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# The IRS' Classification Settlement Program: Is it an Adequate Tool to Relieve Taxpayer Burden for Small Businesses that have Misclassified Workers as Independent Contractors

Judson D. Stelter

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THE IRS' CLASSIFICATION SETTLEMENT PROGRAM: IS IT  
AN ADEQUATE TOOL TO RELIEVE TAXPAYER BURDEN FOR  
SMALL BUSINESSES WHO HAVE MISCLASSIFIED WORKERS  
AS INDEPENDENT CONTRACTORS?

JUDSON D. STELTER\*

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### I. INTRODUCTION

It is the quintessential American dream: Jeff scraped together what little resources he had, got a loan, created a small business—a fledgling freight company—and made it work. Not only does Jeff support his family of six with his business, but ten other families also depend on his business succeeding. With large freight companies competing for the same dollars, success does not come easy and profit margins are slim. Cutting costs is not just important for survival, it is essential. Like many small business owners, one way Jeff avoids costs is by hiring workers as independent contractors instead of employees. Although he hires contractors at a higher wage than a typical employee, this practice reduces costs for the business overall because Jeff does not have to pay employment taxes for the contractor. It is a familiar practice. What Jeff did not realize, however, is he may have run afoul of numerous federal and state employment statutes. Among these, his largest concern is the tax code. If the Internal Revenue Service (IRS) audited him today, Jeff would be liable for thousands of dollars in back taxes. This cost could easily put his business under.

An estimated thirty-eight percent of small businesses misclassify employees as independent contractors.<sup>1</sup> The issue of misclassifying workers, although a chronic problem, is incredibly timely because there are current proposals in Congress that seek to more aggressively collect employment taxes in order to increase revenue without technically raising taxes.<sup>2</sup> A major source of lost revenue in employment taxes involves the classification of workers.<sup>3</sup>

Properly classifying workers can be difficult; so much so that large corporations<sup>4</sup> and even the IRS<sup>5</sup> itself struggle to correctly classify workers. Small businesses, often with limited financial resources, bear a disproportionately greater burden than

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<sup>1</sup>Walter H. Nunnallee, *Why Congress Needs to Fix the Employee/Independent Contractor Tax Rules: Principles, Perceptions, Problems, and Proposals*, 20 N.C. CENT. L.J. 93, 94 (1992).

<sup>2</sup>Edmund Andrews, *Democrats Seek Unpaid Taxes, Inviting Clash*, N.Y. TIMES, Feb. 5, 2007, at A1. Andrews reported that “Congressional Democrats, hoping to finance an ambitious agenda without raising taxes, are on a collision course with the Bush administration about pursuing the potentially vast amount of money that people hide from the Internal Revenue Service.” *Id.* Additionally, the government could “collect as much as \$100 billion more a year by whittling the tax gap—the unpaid taxes, mostly on unreported earnings, that the IRS estimated was about \$300 billion a year.” *Id.* Andrews further reported that the IRS stated that the largest source of lost revenue is where people are in business for themselves and do not report income when they pay independent contractors. *Id.*

<sup>3</sup>*Id.*

<sup>4</sup>See *Vizcaino v. Microsoft*, 173 F.3d 713 (9th Cir. 1999).

<sup>5</sup>*I.R.S. Offers New Initiatives for Worker Classification Concerns*, SOC. SECURITY ADMIN./IRS REPORTER: A NEWSLETTER FOR EMPLOYERS (Summer 1996), at 2, available at <http://www.1040.com/New1040/pdfs/1996/Federal/Forms/SSAREP.PDF> [hereinafter IRS NEWSLETTER].

larger businesses in complying with IRS employment tax regulations.<sup>6</sup> Consequently, misclassification of workers has long been a source of confusion, debate,<sup>7</sup> and litigation for the small business owner.<sup>8</sup>

In 1996, the IRS sought to alleviate small business owners' tax burden in worker misclassification situations by instituting the Classification Settlement Program (CSP).<sup>9</sup> Using the CSP, the IRS is able to offer businesses a settlement, rather than engaging in protracted court proceedings.<sup>10</sup> The stated goal is to "allow businesses and tax examiners to resolve worker classification cases as early in the administrative process as possible, thereby reducing taxpayer burden."<sup>11</sup>

While the CSP was once described as one of the most "striking new developments" in the worker classification issue,<sup>12</sup> in its current form the program is inadequate for three reasons. First, it unnecessarily precludes settlement opportunities for employers who have failed to timely file the appropriate informational tax form. Second, its current settlement options are too limited. Third, it grants too much discretion to the tax examiner.

This Note argues that the timely filing of informational tax forms should not be a condition of a CSP settlement offer; the CSP should incorporate more settlement options; and the CSP should make settlement offers mandatory. Part II of this Note

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<sup>6</sup>W. MARK CRAIN & THOMAS HOPKINS, *THE IMPACT OF REGULATORY COSTS ON SMALL FIRMS* (2005), available at [www.sba.gov/advo/research/rs207tot.pdf](http://www.sba.gov/advo/research/rs207tot.pdf).

<sup>7</sup>The classification issue has been so hotly contested, some have called for eliminating the distinction altogether. See Richard Carlson, *Why the Law Still Can't Tell an Employee When It Sees One and How it Ought to Stop Trying*, 22 BERKELEY J. EMP. & LAB. L. 295, 296 (2001). In a similar vein, others have argued that it would be more advantageous to preclude the IRS from making the determination of worker status and permitting the worker to decide. Susan Schwochau, *Identifying an Independent Contractor for Tax Purposes: Can Clarity and Fairness Be Achieved?*, 84 IOWA L. REV. 163, 165 (1999).

