whether workers treated as independent contractors hold substantially similar positions to workers treated as employees. Comparison of job functions is an important fact. Workers with significantly different, though overlapping, job functions are not substantially similar.

IRS Training Guidelines at 1-9. In practice, it nonetheless remains very difficult in most cases to establish that the positions held by two workers who perform the same type of service are not *substantially similar.*

- Businesses that have *ad hoc* needs for certain types of services which require special expertise that their own personnel do not possess. Such businesses purchase the needed services from specialty service providers. Examples include businesses that engage an accountant to conduct an audit or provide tax advice, an attorney to provide legal advice or representation, a business consultant to help the company develop or implement a business strategy, or a "landman" to identify and lease mineral rights. These specialty service providers include both firms and independent contractors.

- Businesses that contract with self-employed service providers to perform a type of service for which the business has a continuing need, based on a philosophical viewpoint that independent contractors tend to be more entrepreneurial and perform at a higher level than comparable individuals who are hired as employees. Examples include outside sales professionals, marketers and delivery drivers.

- Businesses that contract with self-employed service providers to perform a type of service that is ancillary to a product and/or service that the business provides, but is subject to an unpredictable and volatile client demand and/or requires a special expertise that its own personnel do not possess and/or that is outside its core business. Examples include truck drivers, delivery drivers, securities brokers, health-care professionals, floor-covering installers and construction trades.

Many of these businesses have thousands of separate engagements with independent contractors. Their relationships with the independent contractors are a critical component of their respective business models.

VIII. A Detailed Analysis of the Section 530 Requirements Dispels any Misperception that Section 530 is Easy to Satisfy and Vulnerable to Abuse

The principal requirements of Section 530 are set forth above in Section VII. The following discussion is intended to demonstrate that the Section 530 criteria are sufficiently rigorous to protect against an abusive application of its safe-harbor protections.

A. The Substantive Consistency Requirement

To satisfy the substantive consistency requirement, a company must be able to demonstrate several facts, namely:

- That the company has *always* treated the covered workers as independent contractors for federal employment-tax purposes;

- That for all periods beginning after December 31, 1977, the company has consistently treated all other workers holding a *substantially similar position* as independent contractors; and

- That for all periods beginning after December 31, 1977, any *predecessor* of the company has consistently treated all other workers holding a *substantially similar position* as independent contractors.[55]

The court in *Crowd Management Services, Inc. v. United States,* 889 F. Supp. 1313, 1995 U.S. Dist. LEXIS 5890, 95-1 U.S. Tax Cas. ¶50,260, 75 A.F.T.R.2d 2328 (D. Or. 1995), explained the substantive consistency requirement as follows:

> Congress … included in Section 530 a consistency requirement "to prevent taxpayers from changing the way they treat workers for employment tax purposes solely to take advantage of the relief provisions." H. Rep. No. 95-1748, 95th Cong., 2d Sess. 6 (1978). Pursuant to this provision, an employer does not qualify for relief under Section 530 if he has treated any worker holding a "substantially similar position" as an employee for any period beginning after December 31, 1977. § 530(a)(3).

In *Ewens and Miller, Inc. v. Commissioner*, 117 T.C. 263, 2001 U.S. Tax Ct. LEXIS 53, 117 T.C. No. 22, 82 T.C.M. 4252, the U.S. Tax Court confirmed that a taxpayer's prior treatment of workers as employees *permanently* precludes the taxpayer from ever qualifying for Section 530 protection with respect to such workers or with respect to workers who hold a *substantially similar* position.[56]

As noted, this requirement of Section 530 operates to significantly narrow the scope of relationships that are eligible for safe-harbor protection. The court decisions discussed below illustrate the harshness with which courts have applied the requirement to protect Section 530 from any taxpayer abuse.

