Bowles Rice

IRS PITFALLS AND COUNTY SCHOOLS BOARDS

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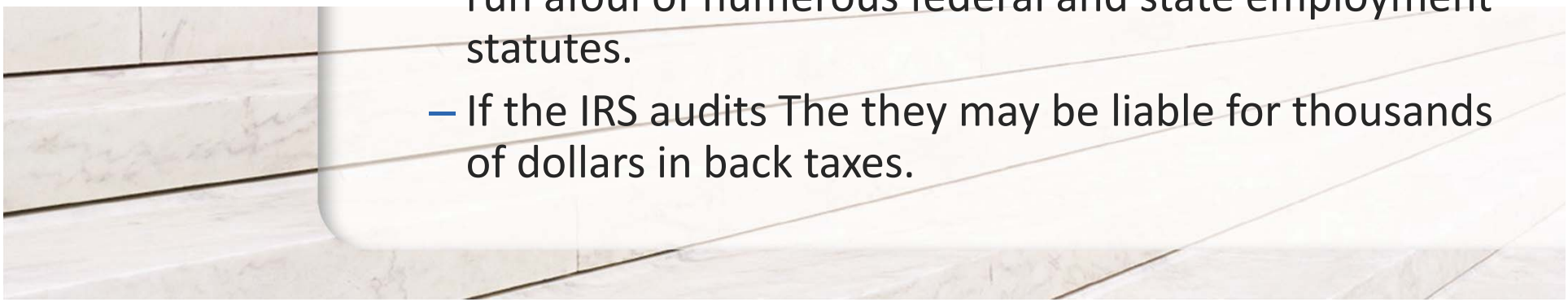
With respect to federal tax issues, no advice, statement or information contained in this communication is intended to be, or written for the purpose of being, (a) relied upon by a taxpayer as the exclusive basis to avoid penalties under the Internal Revenue Code, or (b) used in connection with the promotion, marketing or recommendation of any tax shelter product or tax shelter transaction.

- With limited dollars available School Boards are looking for cost cutting messages to allow them to provide essential services to its students.
- Further the Federal Government continues add requirments upon School Boards to provide services without providing funding ro provide those services.

- The Solution
  - The Board provides these services by hiring professional independent contractors instead of employees.
  - Even if the contractors are hired at a higher wage than a typical employee, this practice reduces costs for The Board overall because The Board does not have to pay employment taxes for the contractor.
  - It is a familiar practice, however The Board may have run afoul of numerous federal and state employment statutes.
  - If the IRS audits The they may be liable for thousands of dollars in back taxes.



- The common law standard for determining whether a worker is an employee is known as the control test.
- The control test defines employee as “an agent employed by an employer to perform service in his affairs whose physical conduct in the performance of the service is controlled or is subject to the right to control by the employer.”

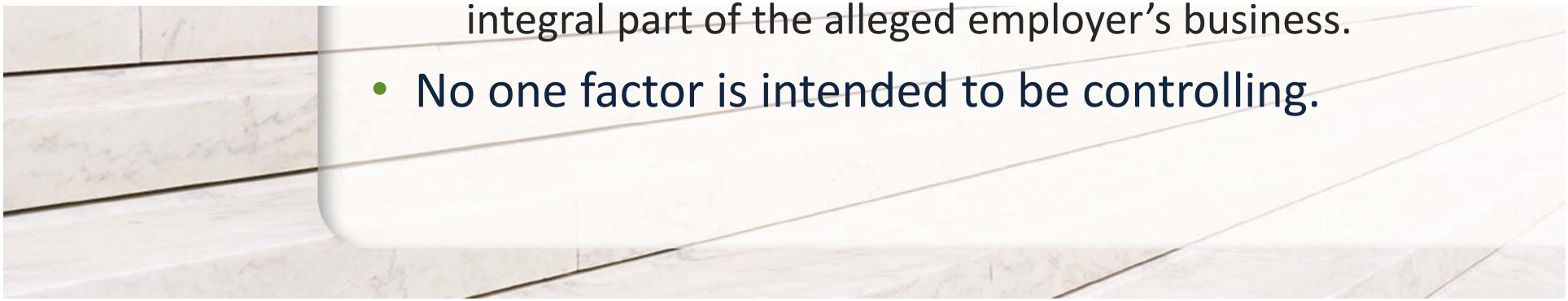
- In determining whether a hired party is an employee under the general common law of agency,
- we consider the hiring party's right to control the manner and means by which the product is accomplished.

- Among the other factors relevant to this inquiry are
  - the skill required;
  - the source of the instrumentalities and tools;
  - the location of the work;
  - the duration of the relationship between the parties;
  - whether the hiring party has the right to assign additional projects to the hired party;
  - the extent of the hired party's discretion over when and how long to work;

- Among the other factors relevant to this inquiry are
  - the method of payment;
  - the hired party's role in hiring and paying assistants;
  - whether the work is part of the regular business of the hiring party;
  - whether the hiring party is in business; the provision of employee benefits; and
  - the tax treatment of the hired party.

- Contrast the common law definition of employee with that of an independent contractor,
- “contracts with another to do something for him but who is not controlled by the other, nor subject to the other’s right to control with respect to his physical conduct in the performance of the undertaking.”