<sup>8</sup>J. Aaron Ball, *The Sea Clammers Doctrine: Reeling in Private Employment Tax Claims in Worker Misclassification Cases*, 1 DEPAUL BUS. & COM. L.J. 215, 217 (2003).

<sup>9</sup>IRS NEWSLETTER, *supra* note 5, at 2.

<sup>10</sup>I.R.S., INTERNAL REVENUE MANUAL, § 4.23.6.1 (1999), available at <http://www.irs.gov/irm/part4/ch23s07.html#d0e298906> [hereinafter MANUAL].

<sup>11</sup>*Id.* § 4.23.6.1.

<sup>12</sup>Marilyn Barrett, *Independent Contractor/Employee Classification in the Entertainment Industry: The Old, the New and the Continuing Uncertainty*, 13 U. MIAMI ENT. & SPORTS L. REV. 91, 138 (1996). Some scholars, however, expressed far less optimism regarding the CSP. There may be many taxpayers who, if they decided to litigate their tax case, would win in court. *Id.* The thought of protracted litigation when victory is not assured, however, is far more daunting than a quick settlement. *Id.* One scholar noted the following:

If it is debatable whether § 530 applies, [the CSP] may assert undue pressure on employers to reclassify its workers who may qualify as independent contractors as employees in order to take advantage of what appears to be a compromised settlement offer. The employer should be advised that many cases are resolved favorably at the appeals level and that employers have been able to continue to treat their workers as independent contractors without any additional tax liability.

Sheri Nott, *Worker Classification of Healthcare Professionals*, 71 FLA. BAR J. 83, 86 (1997).

will discuss the legal history behind worker classification. Part III will demonstrate the unique situation of the small business owner in classifying workers. Part IV will explain § 530, a safe harbor provision for small business owners who have incorrectly classified workers. Part V will introduce the CSP in detail and explain its applications. Part VI will highlight the shortcomings of the CSP. Part VII will discuss possible solutions to CSP shortcomings. Part VIII will conclude.

## II. THE BACKGROUND OF THE CLASSIFICATION PROBLEM

The problem is not new. Issues involving worker classification date back to the mid-fourteenth century.<sup>13</sup> Despite the worker classification debate's protracted history, however, twentieth century federal employment legislation has done much to exacerbate the confusion.<sup>14</sup> The application of federal employment statutes such as the Fair Labor Standards Act (FLSA),<sup>15</sup> the Age Discrimination in Employment Act of 1967 (ADEA),<sup>16</sup> the Occupational Safety and Health Act (OSHA),<sup>17</sup> the Americans with Disabilities Act of 1990 (ADA),<sup>18</sup> the Family Medical Leave Act of 1993 (FMLA),<sup>19</sup> Title VII of the Civil Rights Act of 1964, and the Employee Retirement Income Security Act of 1974 (ERISA),<sup>20</sup> and some aspects of the Internal Revenue Code<sup>21</sup> all turn on worker status.

### A. The Common Law Control Test

The common law standard for determining whether a worker is an employee is known as the control test.<sup>22</sup> 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."<sup>23</sup> The common law control test has been further articulated by the Supreme Court as follows:

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

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<sup>13</sup>See generally MARC LINDER, *THE EMPLOYMENT RELATIONSHIP IN ANGLO-AMERICAN LAW: A HISTORICAL PERSPECTIVE* (1989).

<sup>14</sup>*Id.* at 176.

<sup>15</sup>29 U.S.C. §§ 201-219 (2000).

<sup>16</sup>29 U.S.C. §§ 621-634 (2000).

<sup>17</sup>Occupational Safety and Health Act of 1970, Pub. L. No. 91-596, 84 Stat. 1590.

<sup>18</sup>42 U.S.C. § 12101 (2000).

<sup>19</sup>29 U.S.C. § 2611 (2000).

<sup>20</sup>Employee Retirement and Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829.

<sup>21</sup>I.R.C. §§ 3402, 6651, 3101-3128, 3301 (2000).

<sup>22</sup>RESTATEMENT (SECOND) OF AGENCY § 2 (1958).

<sup>23</sup>*Id.*

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; 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.<sup>24</sup>

Contrast the common law definition of employee with that of an independent contractor, who "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."<sup>25</sup>

The Supreme Court, in *Nationwide Mut. Ins. Co. v. Darden*, held that when construing statutes implicating worker status, the control test should be used unless the federal statute in question expressly defines employee otherwise.<sup>26</sup> *Darden* involved an insurance agent who contracted with Nationwide Mutual Insurance Company ("Nationwide") to sell insurance.<sup>27</sup> As part of the agreement, Nationwide agreed to enroll Darden in a company retirement program.<sup>28</sup> After Nationwide exercised its right to terminate the contract, the company ended Darden's retirement package.<sup>29</sup> Darden brought an action under ERISA claiming the company could not terminate his retirement package as he was a vested employee.<sup>30</sup> The case turned on whether Darden was, in fact, an employee of the company or merely an independent contractor.<sup>31</sup>

ERISA defines employee as "any individual employed by an employer."<sup>32</sup> The Supreme Court commented that this definition of employee is "completely circular and explains nothing."<sup>33</sup> The Court also reasoned that there were no provisions in the body of the statute that would aid in interpreting the definition.<sup>34</sup> For these reasons, the Court adopted the common-law test<sup>35</sup> for determining employee status

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<sup>24</sup>Cnty. for Creative Non-Violence v. Reid, 490 U.S. 730, 751-52 (1989).

<sup>25</sup>RESTATEMENT (SECOND) OF AGENCY § 2 (1958).