1. Zero Tolerance under the Substantive Consistency Requirement

The court in *Institute for Resource Management, Inc. v. United States,* 22 Cl. Ct. 114, 90-2 U.S. Tax Cas. ¶50,586, 66 A.F.T.R.2d 5957, 1990 U.S. Cl. Ct. LEXIS 464 (Cl. Ct. 1990), made clear that there is no *de minimis* exception to the substantive-consistency requirement, and that treating as an employee any worker holding a position substantially similar to a worker with respect to whom Section 530 protection is claimed is fatal to the claim. At issue in *Institute for Resource Management* was a company that provided temporary Health Physics Consultants ("HPCs") to public utilities. It had treated all HPCs as independent contractors for purposes of employment taxes until April 1983, when the company entered into a contract with Consolidated Edison of New York, Inc. ("Con Ed"), which required the company to treat some HPCs as company employees for federal employment-tax purposes. Those were the only HPCs whom the company treated as employees for these purposes, as all remaining HPCs continued to be treated as independent

[55] Two important facts issues that commonly arise under this requirement are (i) whether the position held by one worker is *substantially similar* to the position held by another, and (ii) whether one company is a *predecessor* of another.

[56] *Accord, Railroad Concrete Crosstie Corporation v. United States,* 205 Cl. Ct. 781, 84-2 U.S. Tax Cas. ¶9662, 54 A.F.T.R.2d 5580, 1984 U.S. Cl. Ct. LEXIS 1361 (Cl. Ct. 1984) (noting also that Section 530 applies equally to taxes imposed pursuant to the Railroad Retirement Tax Act, 26 U.S.C. §§ 3201-3233 (the "RRTA"), the court held that a taxpayer's treatment of workers as employees for purposes of FICA and FUTA taxes violates the consistency requirement with respect to and denies Section 530 protection for purposes of RRTA taxes as well).

contractors. IRS examined the company and reclassified the independent-contractor HPCs as employees of the company. The company defended against the reclassification by asserting Section 530 protection, but the court rejected that defense, holding that the company's treatment of the Con Ed HPCs as employees permanently disqualified the company from Section 530 protection with respect to HPCs.

Similarly, in *La Nails, Inc. v. United States,* 1998 U.S. Dist. LEXIS 7733, 98-1 U.S. Tax Cas. ¶50,438, 81 A.F.T.R.2d 2189 (D. Md. 1998), the taxpayer treated just one manicurist as an employee for federal employment-tax purposes and all other manicurists as independent contractors. After IRS reclassified all manicurists as employees of the taxpayer, the taxpayer claimed Section 530 protection. The taxpayer attempted to establish that the position held by the lone employee manicurist was not *substantially similar* to the positions held by all the other manicurists, but the court disagreed and held that the inconsistent treatment – of the one solitary individual – was fatal to the taxpayer's Section 530 claim.

2. ***Substantially Similar*** **Provision Casts a Wide Net**

An illuminating example of just how difficult it is establish two different categories of workers as not *substantially similar* is provided by *Crowd Management Services, Inc. v. United States,* 889 F. Supp. 1313, 1995 U.S. Dist. LEXIS 5890, 95-1 U.S. Tax Cas. ¶50,260, 75 A.F.T.R.2d 2328 (D. Or. 1995). In that case the company attempted to establish that certain security guards whom the company treated as independent contractors commencing in 1982 held positions that are *not* substantially similar to the positions held by security guards whom the company had treated as company employees prior to 1982. The company argued that its supervisors exerted less control over the independent-contractor security guards and that they had more autonomy.

The court reasoned that while the company did establish that its supervisors no longer *exercised* their right to control the details of the independent-contractor security workers' assignments, it failed to establish that the supervisors no longer *possessed the right* of control. The court concluded that no reasonable juror could find that there was a change to this critical factor, and held that the security guards treated as independent contractors after 1982 held a *substantially similar* position to the security guards treated as employees prior to 1982, and that the company was not entitled to relief under Section 530.