- Under the FLSA view,
  - (1) the alleged employee's opportunity for profit or loss depending upon managerial skill;
  - (2) the alleged employee's investment in equipment or materials required for the work;
  - (3) whether the service rendered requires special skills; the degree of permanence in the working relationship; and
  - (4) whether the service rendered by the individual is an integral part of the alleged employer's business.
- No one factor is intended to be controlling.



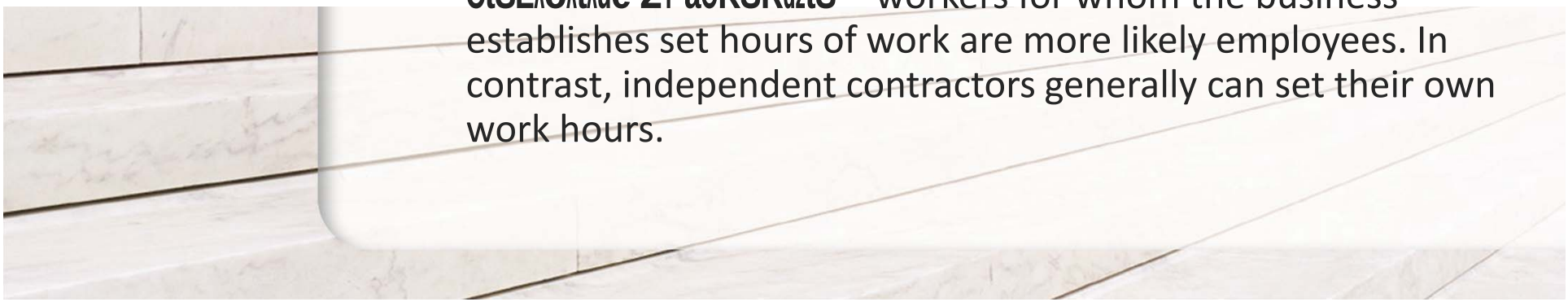
- The National Labor Relations Board (NLRB) also deviated from the common law control test in creating the entrepreneurial opportunity test
- Under the entrepreneurial opportunity test, the determinative factor is not control, but whether owner-operators have a “significant entrepreneurial opportunity for gain or loss.”

- Even if workers might rightly be deemed independent contractors under the common law control test, some workers might still be viewed as employees by statute for certain employment tax purposes
  - Driver who distributes beverages (other than milk) or meat, vegetable, fruit, or bakery products, or who picks up and delivers laundry or dry cleaning, if the driver is an agent of the employer or is paid on commission;
  - Full-time life insurance sales agent whose principal business activity is selling life insurance or annuity contracts, or both, primarily for one life insurance company;

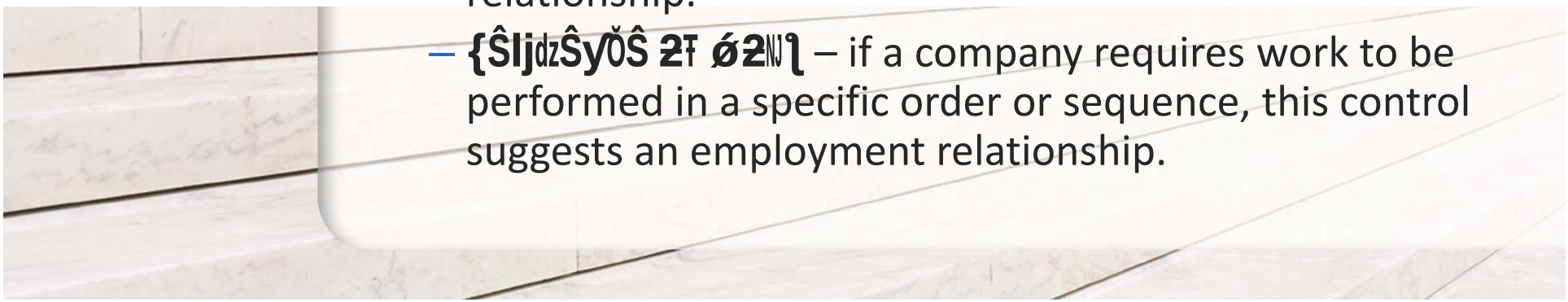
- Individual who works at home on materials or goods that an employer supplies and that must be returned to the employer or to a person the employer names, if the employer also furnishes specifications for the work to be done;
- Full-time traveling or city salesperson who works on behalf of an employer and turns in orders to the employer from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments. The goods sold must be merchandise for resale or supplies for use in the buyer's business operation. The work performed for the employer must be the salesperson's principal business activity.

- The Twenty Factors Test
  - L**y**ã**ú**NJdzŎ**ú**å**2y**ã – workers who must comply with the business' instructions as to when, where, and how they work are more likely to be employees than independent contractors.
  - ¢NJ**l**-å**y**å**y**Ǝ – the more training that the business provides to its workers, the more likely it is that they are employees. The underlying concept is that independent contractors are supposed to know how to do their work and, thus, should not require training from the purchasers of their services.
  - L**y**úŜƎNJ**l**-ű**2y** – workers whose services are integrated into business operations or significantly affect business success are likely to be considered employees.