<sup>26</sup>503 U.S. 318, 323 (1992).

<sup>27</sup>*Id.*

<sup>28</sup>*Id.*

<sup>29</sup>*Id.*

<sup>30</sup>*Id.*

<sup>31</sup>*Id.*

<sup>32</sup>29 U.S.C. § 1002(6) (2000). This definition of employee is common in employment statutes. For example, under Title VII, the statute defines employee as follows: "[t]he term 'employee' means an individual employed by an employer . . ." 42 U.S.C. § 2000e(f) (2000).

<sup>33</sup>*Darden*, 503 U.S. at 323.

<sup>34</sup>*Id.*

<sup>35</sup>*Id.* at 323. The Court restated the common law test as articulated in *Reid*, 490 U.S. at 751-52.

under ERISA.<sup>36</sup> The *Darden* holding applies to any federal employment statute that fails to clearly define employee.<sup>37</sup>

### B. Differing Federal Tests for Employment Status

Not only is the common law standard often difficult to construe, the challenge is exacerbated by varying definitions employed in different areas of the law. Though the control test is to be used when a statute is silent or unhelpful in defining employee, there are statutes that deviate from the control test. In those cases, the statutory definition controls.

#### 1. The Economic Realities Test

In the FLSA, employee is defined as “any individual employed by an employer,” but the statute goes further by stating that to employ means to “suffer or permit to work.”<sup>38</sup> Such statutory language casts a much broader net than that contemplated under the control test because it necessarily encompasses all work relationships that would qualify as employer/employee under the control test, as well as some that may not. In assessing an employer/employee relationship under the FLSA, courts have adopted a test independent of the control test. Under the FLSA view, the following factors are considered: (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.<sup>39</sup> No one factor is intended to be controlling.<sup>40</sup> This test is often referred to as the economic realities test.<sup>41</sup>

#### 2. The Entrepreneurial Opportunity Test

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.”<sup>42</sup> The NLRB approach to defining the employment relationship has been supported by the United States Court of Appeals for the District of Columbia Circuit.<sup>43</sup> In supporting the NLRB, the court stated that they “uphold as reasonable the Board’s decision . . . to focus not upon the employer’s control of the means and manner of

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<sup>36</sup>*Darden*, 503 U.S. at 323.

<sup>37</sup>*Id.* See also *Reid*, 490 U.S. at 730.

<sup>38</sup>29 U.S.C. §§ 203(e), (g) (2000).

<sup>39</sup>*Vizcaino v. U.S. Dist. Ct. for W. Dist. of Wash.*, 173 F.3d 713 (1999).

<sup>40</sup>*Id.*

<sup>41</sup>*Id.*

<sup>42</sup>*Roadway Package Sys., Inc.*, 326 N.L.R.B. 842, 851 (1998).

<sup>43</sup>*C.C. Eastern v. N.L.R.B.*, 60 F.3d 855 (D.C. Cir. 2002).

the work but instead upon whether the putative independent contractor's have a significant entrepreneurial opportunity for gain or loss."<sup>44</sup>

### 3. Statutory Employees

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 if they fall within any one of the following four categories: a 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;<sup>45</sup> a 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;<sup>46</sup> an 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;<sup>47</sup> a 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.<sup>48</sup>

#### C. The IRS' Standard

Like the Supreme Court, the IRS relies on the control test in determining worker status, but it does so in its own unique way.<sup>49</sup> The IRS relies on twenty factors<sup>50</sup> to determine employer control.<sup>51</sup> The twenty factors are not a test per se, but an

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<sup>44</sup>*Id.* at 858.

<sup>45</sup>IRC § 3121(d)(3)(A)(2000).

<sup>46</sup>*Id.* § 3121(d)(3)(B).

<sup>47</sup>*Id.* § 3121(d)(3)(C).

<sup>48</sup>*Id.* § 3121(d)(3)(D).

<sup>49</sup>*See generally* Weber v. Comm'r, 103 T.C. 378 (1994); *Prof'l and Executive Leasing v. Comm'r*, 862 F.2d 751 (9th Cir. 1988); *Avis Rent-A-Car System, Inc. v. United States*, 503 F.2d 423 (2d Cir. 1974); *Simpson v. Comm'r*, 64 T.C. 974 (1975).

<sup>50</sup>Rev. Rul. 87-41, 1987-1 C.B. 296. The twenty factors are:

(1) Instruction; (2) Training; (3) Integration; (4) Services Rendered Personally; (5) Hiring, Supervising, and Paying Assistants; (6) Continuing Relationship; (7) Set Hours of Work; (8) Full Time Required; (9) Doing Work on Employer's Premises; (10) Order or Sequence Set; (11) Oral or Written Reports; (12) Payment by Hour, Week, Month; (13) Payment of Business and/or Traveling Expenses; (14) Furnishing of Tools and Materials; (15) Significant Investment; (16) Realization of Profit or Loss; (17) Working for More than One Company; (18) Making Services Available to General Public; (19) Right to Discharge; (20) Right to Terminate.