Another case illustrating the difficulty of establishing two different groups of individuals who provide a similar type of service as not holding *substantially similar* positions is *Halfhill v. United States*, 927 F. Supp. 171, 1996 U.S. Dist. LEXIS 3769, 96-1 U.S. Tax Cas. (CCH) ¶50,208, 77 A.F.T.R.2d (RIA) 1553 (W.D. Pa. 1996). This case involved a plaintiff who operated a sole proprietorship trucking business. During 1978 and the first half of 1979, the plaintiff's son was the sole truck driver for his business. Although the son's primary duty was to drive the truck, the son also negotiated with carriers regarding future leasing of the company's truck. The plaintiff paid his son a percentage of what the carriers paid to lease the truck, treated him as an employee and issued him Forms W-2. In the middle of 1979, the son left the business and became an employee of another trucking firm. Plaintiff thereafter leased his truck to the same trucking firm that employed his son.

In late 1981, the plaintiff purchased another truck and leased his trucks to different carriers. Beginning in 1982, he engaged his son and other drivers to drive the trucks as independent contractors. All of the drivers had the authority to negotiate leases with carriers and were paid a percentage of what the carriers paid to lease the trucks.

The IRS challenged the plaintiff's treatment of his son and the other drivers as independent contractors, and the plaintiff defended by claiming Section 530 protection. Rejecting that claim, the court held that the plaintiff violated Section 530's substantive consistency requirement based on its determination that the position held by his son in the 1970s as an employee is *substantially similar* to the positions held by all of the drivers in the 1980s. The court concluded that the inconsistent treatment of truck drivers was fatal to the plaintiff's claim for Section 530 protection.

3. Expansive Interpretation of *Predecessor* Restricts Eligibility

A facet of the *substantive consistency* requirement Section 530 that significantly expands its reach for denying safe-harbor protection is the provision that takes into account a taxpayer's *predecessors*. The expansive interpretation of the term *predecessor* for these purposes was illustrated in *In re Critical Care Support Services, Inc.,* 138 B.R. 378, 1992 Bankr. LEXIS 1272 (Bankr. E.D. N.Y. 1992). In this case, a taxpayer's Section 530 claim with respect to its treatment of critical-care nurses as independent contractors was rejected based on a determination that a different company that treated similar workers as employees was the taxpayer's *predecessor* for purposes of Section 530. The court found that the taxpayer's sole owner had owned 80% of a different company that was in a similar business, namely, supplying critical care nurses to hospitals in the New York metropolitan area. The remaining 20% of the other company was owned by his uncle, who was a passive investor. The taxpayer was formed after the other business ceased to operate.

The court held that the other company qualified as the taxpayer's *predecessor* for purposes of Section 530 and, therefore, that the other company's treatment of critical care nurses as employees for federal tax purposes precluded the taxpayer from qualifying for Section 530 protection with respect to its treatment of critical care nurses as independent contractors – even though the two companies operated different types of businesses and the owner of the taxpayer owned only 80% of the other company.

4. The Substantive Consistency Requirement is an Intimidating Gatekeeper

The foregoing demonstrates that the *substantive consistency* requirement operates as a formidable obstacle that denies Section 530 protection to a taxpayer if the taxpayer (or a predecessor) has treated as an employee for federal employment-tax purposes as much as one worker whose position is found to be *substantially similar* to that of the worker at issue.

As noted, the effect of this requirement is to limit Section 530 protection to only certain types of business relationships, and to companies whose business model is predicated on outsourcing the performance of certain types of services. It denies Section 530 protection to any company that has treated a *substantially similar* worker as an employee. Section 530's look-back feature, which also takes into account "predecessors," precludes a taxpayer from engaging in transactions to circumvent the requirement.

B. The Form 1099 Requirement

The Form 1099 requirement is arguably the most straightforward of the Section 530 criteria, as it requires only that a company comply with the Form 1099 reporting requirements that apply with respect to each covered worker. It nonetheless is aggressively enforced. In *Murphy v. United States,* 1993 U.S. Dist. LEXIS 15406, 93-2 U.S. Tax Cas.