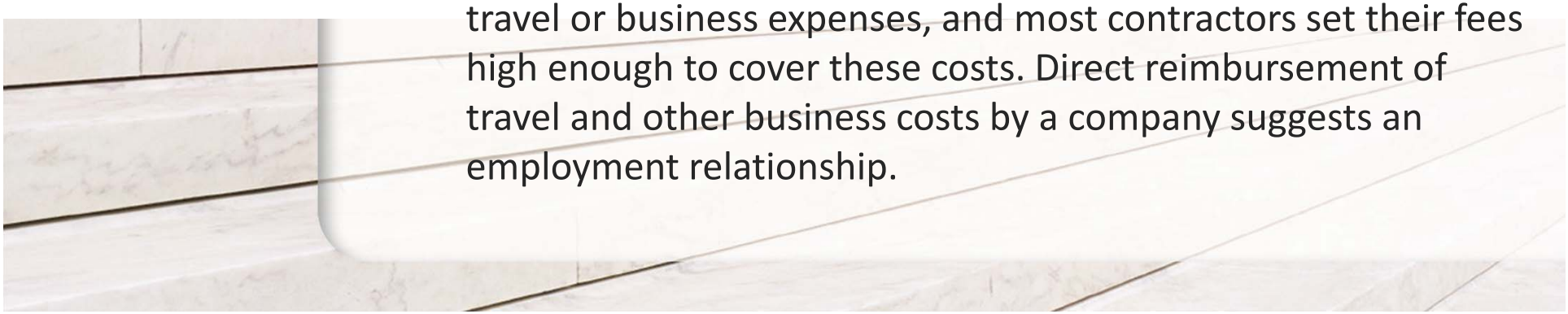
- The Twenty Factors Test
  - **/2yúNJ2f 2T l·ääĺăúl·yúă** – if a company hires, supervises, and pays a worker's assistants, this control indicates a possible employment relationship. If the worker retains control over hiring, supervising, and paying helpers, this arrangement suggests an independent contractor relationship.
  - **/2yúĺyʗz2dzä NJŜfl·úĺ2yãKĺLJ** – A continuous relationship between a company and a worker indicates a possible employment relationship. However, an independent contractor arrangement can involve an ongoing relationship for multiple, sequential projects.
  - **CfŜËĺōĺfĺűè 2T ăŎKŜŘdzfŜ** – workers for whom the business establishes set hours of work are more likely employees. In contrast, independent contractors generally can set their own work hours.



- The Twenty Factors Test
  - **Cdzff űǻY Ŝ ŊŜIjdzǻŊŜŘ** – workers whom the company requires to work or be available full time are likely to be employees as it gives the company control over most of the worker's time. In contrast, independent contractors can generally work whenever and for whomever they choose.
  - **bŜŜŘ ŦƵŊ ƶyƒπǎǻűŜ ǎŜŊØǻǑŜǎ** – requiring someone to work on company premises, particularly if the work can be performed elsewhere, indicates a possible employment relationship.
  - **{ŜIjdzŜyǑŌŜ ƶŦ ø2ŊƖ** – if a company requires work to be performed in a specific order or sequence, this control suggests an employment relationship.

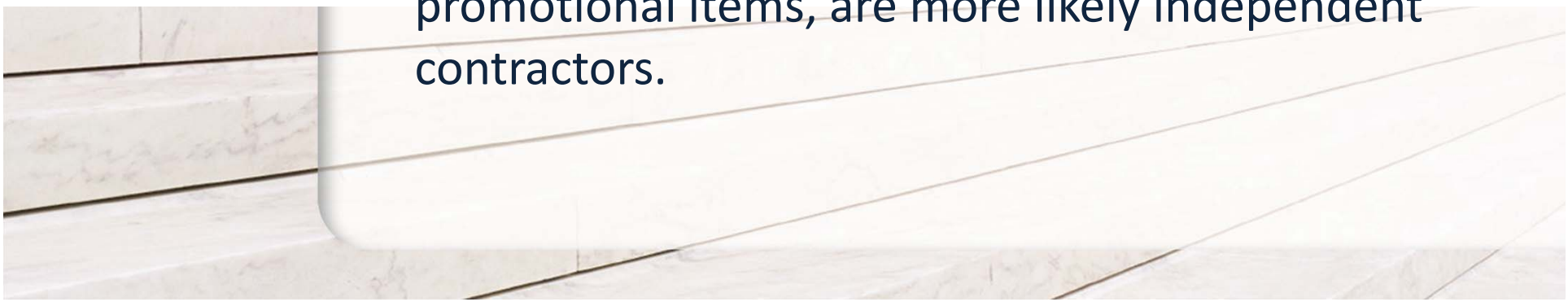


- The Twenty Factors Test
  - wŜLJ2ℕűă – if the business requires workers to submit regular reports on the status of a project, an employment relationship may be indicated
  - tl·èYˆŜyű YˆŜűK2Ř – hourly, weekly, or monthly pay schedules are characteristic of employment relationships, unless the payments simply are a convenient way of distributing a lump-sum fee. Payment on commission or project completion is more characteristic of independent contractor relationships.
  - 9ÈLJŜyãŜă – independent contractors typically bear the cost of travel or business expenses, and most contractors set their fees high enough to cover these costs. Direct reimbursement of travel and other business costs by a company suggests an employment relationship.