*Id.*

<sup>51</sup>Kirsten Harrington, *Employment Taxes: What Can the Small Businessman Do?*, 10 AKRON TAX J. 61, 78 (1993).



analytical tool used in arriving at a determination of the control test.<sup>52</sup> In 1996, Congress passed the Small Business Job Protection Act (SBJPA), which included significant changes to the way the twenty-factor analytical tool is implemented.<sup>53</sup> The current IRS view clusters various factors into three categories involving control: behavioral control, financial control, and the relationship of the worker with the business.<sup>54</sup> Each category contains multiple factors in making a determination for the total area.<sup>55</sup>

Behavioral Control contemplates the degree to which the employer gives instruction to the worker.<sup>56</sup> It asks about daily routines, work requirements, and which party determines the manner in which work is performed.<sup>57</sup> Financial Control involves the costs associated with the work relationship.<sup>58</sup> It seeks to understand who paid for supplies, equipment, material and property used to undertake work projects.<sup>59</sup> Relationship of the Worker and the Firm focuses on elements that evince

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<sup>52</sup>Jack E. Karns, *Current Federal and State Conflicts in the Independent Contractor Versus Employee Classification Controversy*, 22 CAMPBELL L. REV. 105, 108 (1999).

<sup>53</sup>*Id.*

<sup>54</sup>*Id.*

<sup>55</sup>I.R.S., DETERMINATION OF WORKER STATUS FOR PURPOSES OF FEDERAL EMPLOYMENT TAXES AND INCOME TAX WITHHOLDING, FORM SS-8, available at <http://www.irs.gov/pub/irs-pdf/fss8.pdf>.

<sup>56</sup>*Id.* “Behavioral Control” asks the following questions:

- (1) What specific training and/or instruction is the worker given by the firm?
- (2) How does the worker receive work assignments?
- (3) Who determines the methods by which the assignments are performed?
- (4) Who is the worker required to contact if problems or complaints arise and who is responsible for their resolution?
- (5) What types of reports are required from the worker?
- (6) What is the worker’s daily routine?
- (7) At what location does the worker perform services?
- (8) What meetings is the worker required to attend and are there penalties for not attending?
- (9) Is the worker required to provide the services personally?
- (10) If substitutes or helps are needed, who hires them?
- (11) If the worker hires the substitutes or helpers, is approval required?
- (12) Who pays the substitutes or helpers?
- (13) Is the worker reimbursed if the worker pays the substitutes or helpers?

*Id.*

<sup>57</sup>*Id.*

<sup>58</sup>Karns, *supra* note 52, at 108.

<sup>59</sup>I.R.S., *supra* note 55. “Financial Control” asks the following questions:

- (1) What supplies, equipment, materials, and property are provided by the parties?
- (2) Does the worker lease equipment?
- (3) What expenses are incurred by the worker in the performance of services for the firm?
- (4) What expenses are reimbursed by the company?
- (5) Is the work compensated by the hour, salary, commission, piece work, lump sum, or something else?
- (6) Does the worker work for any other business?
- (7) Is the worker allowed a drawing account for advances?
- (8) Whom does the customer pay?
- (9) Does the firm carry worker’s compensation insurance on the worker?
- (10) What economic loss or financial risk, if any, can the worker incur beyond the normal loss of salary?

*Id.*

the intended relationship of the parties.<sup>60</sup> More specifically, it asks if the parties intend an employer/employee relationship in substance, when it may not appear so in form.<sup>61</sup> Many cases have turned on this issue alone.<sup>62</sup> Understanding the intricacies of the control test, the economic realities test, and the entrepreneurial opportunities test, along with being aware of the enumerated statutory employees, can be a formidable task for someone who is also trying to run a business.

### III. THE SMALL BUSINESS OWNER

Small businesses<sup>63</sup> are a critical component of our national economy.<sup>64</sup> They represent 99.7% of all employer firms.<sup>65</sup> They employ half of all private sector employees.<sup>66</sup> They pay more than 45% of the total private payroll for the country.<sup>67</sup> They have generated 60 to 80% of net new jobs annually over the last decade.<sup>68</sup> They create more than 50% of non-agricultural private gross domestic product.<sup>69</sup>

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<sup>60</sup>*Id.* “Relationship of the Worker and the Firm” asks the following questions:

- (1) What benefits are available to the worker?
- (2) Can the relationship be terminated by either party without incurring liability or penalty?
- (3) Does the worker perform similar services for others?
- (4) Are there any agreements prohibiting competition between the worker and the firm while the worker is performing services or during any later period?
- (5) Is the worker a member of a union?
- (6) What type of advertising, if any, does the worker do?
- (7) If the worker assembles or processes a product at home, who provides the materials and instructions or pattern?
- (8) What does the worker do with the finished product?
- (9) How does the firm represent the worker to its customers?
- (10) If the worker no longer performs services for the firm, how did the relationship end?

*Id.*

<sup>61</sup>*Id.*

<sup>62</sup>*Illinois Tri-Seal Prods., Inc. v. United States*, 353 F.2d 216, 218 (Ct. Cl. 1965). The contractual designation of the worker is “very significant in close cases.” *Weber v. Comm’r*, 103 T.C. 378 (1994) (stating the receipt of benefits was an important fact in determining employee status).

<sup>63</sup>Defining small businesses can be problematic as it varies by industry. Further, some industries are measured, not by the number of employees, but by the profits they earn. The Small Business Administration publishes a comprehensive table listing the required threshold to be considered a small business by industry. For example, if you produced soybean, you would be considered a small business if you earned less than \$750,000 per year. However, if you owned a logging company, the threshold would not be based on your earnings, but the number of employees—fewer than 500. 13 C.F.R. 121.201 (2007), *available at* [http://www.sba.gov/idc/groups/public/documents/sba\\_homepage/serv\\_sstd\\_tablepdf.pdf](http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_sstd_tablepdf.pdf).

<sup>64</sup>Small Business Administration, *Frequently Asked Questions* (2007) <http://app1.sba.gov/faqs/faqIndexAll.cfm?areaid=24> (last visited Feb 7, 2007).