¶50,610, 72 A.F.T.R.2d 6698 (W.D. Wis. 1993), for instance, the taxpayer's admission of a failure to file Forms 1099 resulted in the court denying the taxpayer any relief under Section 530.

Similarly, in *Prince Cable, Inc. v. United States,* 1998 U.S. Dist. LEXIS 5981, 98-1 U.S. Tax Cas. ¶50,377, 81 A.F.T.R.2d 1821 (D. De. 1998), a taxpayer claimed that it satisfied Section 530's Form 1099 requirement by submitting to the court copies of all Forms 1099, but not the accompanying Forms 1096.[57] The IRS maintained that its records indicate that the taxpayer submitted Forms 1099 and 1096 for *prior* years, but not for the tax years at issue. Reasoning that the party seeking Section 530 protection has the burden of establishing that it meets all requirements of Section 530, the court concluded that the taxpayer, by providing copies of only the Forms 1099 but not the accompanying Forms 1096, did not satisfy its burden and ergo did not qualify for Section 530 protection.

Courts also have held that filing Forms 1099 late can disqualify a taxpayer from Section 530 protection. In *Bruecher Foundation Services, Inc. v United States,* 484 F. Supp. 2d 600, 2007 U.S. Dist. LEXIS 35156, 99 A.F.T.R.2d 2653 (W.D. Tex. 2007), the IRS contended that the taxpayer was not entitled to Section 530 relief because it did not file Forms 1099 for the workers at issue until two days before filing a lawsuit asserting a Section 530 defense against an IRS reclassification. Based on IRS guidance requiring that Forms 1099 be filed timely,[58] the court held that the taxpayer's filing of Forms 1099 only after the IRS challenged the classification of the workers fails to demonstrate the good faith that Congress sought to require by demanding that a taxpayer file the appropriate tax returns. On that basis, the court denied the taxpayer's claim for Section 530 protection.[59]

These court decisions show that while the Form 1099 requirement is arguably the easiest of Section 530 to satisfy, courts have interpreted the requirement in a manner that it, too, can operate to deny taxpayers protection under Section 530.

C. The Reasonable Basis Requirement

To satisfy the reasonable-basis requirement of Section 530 a company must establish three separate facts, namely:

- a *reasonable basis* for its treatment of the covered worker as an independent contractor for federal employment-tax purposes;
- that it relied upon that *reasonable basis* when it treated the covered worker as an independent contractor; and
- that its reliance on that *reasonable basis* was reasonable.

Reasonable basis can be established by showing that the classification of a worker was in reasonable reliance on any of the following:

- acceptable precedent, Section 530(a)(2)(A);

[57] Forms 1096 are the transmittal forms that must accompany Forms 1099 submitted to the IRS.

[58] *See,* Rev. Rul. 81-224, 1981-2 C.B. 197, and Rev. Proc. 85-18, 1985-1 C.B. 518 n.2.

[59] Compare, *Medical Emergency Care Assoc., S.C. v. Commissioner*, 120 T.C. No. 15 (2003) (holding that in some cases late-filed Forms 1099 can satisfy the Form 1099 requirement of Section 530.

- a prior IRS audit, Section 530(a)(2)(B); or
- industry practice, Section 530(a)(2)(C).

In addition, the legislative history accompanying Section 530 and Rev. Proc. 85-18, 1985-1 C.B. 518, makes clear that reasonable basis can also be demonstrated "in some other manner." In Rev. Proc. 85-18, 1985-1, C.B. 518, the IRS acknowledges the congressional intent that reasonable basis should be construed liberally in favor of the taxpayer. Each reasonable basis is discussed separately below.

This requirement operates to deny Section 530 protection to taxpayers that lack a "reasonable basis" for treating workers as independent contractors. As is true with respect to the *substantive consistency* requirement, the courts have interpreted this requirement in a manner that jealously guards the safe harbor against abuse. Examples of how courts have construed this requirement are provided below.

