

Your Changing Work Force, Independent Contractors and the Tax Laws: The Stars Are Realigning

For many years, the Internal Revenue Service exploited the proverbial low-hanging fruit in audits of business enterprises: the tax classification of workers that management has treated as independent contractors and not as employees for Internal Revenue Code ("Code") purposes. Congress responded to the billions of dollars these audits have brought into government coffers by increasing budgets for such examinations.

The tax consequences of workers being reclassified, years after the fact, from an independent contractor status to an employee are severe. In addition to the employer's 7.65 percent social security obligation (and the employer's 1.45 percent for Medicare on the excess over the annual limit), the employee's similar shares have not been withheld. Furthermore, federal income tax has not been withheld. There are also ERISA, state tax law, and workers' compensation consequences arising from worker classification. By way of employer mitigation, there is a mechanism for the employer to effectively obtain a credit for each employee that gives the Internal Revenue Service a statement showing that he or she did report the monies and pay employment and income tax. That is cumbersome and not always practical with many employees.

Section 530, Businesses' Friend

Many employers have avoided reclassification as to different groups of employees by arguing that they qualified under a safe harbor known as section 530 relief. This relief is only available to employers, and not to employees. Section 530 is not a relief provision under the Code, but rather, it is section 530 of the 1978 Tax Act, originally a temporary measure. Congress made it permanent in the 1982 Act, and has periodically tinkered with it. Section 530 relief basically

allows the taxpayer to treat qualifying workers as independent contractors if the industry practice was to categorize such workers as independent contractors, and there was a "reasonable basis" to treat them as independent contractors under common law principles. Then relief is construed liberally in favor of the taxpayer. There has to have been consistent treatment of such workers and substantially similar workers, and Form 1099s had to have been issued. If section 530 applies, then the relief, independent contractor tax status, must be applied to both a) the audit years and b) going forward. Section 530 also banned the issuance of regulations and guidance. As a practical matter, this safe harbor saved many business taxpayers large sums.

Serious bipartisan legislation has been introduced in Congress and has the backing of both presidential candidates. Since this is revenue positive from the federal government's perspective, given the structural deficits, it is likely that the legislation will pass.

Although there are minor technical differences among the major proposed bills, they would essentially gut section 530 as we know it. They would all eliminate the key provision that allows employers to rely upon industry practices as a basis for independent contractor status. The limited number of employers that could still survive that gauntlet would then face another problem. The bills would allow the Internal Revenue Service to prospectively treat the individual as an employee. For the last three decades, under section 530, if a taxpayer qualified under the safe harbor, it could continue to treat the worker as an independent contractor rather than as an employee. Proposed legislation would also lift the ban on regulations and published Treasury guidance and make other changes.

What Steps Should Businesses Take?

It is strongly recommended that businesses undertake serious and realistic reviews of various workers' job status on their own, before the IRS does it for them. Many sophisticated employers have self-audits undertaken by counsel. Accountants may assist in the review process, but the accounting firm should be retained under a *Kovel* letter by which the attorneys retain the accountants as their technical assistants. This preserves the attorney-client privilege for the results of the report. Such taxpayer-spawned analysis inevitably will recommend some changes for various workers. There are decades of wisdom and experience supporting the use of *Kovel* letters in this and many other circumstances.

Why Should the Businesses Make Any Changes?

Businesses are caught somewhere between the dog and the fire hydrant. On one hand, the economy is migrating toward a mobile technological work force, including telecommuting and part-time workers. There has been a shift in the work force away from the traditional employment model toward independent contractor arrangements. Conversely, with the impending repeal of section 530 relief, the rules for judging the status become much more favorable to the Internal Revenue Service. What employers can do for those who under current law may have had some section 530 protection, as well as for those workers for whom there would be none, is shift the arrangement from independent contractor to employee status. While this may have costs to the employer in terms of employment taxes, pension coverage, and the like, it is better to renegotiate the terms with the workers, mindful of the certain tax consequences, than

play the audit lottery with the government. We should remind clients that this is one area where the ounce of prevention is less costly than the pound of cure.

NOTES

1. *United States v Kovel*, 296 F2d 918 (2d Cir 1961).



Paul L. B. McKenney of Varnum Riddering Schmidt & Howlett LLP, Novi, specializes in Federal taxation. He is a member of the Sales, Exchanges

*and Basis Committee of the Taxation Section of the American Bar Association, and the Taxation Section of the State Bar of Michigan. He is currently a sub-committee chair in the American Bar Taxation Section. Mr. McKenney has also served as Chairman of the Taxation Committee of the Detroit Bar Association, as well as of the Oakland County Bar Association's Taxation Committee. He previously was a member of the Taxation Section Council of the State Bar of Michigan. Mr. McKenney was an adjunct professor in the graduate taxation program at Walsh College. He has published numerous articles and is a frequent lecturer on tax topics before ICLE, the American Bar Association Taxation Committee, and other organizations. Mr. McKenney authored the taxation chapter in *Torts: Michigan Law and Practice* (ICLE 2d ed.).*