<sup>65</sup>*Id.*

<sup>66</sup>*Id.*

<sup>67</sup>*Id.*

<sup>68</sup>*Id.*

<sup>69</sup>*Id.*

They supplied more than 23% of the total value of federal prime contracts in 2005.<sup>70</sup> They produce thirteen to fourteen times more patents per employee than large patenting firms.<sup>71</sup> They employ 41% of high tech workers such as engineers and computer workers.<sup>72</sup> They made up 97% of all identified exporters and produced 28.6% of the known export value in fiscal year 2004.<sup>73</sup>

Many employment laws contain threshold provisions based on workforce size.<sup>74</sup> In other words, the statute only applies if a company has a minimum number of employees.<sup>75</sup> The FMLA, for example, is only implicated if an employer has fifty or more employees.<sup>76</sup> The reason for this recognizes a collateral proposition advanced by this Note: that small business owners often do not have the resources to ensure compliance with complex and elaborate legal standards.<sup>77</sup>

Employment taxes are applicable irrespective of the number of employees.<sup>78</sup> If a sole proprietor of a hot dog stand hires one employee, that employer must understand and comply with the same legal requirements for employment tax purposes as a corporation such as IBM or Microsoft.<sup>79</sup> Small business owners often do not have the resources to ensure compliance at the level of large corporations who have dedicated human resource departments and specialists, whose job it is to ensure corporate compliance with employment statutes.<sup>80</sup>

Not only do small business owners not have the resources to ensure compliance, they frequently do not have the capital that large corporations do to withstand the unexpected financial burden that comes with an IRS determination of non-compliance.<sup>81</sup> Paying back taxes and the accompanying fines are costs that many

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<sup>70</sup>Small Business Administration, *Frequently Asked Questions* (2007) <http://app1.sba.gov/faqs/faqIndexAll.cfm?areaid=24> (last visited Feb 7, 2007).

<sup>71</sup>*Id.*

<sup>72</sup>*Id.*

<sup>73</sup>*Id.*

<sup>74</sup>*See supra* Part II.

<sup>75</sup>For example, FMLA only applies to employers with fifty or more employees. 29 U.S.C. § 2611 (2000). Title VII applies to employers with fifteen or more employees. 42 U.S.C. § 2000e (2000).

<sup>76</sup>*See supra* Part II.

<sup>77</sup>*See generally* CRAIN & HOPKINS, *supra* note 6.

<sup>78</sup>*See supra* Part II.

<sup>79</sup>Crain, *supra* note 6.

<sup>80</sup>*Id.*

<sup>81</sup>*In re Rasbury v. IRS*, 24 F.3d 159 (11<sup>th</sup> Cir. 1994). Billie Rasbury built a successful logging company in Alabama. In 1989, the IRS randomly selected Rasbury's business for audit and examined his company over the years 1986, 1987, 1988. The IRS employed the 20-factor test and determined that Rasbury had misclassified many of his employees as independent contractors. His business was assessed \$161,502.69 in back employment taxes. Rasbury eventually prevailed in the action citing authority that supported his contention that tree cutters in the logging industry were considered independent contractors. The court stated

businesses simply cannot absorb.<sup>82</sup> If they can, the cost may limit their profits so as to eliminate any incentive to be exposed to the risk that comes with owning a business.<sup>83</sup>

#### IV. SECTION 530—A SAFE HARBOR

There is a safe harbor provision for employers who have misclassified employees as independent contractors. Section 530<sup>84</sup> 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.<sup>85</sup> Section 530 was first added to the Internal Revenue Code (IRC) nearly thirty years ago with the passage of the Revenue Act of 1978, but it was not until amendments included in the SBJPA in 1996 that it became the safe harbor provision that employers know today.<sup>86</sup>

With the passage of the SBJPA, the IRS changed its policy regarding when § 530 is implicated.<sup>87</sup> Prior to 1996, a tax examiner would first begin with the twenty-factor test to determine if the workers were employers.<sup>88</sup> After 1996, however, § 530 became the first step in all cases involving worker classification.<sup>89</sup> Consequently, § 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.<sup>90</sup>

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that the IRS “lost about every way it could lose.” *Id.* at 163. Despite the victory, Rasbury’s business was forced to file bankruptcy. *Id.*

<sup>82</sup>*Id.*

<sup>83</sup>*Id.*

<sup>84</sup>Section 530 of the Revenue Act of 1978, as amended, is technically not part of IRC, although it is often included after IRC section 3401(a). It was originally meant to be temporary. The Tax Equity and Fiscal Responsibility Act of 1982, however, extended it indefinitely. Section 530(e) was last amended in 1996 by the addition of § 1122 of the Small Business Job Protection Act of 1996 (H.R. 3448).

<sup>85</sup>*See generally* Revenue Act of 1978, Pub. L. 96-600, § 530, 92 Stat. 2885 (as amended by Pub. L. 96-167, 93 Stat. 1278 (1979); Pub. L. 96-541, 95 Stat. 3204 (1980); Pub. L. 97-248, 96 Stat. 552 (1982); Pub. L. 104-188, 110 Stat. 1766 (1996)).

<sup>86</sup>Karns, *supra* note 52.

<sup>87</sup>I.R.S., INDEPENDENT CONTRACTOR OR EMPLOYEE? TRAINING MATERIALS, 1-5 (1996), available at <http://www.irs.gov/pub/irs-utl/emporind.pdf> [hereinafter TRAINING MATERIALS]. Throughout this Note, these training materials will be referenced. The IRS disclaims the use of its training manuals to cite a technical position as it was created as an in-house training manual. Consequently, any reference to the training materials are to be viewed only as how the IRS trains its workers and not necessarily as an official, technical position.