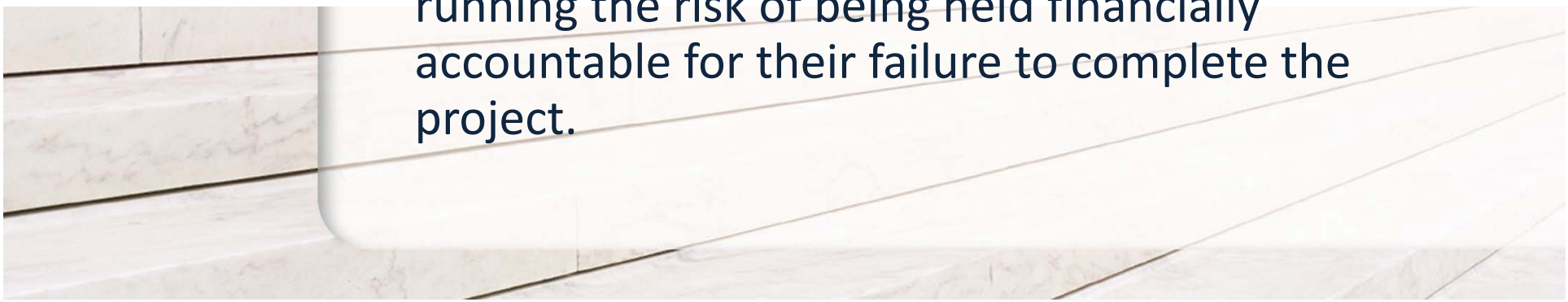


- The Twenty Factors Test
  - **¢22fă I-yŘ Y I-űŜNJăI-fă** – workers who use company-provided equipment, tools and materials are more likely employees.
  - **LyØŜăűY Ŝyű** – independent contractors typically invest in and maintain their own work facilities. In contrast, most employees rely on their employer to provide work facilities.
  - **wŜI-făÎI-űă2y 2Ŧ LJN2Ŧăű 2N f2ăă** – workers who receive predetermined earnings and have little chance to realize significant profit or loss through their work generally are employees.

- The Twenty Factors Test
- ² ƧNJ ł ŦƧNJ YʻdzfűƛLJfŜ Ǒ2YʻLJl-yƛŜă – workers who simultaneously provide services for several unrelated companies are likely to qualify as independent contractors.
- {ŜNJØƛǑŜă l-Øl-ƛfl-ōfŜ ű2 ƎŜyƧŜNJl-f LJdzōfƛǑ – workers who make their services available to the general public through business cards, advertisements, and other promotional items, are more likely independent contractors.



- The Twenty Factors Test
- **wΛƎKű ű2 ŦΛNJŜ** – workers who can be fired at any time are more likely employees. In contrast, your right to terminate an independent contractor is generally limited by specific contractual terms.
- **wΛƎKű ű2 IjdzΛű** – workers who can quit at any time without incurring any liability to you are more likely employees. Independent contractors generally cannot walk away in the middle of a project without running the risk of being held financially accountable for their failure to complete the project.



- Control. The relationship between a worker and a business is important.
- If the business controls what work is accomplished and directs how it is done, it exerts **ōŜKI-Øƛ2NJI-f Ŏ2yúNJ2f**.
- If the business directs or controls financial and certain relevant aspects of a worker's job, it exercises **ŦƛyI-yŎƛI-f Ŏ2yúNJ2f**.

- This includes:
  - The extent of the worker's investment in the facilities or tools used in performing services
  - The extent to which the worker makes his or her services available to the relevant market
  - How the business pays the worker, and
  - The extent to which the worker can realize a profit or incur a loss

- Relationship. How the employer and worker perceive their relationship is also important for determining worker status.
- Key topics to think about include:
  - Written contracts describing the relationship the parties intended to create
  - Whether the business provides the worker with employee-type benefits, such as insurance, a pension plan, vacation or sick pay

- Relationship. How the employer and worker perceive their relationship is also important for determining worker status.
- Key topics to think about include:
  - The permanency of the relationship, and
  - The extent to which services performed by the worker are a key aspect of the regular business of the company
  - The extent to which the worker has unreimbursed business expenses

- There is a safe harbor provision for employers who have misclassified employees as independent contractors.
- Section 530 allows employers to claim relief from retrospective and prospective liability, so long as the employer meets three requirements:
  - reporting consistency,
  - substantive consistency, and a
  - reasonable basis for the classification.

- § 530 can grant an employer freedom from tax liability before a determination as to worker status is even made, even if the IRS later decides the employer has misclassified the employees as independent contractors

- Any tax returns filed on behalf of a worker must be consistent with the employer's treatment of that worker.
- For independent contractors, the IRS requires the employer to file Form 1099.
- If the employer is to successfully claim a worker as an independent contractor, he must have filed the 1099.

