

IRS AND EDD IMPLEMENT NEW APPROACHES  
TO WORKER CLASSIFICATION

by

Charles Rettig, Esq. and Steven Toscher, Esq.

Hochman, Salkin, Rettig, Toscher and Perez, P.C.

For years, the Internal Revenue Service and the California Employment Development Department have challenged the treatment of workers as independent contractors, rather than employees. Historically, the determination of a worker's status originates from the legal definition developed in the law of agency - whether the principle is legally responsible for the acts or omissions of its agent - and generally depends on the principle's right to direct and control the agent. The right to direct and control - or its absence - has been exhibited by : (a) behavioral control - whether there is a right to direct or control how the worker performs the specific tasks for which they are hired and the extent of instructions and training required to complete the tasks involved, (b) financial control - whether there is a right to direct or control the manner in which the business aspects of the worker's activities are conducted; whether the worker has a significant investment in the tools of their trade; whether the worker is reimbursed for expenses; whether the worker generally makes their services available to the public; the method of payment (i.e., by the project or the week); and the opportunity for the worker to incur profit or loss as a result of the project, and (c) the relationship of the parties -how the parties perceive their relationship; whether the employer provides medical or retirement benefits to the worker; the intent of the parties in any written contract; the permanency of the relationship; the ability to discharge or terminate the worker without; and whether the services provided by the worker are an integral part of the business operations.

Section 530 of the Revenue Act of 1978 provides retroactive and prospective relief from federal employment tax obligations arising out of the potential reclassification of workers as employees if the business satisfies each of the following requirements:

- a) Reporting Consistency - All federal tax returns and information returns have been filed on a basis consistent with the business' treatment of the worker as being an independent contractor, rather than as an employee.
- b) Substantive Consistency - The business has consistently treated similarly situated workers (workers performing similar tasks) as independent contractors, rather than as employees. If the business treated a similarly situated worker as an employee, Section 530 relief from liability does not apply.
- c) Reasonable Basis - There must have been some reasonable basis for treating the worker as an independent contractor, rather than as an employee. A reasonable basis exists if there is reasonable reliance on judicial precedent, a published ruling of the IRS, a private

letter ruling or a technical advice memorandum issued by the IRS to the taxpayer, the results of a past IRS audit of the taxpayer determined the worker to be an independent contractor, or there is a long-standing recognized practice of a significant segment of the taxpayer's industry treating similarly situated workers as independent contractors.

Since IRS administrative procedures do not allow examiners to propose settlements based upon the relative hazards of potentially litigating the issues involved, businesses seeking to negotiate a settlement of an employment tax issue, including relief under Section 530, have historically been forced to move their cases through the lengthy administrative or judicial processes at increased costs to both taxpayers and the government. However, commencing March 5, 1996 on a special two year test basis, the Internal Revenue Service has implemented a Classification Settlement Program ("CSP") providing for an expedited resolution of the worker classification issue at the earliest stages of the employment tax examination. Under the CSP, at the request of the taxpayer, a series of graduated settlement offers will be available ranging from treatment of the workers as employees for the entire audit period (but subject to favorable rates of taxation) through treatment of the workers as independent contractors on a retroactive and a prospective basis. The graduated settlement offers are intended to simulate the results that would be obtained under current law if the business accepting the offer had instead exercised their right to exhaust the available administrative and/or judicial processes.

In addition to the CSP, commencing March 18, 1996 the Internal Revenue Service implemented a one-year test program in which businesses may appeal an unagreed employment tax issue, including a worker classification issue, for resolution to a higher administrative level of the IRS before there has been a resolution of the other issues involved in the employment tax examination. An early referral of an unagreed employment tax issue arising from an examination is expected to allow for an expeditious resolution of the issue being referred and will hopefully result in an expeditious resolution of the entire employment tax examination.

The California Economic Development Department is responsible for the administration and collection of California employment taxes. Beginning January 1, 1997, the California Employment Development Department will have the authority to recommend settlements of disputed employment tax issues, including a worker classification issue, to the California Unemployment Insurance Appeals Board based on the relative merits involved. The financial and business decisions of many taxpayers undergoing an employment tax worker classification examination are often held in abeyance since the potential outcome of the disputed issues can be anticipated to have a substantial adverse economic impact upon the financial and business affairs of the taxpayer. An expeditious negotiated resolution of the worker classification issue with the Internal Revenue Service and the Employment Development Department (beginning January 1, 1997) will provide a level of certainty for the taxpayer's future business decisions.

Taxpayers currently involved in an IRS employment tax examination should seriously consider taking advantage of the CSP in order to avoid the uncertainty of a lengthy examination and the potential significant adverse economic consequences to the future business operations. After January 1, 1997, taxpayer's involved in a California Employment Development Department worker classification examination, should consider submission of a settlement proposal classifying the workers as independent contractors for a portion of the audit period and, if

warranted by the facts involved, classification as employees going forward on a prospective basis.