<sup>88</sup>*Id.*

<sup>89</sup>*Id.*

<sup>90</sup>*Id.* It is worth noting that § 530 only applies to businesses. A business could receive § 530 relief, but that relief does not protect the worker. If the IRS determines the workers are, in fact, employees, the worker may be liable for their portion of employment taxes.

### A. Reporting Consistency

Any tax returns filed on behalf of a worker must be consistent with the employer's treatment of that worker.<sup>91</sup> For independent contractors, the IRS requires the employer to file Form 1099, an informational form stating the amount paid to the contractor during the pertinent year.<sup>92</sup> If the employer is to successfully claim a worker as an independent contractor, he must have filed the informational form for the worker during the period in question.<sup>93</sup>

The reporting consistency requirement is well illustrated in *Murphy v. United States*. In *Murphy*, the taxpayer owned a truck driving company.<sup>94</sup> The company hired truck drivers and the billing clerk as independent contractors for federal income tax purposes.<sup>95</sup> After the IRS determined that Murphy's workers were employees and not independent contractors, the IRS assessed \$203,319.73 against the company for unpaid federal employment and unemployment taxes for a period of

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<sup>91</sup>Revenue Act of 1978, Pub. L. 96-600, § 530(a)(1)(B), 92 Stat. 2885.

<sup>92</sup>MANUAL, *supra* note 10, § 4.23.6.8.

<sup>93</sup>Revenue Act of 1978, Pub. L. 96-600, § 530(a)(1)(B), 92 Stat. 2885.

#### Example 1

C owns a small insurance agency. Four times a year C mails information packets to all current and prospective clients. C employs four high school students to stuff envelopes. Each is paid \$400. C treats the students as independent contractors. No Forms 1099 were filed for the \$400 paid to each student. Section 530 relief will not be denied on the basis of failure to file required information returns. C is NOT "required to file" information returns because the \$600 threshold has not been met.

#### Example 2

In 1992, C increased the number of mailings to five per year and raised the payment to the students to \$750. C continued to treat the four students as independent contractors. In 1992, no Forms 1099 were filed for the \$750 paid to each student. All required information returns were filed for 1993, 1994, and 1995. C would not be entitled to relief for the 1992 year as the "required" information returns were not filed. However, C may still qualify for section 530 relief for the subsequent years.

#### Example 3

R corporation has 30 workers whom it treated as independent contractors in 1995. You requested copies of all Forms 1099 filed with the IRS and found none were filed. The due date for these filings has passed. You discuss this with the controller, who states that R corporation forgot to file Forms 1099 but will see that they are prepared and filed next week. R corporation should have filed Forms 1099 with the IRS by the end of February, 1996, in order to qualify for the relief provisions of section 530. However, if R corporation has other workers for whom Forms 1099 were filed, section 530 relief may be available with respect to those workers. You should continue the examination and consider the relationship between the 30 workers and R corporation.

TRAINING MATERIALS, *supra* note 87, at 1-6.

<sup>94</sup>1993 U.S. Dist. LEXIS 15406 (W.D. WI Oct. 22, 1993).

<sup>95</sup>*Id.*

five years.<sup>96</sup> Murphy paid the taxes, but later sued for refunds claiming § 530 relief.<sup>97</sup> The court held that Murphy was not entitled to § 530 for the sole reason that the company failed to file Form 1099.<sup>98</sup>

There is some forgiveness, however, for businesses that mistakenly file the *wrong type* of Form 1099.<sup>99</sup> Businesses that file the wrong type of Form 1099 might not lose § 530 eligibility, so long as the mistake was in good faith.<sup>100</sup>

### B. Substantive Consistency

An employer cannot treat one worker as an independent contractor and another as an employee when they both perform the same function.<sup>101</sup> 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.”<sup>102</sup> 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 *not* substantially similar.”(emphasis added).<sup>103</sup>

A well known case implicating substantive consistency is *Vizcaino v. Microsoft Corp.*<sup>104</sup> In *Vizcaino*, Microsoft hired numerous workers as independent contractors to work on specific projects and to fulfill various duties including production editing, proofreading, formatting, indexing, and testing.<sup>105</sup> These employment arrangements often lasted more than two years.<sup>106</sup> Perhaps most damning to Microsoft, the court stated that “Microsoft fully integrated [the workers] into its workforce: they often

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<sup>96</sup>*Id.*

<sup>97</sup>*Id.*

<sup>98</sup>*Id.*

<sup>99</sup>TRAINING MATERIALS, *supra* note 87, at 1-7.

<sup>100</sup>*Id.* at 1-7.

<sup>101</sup>Revenue Act of 1978, Pub. L. 96-600, § 530(a)(3), 92 Stat. 2885.

<sup>102</sup>TRAINING MATERIALS, *supra* note 87, at 1-9.

<sup>103</sup>*Id.*

<sup>104</sup>120 F.3d 1006 (9th Cir. 1997); *see also* Inst. for Res. Mgmt., Inc. v. United States, 22 Cl. Ct. 114 (1990) (holding no safe haven was available for employment tax treatment of any worker who was treated as an independent contractor if the business treated any worker holding a substantially similar position as an employee for employment tax purposes). Further, the following example is illustrative:

V corporation's 1992 returns were examined and it was found that 100 workers, all doing the same job, were being treated as independent contractors. The examiner discovered that five of these 100 workers were, in 1988, treated as employees while they performed substantially the same job as in 1992. V corporation cannot claim relief under section 530 in 1992 for any of these 100 workers because of inconsistent treatment of workers as employees in 1988.