1. Acceptable Precedent

Section 530(a)(2)(A) provides that a taxpayer can establish a "reasonable basis" by reasonably relying on judicial precedent, published rulings, technical advice with respect to the taxpayer or a letter ruling to the taxpayer.

In *Peno Trucking, Inc. v. Commissioner*, T.C. Memo 2007-66, 2007 Tax Ct. Memo LEXIS 66, 93 T.C.M. 1027 (2007), the court construed this requirement as demanding (i) that a judicial opinion or administrative ruling upon which a taxpayer relies must clearly indicate that the workers were determined to qualify as independent contractors based on a federal common-law analysis, and (ii) that the taxpayer must have relied on the determination when it treated the workers as independent contractors for federal employment-tax purposes. The U.S. Tax Court explained that:

> For a taxpayer to have a reasonable basis for not treating an individual as an employee under the judicial precedent safe harbor, the judicial precedent relied upon must have evaluated the employment relationship through a Federal common law analysis.

The court in *Peno Trucking, Inc.* rejected a taxpayer's contention that it treated drivers as independent contractors based on court decisions and administrative appeals determinations which determined that the drivers were independent contractors. The court explained that:

> The record does not indicate that the Bureau of Workers' Compensation, the Ohio Industrial Commission, or the court of common pleas evaluated the employment relationships of petitioner's former drivers … through a common law analysis. Only the Bureau of Workers' Compensation's vacated order … indicated the grounds for its decision: "The signed agreement by and between Peno Trucking Inc. and the Injured Worker dated 3/3/97." Moreover, nothing in the record indicates the rulings … were relied upon at the time petitioner's employment decisions were made. Petitioner failed to establish that it relied upon judicial precedent or otherwise provided a reasonable

> basis to disregard section 3121(d)(2) and sections 31.3121(d)-1(c) and 31.3306(i)-1, Employment Tax Regs. Therefore this Court finds petitioner is not entitled to act section 530 relief for its drivers.

As the foregoing demonstrates, the legal precedent upon which a taxpayer relies must, among other things, be squarely on point, must clearly indicate that the precedent applied the same or a comparable legal test as is followed for federal employment-tax purposes and must have been relied upon by the taxpayer when it treated the workers at issue as independent contractors.

2. Prior IRS Audit

Section 530(a)(2)(B) provides that a taxpayer can establish a "reasonable basis" for purposes of Section 530 by showing reasonable reliance on a past IRS audit of the taxpayer in which there was no assessment attributable to its treatment as independent contractors of individuals holding substantially similar positions.

The Small Business Job Protection Act of 1996 (the "1996 Act") tightened the requirements for establishing a reasonable basis premised on a prior IRS audit. The 1996 Act amended Section 530 to provide that an IRS audit commencing after December 31, 1996, can be relied upon to establish a reasonable basis under Section 530 *only* if the taxpayer can demonstrate that the audit included an examination for federal employment tax purposes of whether the specific worker involved, or a worker holding a substantially similar position, was properly classified as an independent contractor.

It follows that in order to establish a reasonable basis for purposes of Section 530 by relying on a prior IRS audit commencing after December 31, 1996, a taxpayer generally must be able to provide documentation establishing that during the prior audit IRS affirmatively considered the taxpayer's treatment for federal employment-tax purposes of workers whose positions are substantially similar to the workers at issue.

3. Industry Practice

Section 530(a)(2)(C) provides that a taxpayer can establish a "reasonable basis" by showing that the taxpayer's classification of a worker as an independent contractor was in reasonable reliance on a long-standing practice of a significant segment of the taxpayer's industry.[60] *See, e.g., Springfield v. United States,* 88 F.3d 750 (9th Cir. 1996) and *JJR, Inc. v. United States,* 950 F. Supp. 1037 (W.D. Wash. 1997).

This safe harbor appears on its face as relatively easy to satisfy, but appearances can be deceiving. One aspect of this safe harbor that can make it difficult to satisfy is the type of proof required to establish what an industry practice is.