- There is some forgiveness, however, for businesses that mistakenly file the øℕ2y∃ ΰëLJŜ of Form 1099.
- Businesses that file the wrong type of Form 1099 might not lose § 530 eligibility, so long as the mistake was in good faith.

- An employer cannot treat one worker as an independent contractor and another as an employee when they both perform the same function.
- The IRS Training Manual instructs examiners that "[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."

- Actually determining work that is substantially similar turns on the facts of each case, but tax examiners are instructed that "[w]orkers with significantly different, though overlapping, job functions are *y2ű* substantially similar."(emphasis added).

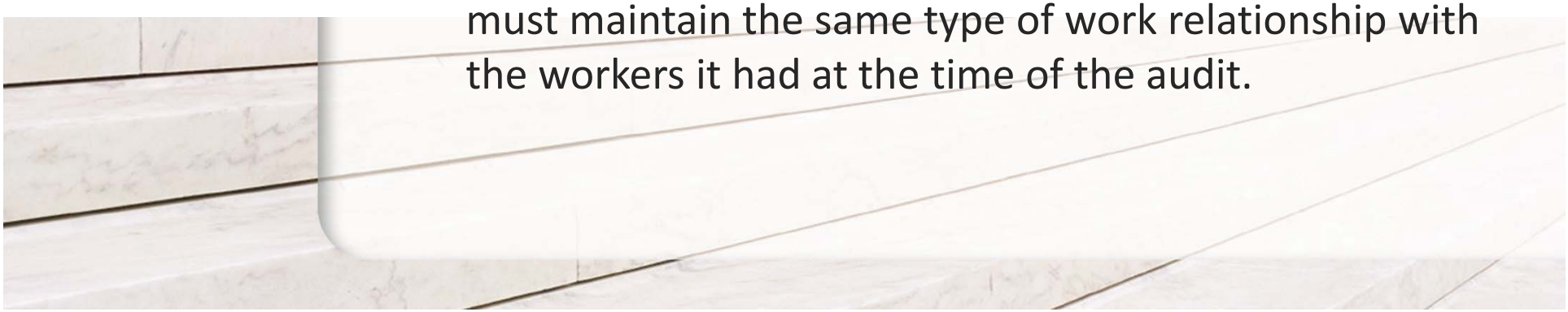
- An employer must have some reasonable basis for treating the worker as an independent contractor.
- A reasonable basis includes reasonable reliance on any of the following:
  - Judicial precedent,
  - The results of a past audit of the taxpayer, or
  - A long-standing recognized practice of a significant segment of the industry.

- Judicial Precedent
  - Such reliance must be deemed reasonable, which generally means that the facts in the case relied upon must be similar to the business's situation.
  - In demonstrating that the business reasonably relied upon the judicial precedent the precedent must have necessarily been decided prior to the employer treating the workers as independent contractors.

- Judicial Precedent
  - There is no minimum threshold number of cases, however, required to establish a precedent.
  - Reasonably relying on just one case is sufficient to claim § 530 relief, assuming the other prongs are met.
  - Further, existing case law that adopted an opposing decision to the same issue the employer relied upon will not defeat the employer's reasonable basis for treating a worker as an independent contractor.

- Judicial Precedent
  - It is critical to note, however that the types of cases an employer can reasonably rely upon are limited.
  - Only federal court decisions and revenue rulings interpreting the IRC can satisfy a reasonable basis based on judicial precedent.
  - An employer cannot claim safe haven based upon reliance on a state court decision.

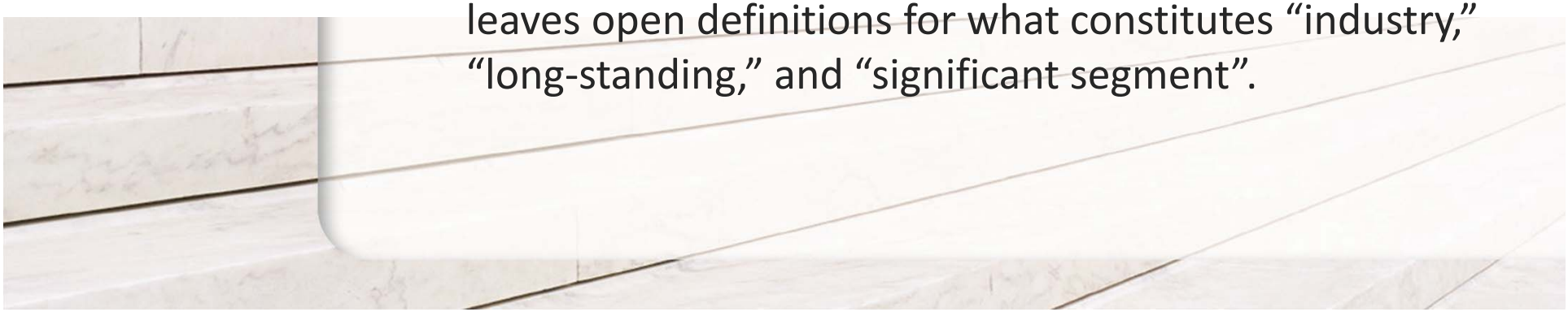
- Prior Audit
  - Tax examiners are instructed that reliance on a prior audit is the easiest way an employer can establish § 530 relief.
  - If the IRS has inspected a business's books and records, the business will be able to claim that it was subjected to a prior audit.
  - It is worth noting, however, that in order to claim a reasonable basis because of a prior audit, a company must maintain the same type of work relationship with the workers it had at the time of the audit.