TRAINING MATERIALS, *supra* note 87, at 1-14.

<sup>105</sup>*Vizcaino*, 120 F.3d 1006.

<sup>106</sup>*Id.*

worked on teams along with regular employees, sharing the same supervisors, performing identical functions, and working the same core hours.”<sup>107</sup> Since the independent contractors were, in substance, being treated like and performing the functions of employees, the IRS determined that they were employees and not independent contractors, which resulted in a substantial judgment against Microsoft.<sup>108</sup>

### C. A Reasonable Basis

An employer must have some reasonable basis<sup>109</sup> for treating the worker as an independent contractor.<sup>110</sup> A reasonable basis includes reasonable reliance on any of the following: a judicial precedent,<sup>111</sup> the results of a past audit of the taxpayer,<sup>112</sup> or a long-standing recognized practice of a significant segment of the industry.<sup>113</sup>

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<sup>107</sup>*Id.* (quoting *Vizcaino v. Microsoft Corp.*, 97 F.3d 1187, 1190 (9th Cir. 1996) (*Vizcaino I*)).

<sup>108</sup>*Id.*

<sup>109</sup>*Boles Trucking, Inc. v. United States*, 77 F.3d 236 (8th Cir. 1996) (holding where the business has the initial burden of proof in demonstrating that it is entitled to relief under § 530). *But see* Revenue Act of 1978, Pub. L. 96-600, § 530(e)(4), 92 Stat. 2885, which shifts the burden of proof to the IRS if two requirements are satisfied: (1) the taxpayer establishes a prima facie case that it was reasonable not to treat an individual as an employee; and (2) the taxpayer cooperates fully with reasonable requests from the examiner; *McClellan v. United States*, 900 F.Supp. 101 (E.D. Mich. 1995) (holding that if the taxpayer came forward with an explanation and enough evidence to establish prima facie grounds for a finding of reasonableness, then the burden shifted to the IRS to verify or refute the taxpayer’s explanation).

<sup>110</sup>§ 530(a)(1)(B).

<sup>111</sup>*Id.*; § 530(a)(2)(A). The judicial precedent category includes a published ruling, technical advice memorandum or private letter ruling with respect to the individual or specific taxpayer under examination.

<sup>112</sup>*Id.*; § 530(a)(2)(B). This means a prior IRS audit of the taxpayer in which employment tax deficiencies were not assessed for amounts paid workers holding positions substantially similar to that held by the worker in question. To illustrate:

U corporation’s federal income tax return for 1989 was examined in 1991 and the status of two workers who were paid by the corporation as independent contractors was not questioned. U corporation’s 1992 federal income tax return was examined in 1994 and the status of 45 workers holding positions substantially similar to the positions held by the two workers treated as independent contractors in the 1989 return was questioned. The failure to raise the issue in the 1991 examination of the 1989 return has created a prior audit safe haven for the U corporation. U corporation can continue to treat the 45 workers as independent contractors as well as any others who perform substantially similar services provided the other requirements of section 530 are met.

TRAINING MATERIALS, *supra* note 87, at 1-22.

<sup>113</sup>§ 530(a)(1)(B). This is a long-standing recognized practice of a significant segment of the industry in which the worker is engaged. *See generally* *Gen. Inv. Corp. v. United States*, 823 F.2d 337 (9th Cir. 1987).

### 1. Judicial Precedent

The first way an employer can assert a reasonable basis for treating a worker as an independent contractor is by reliance on a 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.<sup>114</sup> 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.<sup>115</sup>

There is no minimum threshold number of cases, however, required to establish a precedent.<sup>116</sup> Reasonably relying on just one case is sufficient to claim § 530 relief, assuming the other prongs are met.<sup>117</sup> 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.<sup>118</sup> It is critical to note, however that the types of cases an employer can reasonably rely upon are limited.<sup>119</sup> Only federal court decisions and revenue rulings interpreting the IRC can satisfy a reasonable basis based on judicial precedent.<sup>120</sup> An employer cannot claim safe haven based upon reliance on a state court decision.<sup>121</sup>

### 2. Prior Audit

Tax examiners are instructed that reliance on a prior audit is the easiest way an employer can establish § 530 relief.<sup>122</sup> 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.<sup>123</sup> 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.<sup>124</sup> 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.<sup>125</sup> Additionally, evidence of a prior audit, by itself is insufficient to establish a reasonable basis.<sup>126</sup> Establishing a reasonable basis based on a prior audit requires that the employer *relied* on the prior audit in

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<sup>114</sup>TRAINING MATERIALS, *supra* note 87, at 1-24.

<sup>115</sup>*Id.*

<sup>116</sup>*Id.*

<sup>117</sup>*Id.*

<sup>118</sup>*Id.*

<sup>119</sup>*Id.*

<sup>120</sup>TRAINING MATERIALS, *supra* note 87, at 1-24.

<sup>121</sup>*Id.*

<sup>122</sup>*Id.* at 1-19.

<sup>123</sup>*Id.* at 1-20.

<sup>124</sup>*Id.*

<sup>125</sup>*Id.*

<sup>126</sup>TRAINING MATERIALS, *supra* note 87, at 1-22.



treating workers as independent contractors.<sup>127</sup> Proving reliance, however, does not impose a terribly high burden.<sup>128</sup> 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.”<sup>129</sup>

### 3. 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.”<sup>130</sup> The IRS described this type of reasonable basis as “the one which causes the most controversy between businesses and the government.”<sup>131</sup> The language of this provision lends itself to debate as it leaves open definitions for what constitutes “industry,” “long-standing,” and “significant segment”.