This difficulty was aptly illustrated in *In re McAtee,* 115 B.R. 180, 1990 U.S. Dist. LEXIS 6895, 90-1 U.S. Tax Cas. ¶50,242, 66 A.F.T.R.2d (RIA) 5739 (N.D. Iowa 1990), wherein a taxpayer's effort to establish an industry practice safe harbor based on the taxpayer's own personal knowledge was rejected. The court held that a taxpayer's reliance

[60] The 1996 Act clarified two key requirements of the industry practice safe harbor, namely, that (1) a practice qualifies as "long standing" by existing for no more than 10 years, and (2) a "significant segment" of an industry constitutes no more than 25 percent of the industry.

on even 14 years of his *own* industry experience to establish the industry practice of treating of truck drivers as independent contractors was *insufficient as a matter of law*.

Reaffirming this interpretation, the U.S. Tax Court subsequently held in *Day v. Commissioner,* T.C. Memo 2000-375, 2000 Tax Ct. Memo LEXIS 444 (2000), that a taxpayer's *own* "experience by itself is not evidence of a long-standing recognized practice." The court denied the taxpayer's Section 530 claim even though its owner had been an independent-contractor driver for other companies and had additional personal knowledge about the industry practice of treating drivers as independent contractors.

Courts also have interpreted the industry practice safe harbor as requiring a taxpayer to specifically identify the other companies whose business practice the taxpayer claims to follow. For example, *Overeen v. United States,* 1991 U.S. Dist. LEXIS 13143, 91-2 U.S. Tax Cas. ¶50,459 (W.D. Okla. 1991), involved a sole proprietor who operated a home-care registry and treated the home-care workers as independent contractors. The IRS reclassified the home-care workers as employees of the taxpayer and the taxpayer defended against the reclassification by asserting Section 530 protection. The taxpayer claimed that its treatment of home-care workers as independent contractors was in reasonable reliance on the practice of other homemaker services from which she patterned her business. The taxpayer specifically identified one such firm and stated that she also relied upon the same practice followed by other similar firms, but did not identify them. The government disputed the taxpayer's claim and the Court concluded that the taxpayer failed, as a matter of law, to establish that a significant segment of the homemaker service industry treats home-care workers as independent contractors because while the taxpayer claimed to have relied on numerous homemaker services, she specifically identified only one.

The foregoing decisions illustrate the demanding evidentiary burden that taxpayers need to meet in order to establish an industry practice. In this regard, a taxpayer must, among other things, be able to establish the existence of an industry practice through a means other than personal experience, *e.g.,* by commissioning a third-party industry survey, and must specifically identify each of the other companies who allegedly follow the practice which the taxpayer asserts is the industry practice.

4. Establishing a Reasonable Basis Requires a Showing of Good Faith and the Absence of a Right of Control

An often overlooked aspect of the reasonable-basis requirement is that a taxpayer's reliance on an asserted reasonable basis must be in *good faith*. In *In re Compass Marine Corporation,* 146 B.R. 138, 1992 Bankr. LEXIS 1290 (Bankr. E.D. Penn. 1992), the court explained that:

> A review of relevant legislative materials suggests that Section 530 was intended to prohibit the reclassification of workers "whom the taxpayer consistently has treated *in good faith* as independent contractors." S. REP. NO. 1263, 95th Cong., 2d Sess., at 210 (1978).[61]

[61] *See, also, Crowd Management Services, Inc. v. United States,* 889 F. Supp. 1313, 1995 U.S. Dist. LEXIS 5890, 95-1 U.S. Tax Cas. ¶50,260; 75 A.F.T.R.2d (RIA) 2328 (D. Or. 1995), wherein the court noted that "Congress passed Section 530 of the Revenue Act of 1978 to protect employers who had, in good faith, been

146 B.R. at 154. (Emphasis added). The court also explained that:

> Under the standards articulated in the Senate report, Debtor has a "reasonable basis" for Section 530 protection if he acted in "good faith." In *Darrell Harris, supra,* the court discussed the issue of "good faith" and "reasonable basis" under Section 530. There, the court found that a taxpayer who asserted that it had classified its sole worker as independent contractor because of cash flow problems did not have a Section 530 "reasonable basis" for such classification. Rather, the court found that the evidence, which established that, instead of the taxpayer's paying the contractor a fixed salary, it commingled the contractor's personal bills with its own and paid personal bills through salary advances, proved that the taxpayer had not acted in "good faith" and, as such, its rationale for the independent contractor treatment of its worker was not a "reasonable basis." 770 F. Supp. at 1497.

