

Tax Court Ruled Employer's Independent Contractor Interpretation Reasonable

Article Highlights:

- IRS Challenge
- Section 530 Relief
- Reasonable Basis
- Court Ruling

One of the most challenging issues facing employers is whether a worker should be classified as an employee or an independent contractor. A case recently concluded in federal district court illustrates this point. An employer, Nelly Home Care, Inc., had classified a group of 35 workers as independent contractors and was charged by the IRS with owing substantial employment taxes. The agency pursues those who try to avoid having to pay FICA, FUTA and income tax withholding by mislabeling employees in this way. Upon review of the specifics of the case, the court determined that the employer did not owe these taxes and was entitled to relief under Section 530 of the Revenue Act of 1978. The case was Nelly Home Care, Inc., DC-Pa., May 10, 2016.

The Case Against Nelly Home Care - Though the court's decision may mean that the IRS now pursues each independent contractor for self-employment taxes owed, for our purposes it is of interest to understand the terms of Section 530, the safe harbor rule on which the ruling was based. Section 530 spells out circumstances that allow a taxpayer to escape liability for paying employment taxes for a prior period — even if the case pursued by the IRS is correct and the workers should not have been classified as independent contractors. In order for Section 530 to apply, an employer needs to show that it has never treated the workers as employees, it has consistently filed all federal returns (including 1099s) and it has a reasonable basis for not treating the worker as an employee. Reasonable basis is present if any of the following can be shown:

- Having a previous judicial ruling or precedent, or technical advice, letter rulings, or a determination letter from the IRS pertaining to that business.
- Having already undergone an IRS audit that made no adjustment to the way that the workers were classified.
- Being able to show that a large percentage of businesses in the same industry follow the same practice and have done so for a significant amount of time.

Even when an employer fails to meet one of these tests, the employer can still get Section 530 relief by showing reasonable basis in some other reasonable manner. Section 530 indicates that this reasonable basis is to be construed liberally in favor of the taxpayer.

How the Court Ruled - In this particular case, the employer was in the homecare services industry, and the 35 workers in question worked with the elderly. The employer provided them with workers' compensation insurance but did not train them or control many aspects of their work. Upon review of the circumstances, the IRS determined that they were not independent contractors, but employees. However, the district court determined otherwise. Though the court indicated that the threshold had not been met for use of the statutory safe harbor, it

noted that the employer had given consideration to a number of other factors that qualified Nelly Home Care for the reasonable basis safe harbor. Those factors included the fact that others in the field categorized their workers in the same way and that the personal income tax returns of the corporation's shareholders had previously undergone an IRS audit that did not raise the issue, despite the IRS having reviewed business documents involving the workers during the audit. The court ruled that these two factors were enough for the employer to have made a reasonable assumption that the practice was correct.

Though this case ended well for the employer, not all stories end so happily. Making the wrong decision can end up costing a business a significant amount of money in fines and back taxes. If you are not certain as to how to categorize your own workers, give this office a call. In some cases it may also be appropriate to seek legal advice.