- Prior Audit
  - If the relationship between the business and the workers is substantially different from that which existed at the time of the relied upon audit, the safe haven will not apply.
  - Additionally, evidence of a prior audit, by itself is insufficient to establish a reasonable basis.
  - Establishing a reasonable basis based on a prior audit requires that the employer relied on the prior audit in treating workers as independent contractors.

- Prior Audit
  - Proving reliance, however, does not impose a terribly high burden.
  - Tax examiners are instructed that in order to show reliance, “the business need only show that the same class of workers currently under consideration was treated as independent contractors during the period covered by the prior examination.”

- Industry Practice
  - The third way an employer can claim a reasonable basis is by reliance on a “long¬standing recognized practice of a significant segment of the industry in which such individual was engaged.”
  - The IRS described this type of reasonable basis as “the one which causes the most controversy between businesses and the government.”
  - The language of this provision lends itself to debate as it leaves open definitions for what constitutes “industry,” “long-standing,” and “significant segment”.



- Industry Practice
  - The IRS teaches its examiners that an industry “generally consists of businesses located in the same geographic metropolitan area which compete for the same customers.”

- Industry Practice
  - Although what constitutes a “long-standing” practice is also debatable, and depends on the facts of each case, examiners are instructed that “a practice that has existed for ten years or more should *l·fø l·ěă* be treated as long-standing.”(emphasis added).

- Industry Practice
- Examples of “long-standing”:
  - Business A, the first business in the industry, began to sell its product in 1989, treating all of its salespeople as independent contractors.
  - Business B, the second business to enter the industry, started its operations in 1991.
  - Business B copies Business A’s treatment of its workers as independent contractors.
  - Business B cannot obtain section 530 relief, because two years of industry practice do not constitute a long-standing recognized practice.
  - However, if Business A had been treating workers as independent contractors for a ten-year period before Business B began its operations and its independent contractor treatment, the industry practice created by Business A is long-standing for purposes of determining whether Business B is entitled to section 530 relief.[145]

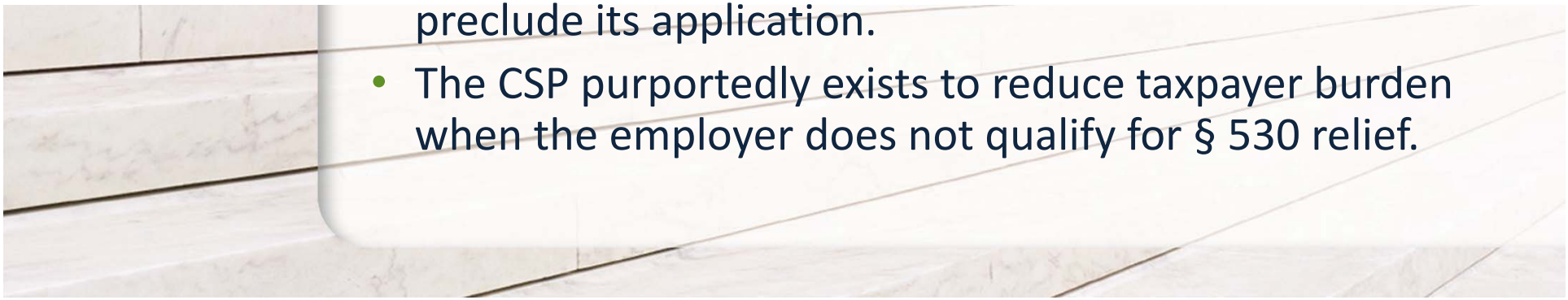
- Industry Practice
- Understanding “significant segment”
  - Amendments to § 530 established a threshold of twenty-five percent as constituting a significant segment of an industry.
  - Even still, there is a discretionary range below twenty-five percent wherein an examiner may deem a practice a “significant segment” of an industry, provided the segment of the industry is more than de minimis.
  - It is worth noting that the twenty-five percent comprising a significant segment of an industry cannot include the employer in question.[149]

- Other Reasonable Bases
  - Although relying on judicial precedent, a prior audit, or industry practice are the main avenues for claiming a reasonable basis, the IRS has intimated that these bases are not exhaustive.
  - There are cases where courts have entertained other reasonable bases.
  - Additionally, the legislative history indicates that Congress intended the reasonable basis prong to have broad application.