Id.

In evaluating the reasonableness of a taxpayer's reliance on a safe harbor, the court in *Compass Marine Corporation,* also pointed out that courts consider a company's right of control over workers with respect to whom Section 530 protection is asserted:

> [C]ourts attempting to define the term "reasonable basis" have placed particular emphasis on issue of the taxpayer's control over the workers in question in determining whether a ground for finding a "reasonable basis" for the taxpayer's actions existed….
>
> Accordingly, in this proceeding the most important touchstone for the Debtor in establishing a "reasonable basis" for its classification would be proof that it did not have the right to control or direct the independent contractor workers.

146 B.R. at 155.

Another example of the court's application of the *good faith* requirement of Section 530 is *Spicer Accounting, Inc. v. United States,* 918 F.2d 90, 1990 U.S. App. LEXIS 19167, 91-1 U.S. Tax Cas. ¶50,103, 66 A.F.T.R.2d 5806 (9th Cir. 1990).[62] This case involved Mr. Spicer, who was the president, treasurer, and director of the taxpayer corporation. The court found that at no time during his relationship with the taxpayer had he been paid wages or salary denominated as such. According to the court's findings, Mr. Spicer would donate his services to the corporation, and as a stockholder he would withdraw earnings in the form of dividends. Mr. Spicer was found to have consistently reported his income from the corporation as dividend income.

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treating their workers as independent contractors from harsh penalties should the IRS decide to reclassify those workers as employees. *See* S. Rep. No. 1263, 95th Cong., 2d Sess. 209-10 (1978)."

[62] *See, also, Dunn & Clark, P.A. v. Commissioner,* 1995 U.S. App. LEXIS 14334, 95-2 U.S. Tax Cas. ¶50,383, 75 A.F.T.R.2d 2714 (9th Cir. 1995).

When IRS challenged Mr. Spicer's relationship with his corporation, he defended by claiming the corporation treated him as an independent contractor and that the corporation qualified for Section 530 protection with respect to such treatment. The court held that the corporation did not qualify for Section 530 relief because it "had no reasonable basis for not treating [him] as an employee." The court explained that Mr. Spicer was, for all practical purposes, the central worker for the taxpayer and that a corporation's sole full-time worker must be treated as an employee. The court concluded that Section 530 is not applicable in light of taxpayer's *unreasonable* treatment of Mr. Spicer as an employee.

The foregoing court decisions identify two important protections against abusive reliance on Section 530, namely, a requirement of good faith and a requirement that the taxpayer not retain a sufficient right of control over the worker at issue as to render *unreasonable* the taxpayer's reliance on an asserted reasonable basis for treating the worker as an independent contractor. Both these principles deny Section 530 protection to taxpayers that might satisfy its literal requirements but do not present the type of circumstance that Section 530 was designed to cover.

5. A Taxpayer Must Rely on an Asserted Reasonable Basis When it Treats Covered Workers as Independent Contractors

A requirement for establishing a reasonable basis that comes as a surprise to many is that a taxpayer must have relied on an asserted reasonable basis at the time the taxpayer treated the workers at issue as independent contractors. One example of the application of this requirement to defeat a taxpayer's claim for Section 530 protection is *Nu-Look Design, Inc. v. Commissioner*, T.C. Memo. 2003-52, affd. 356 F.3d 290 (3d Cir. 2004). In this case, the U.S. Tax Court explained that for a taxpayer to qualify for the Section 530 safe harbor:

> the taxpayer must have relied on the alleged authority during the periods in issue, at the time the employment decisions were being made. The statute does not countenance ex post facto justification.

Similarly, in *West Virginia Personnel Services, Inc. v. United States,* 1996 U.S. Dist. LEXIS 14450, 96-2 U.S. Tax Cas. ¶50,554, 78 A.F.T.R.2d 6600 (S.D. W.Va. 1996), the court, rejecting a claim to Section 530 protection, explained:

> The plain meaning of section 530(a)(2) is that only evidence known to and relied upon by the taxpayer is relevant. Facts that are learned after the incorrect treatment of the employees, particularly facts that are learned after an IRS audit and, essentially, in anticipation of litigation, are not facts that a taxpayer relied upon in making its original decision regarding how to treat its employees. Accordingly, plaintiff has not established a "reasonable basis" for treating its employees as independent contractors ….

In *Prince Cable, Inc. v. United States,* 1998 U.S. Dist. LEXIS 5981, 98-1 U.S. Tax Cas. ¶50,377, 81 A.F.T.R.2d 1821 (D. De. 1998), a taxpayer was audited by IRS concerning its treatment of cable installers as independent contractors for tax years 1991 through 1993, and IRS reclassified the installers to employee status. The taxpayer contested the reclassification by claiming Section 530 protection and offering as its reasonable basis a

decision by the New York State Department of Labor dated March 11, 1993. The Court held that a determination in 1993 might form a sufficient basis for determining tax treatment in 1993 and beyond, but cannot form a basis for reliance for the years 1991 and 1992.

The foregoing dispels the notion that taxpayers can establish Section 530 protection by conjuring up a theory of protection during an IRS examination. The *reliance* requirement of Section 530 has denied Section 530 protection to many taxpayers that have tried that strategy.

IX. Conclusion

The *prospective* protections that Section 530 provides have become essential to the continued viability of many companies. They enable such companies to plan for the future and attract the necessary capital to fund current operations and make prudent investments that might take years to become profitable. The benefits of Section 530 are in no sense limited to companies, however, as millions of self-employed service providers currently benefit from the certainty of Section 530; it enables them to compete when selling their services on a level playing field against competitors that are larger in size and operate out of legal entities.

The elimination of Section 530's prospective protection would have far-reaching ramifications that, in an economy as complex and interdependent as ours, cannot be meaningfully quantified. What is clear, however, is that the resulting chilling effect would lead to business closures and greatly diminished client opportunities for those self-employed service providers who are able to survive.

If independent contractors were to react to the resulting diminished client opportunities by offering their services through third-party employers of record, the cost for their services would be artificially inflated and their net earnings would likely decline. If they were to respond by forming corporations, many would simply cease operations due to the cost and administrative burden associated with operating out of a corporation. For those who can make the transition, IRS data suggest that their tax compliance would drop, since their fees would not longer be reportable on Forms 1099-MISC.

Section 530 has ample safeguards to protect its safe-harbor protections against taxpayer abuse. The scores of taxpayers that have asserted Section 530 protection and lost can attest to the efficacy of such safeguards. Moreover, the Form 1099 reporting requirement of Section 530 ensures that the tax compliance rate among self-employed providers who are covered by the protections will remain high.

It is respectfully submitted that Section 530, in its current form, is working as intended and should be retained. The certainty that Section 530 provides to the marketplace for freelance talent is precious. Any repeal of Section 530 – or its *prospective protection* – would be a grave mistake. The price exacted by such a mistake would be borne most heavily by the self-employed service providers who are already in an economically vulnerable position. Many are seeking to support their families by working as self-employed service providers while others are struggling to make ends meet by supplementing their income with freelance work on a part-time basis. A repeal of Section 530, which ensures a level playing field for freelance talent, would be a most cruel act of discrimination against the self-employed sector of our economy.

If you have any questions or comments concerning the foregoing, please let us know.

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