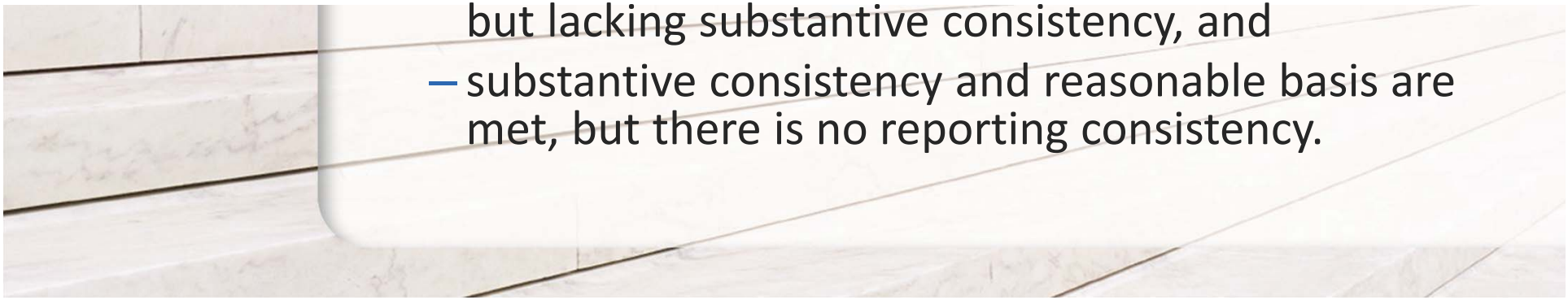
- Other Reasonable Bases
  - "[g]enerally, the bill grants relief if a taxpayer had any reasonable basis for treating workers as other than employees. The committee intends that this reasonable basis be Ǒ2ƴãúNJdzŜŘ fλōŜNJl·ffè λƴ₮l·Ø2NJ 2₮ űl·ÈLJl·èŜNJă."
  - Examiners are cautioned, however, that "[f]ailures to satisfy one or more of the conditions for eligibility for section 530 relief are not cured by the requirement of liberal construction of the reasonable basis requirement."

- Other Reasonable Bases
  - Further, businesses have the initial burden of proof in establishing they qualify for relief under § 530.
  - This burden, however, can shift to the government if the taxpayer establishes a prima facie case that it was reasonable not to treat an individual as an employee and the taxpayer "cooperates fully with reasonable requests from the examiner."

- If the three requirements in § 530 have been satisfied, no assessment against the employer will be made
- The employer may continue to treat the workers as independent contractors, even if the IRS later determines the workers have been misclassified.
- If, however, the workers are deemed employees and any one of the three § 530 prongs is not met, the safe harbor will not apply.
- This may be problematic because there are situations where equitable relief is appropriate, but the facts preclude its application.
- The CSP purportedly exists to reduce taxpayer burden when the employer does not qualify for § 530 relief.



- The CSP is an opportunity for early settlement when an employer is unable to claim complete relief under § 530, which occurs when at least one of the three § 530 criteria is not met.
- It follows that there are three scenarios where the CSP may be implicated:
  - reporting and substantive consistency are met, but there is no reasonable basis for treating workers as independent contractors;
  - reporting consistency and reasonable basis are met, but lacking substantive consistency, and
  - substantive consistency and reasonable basis are met, but there is no reporting consistency.

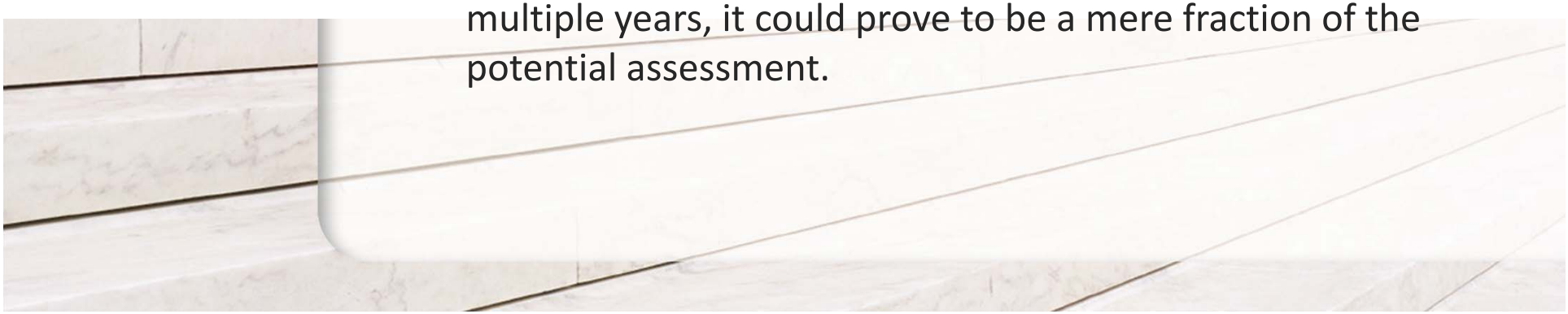


- Implementing the CSP
  - If, however, the employer does not qualify for § 530 relief, the examiner will then determine whether the workers are employees or independent contractors.
  - If no reclassification issue exists, no tax assessment is made.

- Implementing the CSP
  - If, however, there is a reclassification issue, the examiner then must determine whether the CSP applies.
  - The CSP will apply if the employer has failed to satisfy either the reasonable basis requirement or the substantive consistency requirement.
  - In either situation, however, reporting consistency must be met.
  - Simply put, the untimely filing of Form 1099 will act as an l·dzű2Yl·ű‰Ŏ bar to CSP settlement.[175]

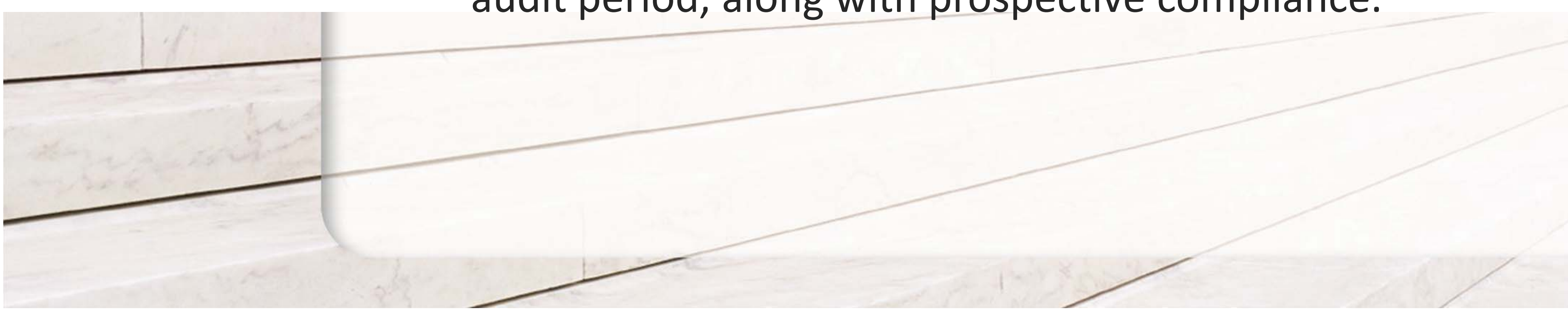
- Potential Settlement Scenarios
  - The first settlement option contemplates a situation where workers have been misclassified, Form 1099 was timely filed, but the employer is definitely precluded from claiming § 530 relief.

- Potential Settlement Scenarios
  - This can arise either from a clear determination that the employer failed to have a reasonable basis for treating workers as independent contractors or the employer failed to satisfy the substantive consistency prong.
  - In the event it is clear that no § 530 is available, the CSP offer is a full tax assessment of the last year of the audit period, along with prospective compliance.
  - While a full tax assessment may not sound like much of a generous offer, if the audit period was over the course of multiple years, it could prove to be a mere fraction of the potential assessment.

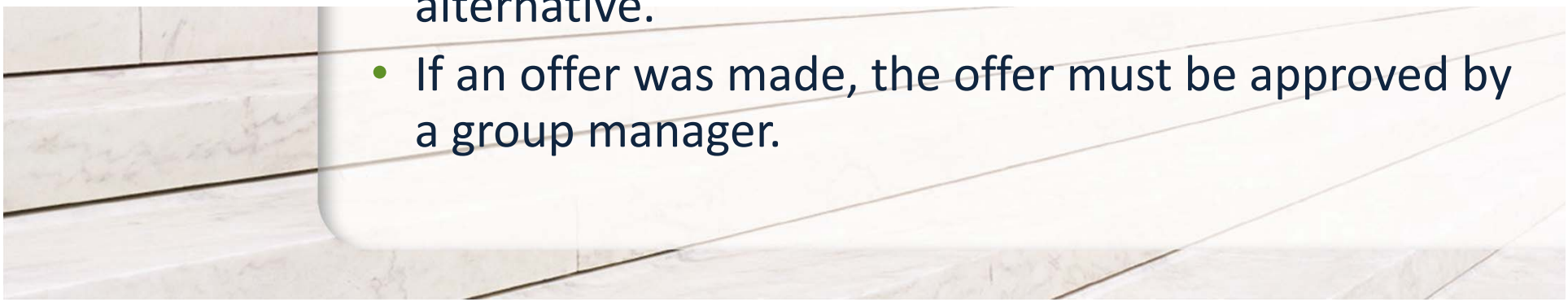


- Potential Settlement Scenarios
  - The second settlement option contemplates a situation where workers have been misclassified, Form 1099 was timely filed, but it is uncertain if the employer is actually barred from § 530 relief.
  - All examiners must ask the question, “Is the taxpayer entitled to § 530 relief?”

- Potential Settlement Scenarios
  - This second settlement offer only arises when the answer to this question is “maybe.”
  - The ambiguity may arise because of several reasons, including an ambiguous judicial opinion the employer agreed upon, or because it is unclear if it is a practice of a *ăƚƎyƒƚŦƚŎl·yű* segment of the industry.
  - Under the second settlement option, the employer is only assessed twenty-five percent of one year of the audit period, along with prospective compliance.[186]



- If settlement is appropriate for the reasons stated above, the examiner is instructed that a CSP offer “should generally” be made.
- While it is not mandatory to extend a CSP offer, an examiner must comment on the CSP in any case involving a determination that a worker was misclassified.
- The examiner should explain why an offer was made and what course of action was taken in the alternative.
- If an offer was made, the offer must be approved by a group manager.



- While the CSP was a step in the right direction, its present form is inadequate because it unnecessarily precludes settlement in the event of untimely filing of tax forms, it grants too much discretion to the examiner, and its settlement options are too few.

Questions?