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.”<sup>132</sup> A prominent case illustrating “industry” is *General Investment Corp. v. United States*, in which the court held that an industry can be limited by geography.<sup>133</sup> In *General Investment*, the company (“GIC”) was a mining company that operated a small gold and silver mine in Arizona.<sup>134</sup> As was common practice in the county, GIC hired Mexican nationals as independent contractors to operate the mine.<sup>135</sup> GIC claimed that the workers did not want employee status as they did not want their employment taxes taken out of their paycheck.<sup>136</sup> GIC further argued that if they were to treat them as employees, they would not be able to hire enough workers to operate their mine as hiring workers as employees would be an undesired aberrational practice within the county.<sup>137</sup>

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<sup>127</sup>*Id.*

<sup>128</sup>*Id.* at 1-24.

<sup>129</sup>*Id.*

<sup>130</sup>Revenue Act of 1978, Pub. L. 96-600, § 530(a)(2)(C), 92 Stat. 2885.

<sup>131</sup>TRAINING MATERIALS, *supra* note 87, at 1-26.

<sup>132</sup>The following is provided in IRS training materials as an explanation:

[T]he landscaping industry will generally consist of businesses within a single metropolitan area. However, if the area includes only one or a few businesses in the same industry, the geographic area may be extended to include contiguous areas in which there are other businesses competing for the same customers. If businesses compete in regional or national markets, the geographic area may include the competitors in that region or throughout the United States. For example, the commercial film production industry competes in a national market.

*Id.* at 1-26.

<sup>133</sup>823 F.2d 337 (9th Cir. 1987).

<sup>134</sup>*Id.*

<sup>135</sup>*Id.*

<sup>136</sup>*Id.*

<sup>137</sup>*Id.*

The IRS audited GIC and deemed the company's workers to be employees and assessed over \$83,000 in back taxes.<sup>138</sup> The company paid the taxes and afterward sued for a refund.<sup>139</sup> The issue in the case largely turned on how to define "industry."<sup>140</sup> The IRS argued that "industry" should be based on national practices, whereas GIC contended that its industry was limited to the County.<sup>141</sup> Indeed, GIC was a small operation and did not mine outside the county.<sup>142</sup> The court agreed with GIC's argument and allowed "industry" to be limited to the geography of the county.<sup>143</sup>

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 *always* be treated as long-standing." (emphasis added).<sup>144</sup> IRS training manuals offer an appropriate hypothetical to illustrate the issue 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.<sup>145</sup>

Understanding "significant segment" of an industry may be the least troublesome portion of the "industry practice" argument for the reasonable basis prong because of an amendment to § 530 in the SJBPA.<sup>146</sup> Prior to 1996, neither § 530 nor its legislative history provided helpful instruction as to what a "significant segment" meant.<sup>147</sup> However, amendments to § 530 established a threshold of twenty-five percent as constituting a significant segment of an industry.<sup>148</sup> Even still, there is a discretionary range below twenty-five percent wherein an examiner may deem a

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<sup>138</sup>*Id.*

<sup>139</sup>*Gen. Inv.*, 823 F.2d 337.

<sup>140</sup>*Id.*

<sup>141</sup>*Id.*

<sup>142</sup>*Id.*

<sup>143</sup>*Id.*

<sup>144</sup>TRAINING MATERIALS, *supra* note 87, at 1-27.

<sup>145</sup>*Id.*

<sup>146</sup>*Id.* at 1-31.

<sup>147</sup>*Id.*

<sup>148</sup>*Id.*

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.<sup>149</sup>

#### 4. 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.<sup>150</sup> Further, there are cases where courts have entertained other reasonable bases.<sup>151</sup> Additionally, the legislative history indicates that Congress intended the reasonable basis prong to have broad application.<sup>152</sup> Section 530 legislative history states, “[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 *construed liberally in favor of taxpayers*.”<sup>153</sup> 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.”<sup>154</sup> Further, businesses have the initial burden of proof in establishing they qualify for relief under § 530.<sup>155</sup> 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.”<sup>156</sup>

#### D. Section 530 Relief

If the three requirements in § 530 have been satisfied, no assessment against the employer will be made and she may continue to treat her workers as independent contractors, even if the IRS later determines the workers have been misclassified.<sup>157</sup> If, however, the workers are deemed employees and any one of the three § 530 prongs is not met, the safe harbor will not apply.<sup>158</sup> This may be problematic because

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<sup>149</sup>*Id.*

<sup>150</sup>MANUAL, *supra* note 10, § 4.23.6.13.5. “A taxpayer who fails to meet any of the above safe havens *may demonstrate some other reasonable basis* for not treating the worker as an employee.” (emphasis added). Additionally, the legislative history of section 530 indicates that “reasonable basis” should be construed liberally in favor of the taxpayer. H.R. Rep. No. 95-1748, pt. 1, at 633 (1978).

<sup>151</sup>*See generally In re McAtee*, 115 B.R. 180 (Bankr. N.D. Iowa 1990) (holding that reliance on the advice of an attorney or accountant may constitute a reasonable basis); *Queensgate Dental Family Practice, Inc. v. United States*, No. 1:CV-90-0918, 1991 U.S. Dist. Lexis 13333 (M.D. Pa. 1991) (finding a decision by the State Dental Board that dentists were independent contractors of unlicensed business corporations to be a reasonable basis).

<sup>152</sup>H.R. Rep. No. 95-1748, pt. 1, at 633 (1978).

<sup>153</sup>*Id.*

<sup>154</sup>TRAINING MATERIALS, *supra* note 87, at 1.16.

<sup>155</sup>*Id.* at 1-17.

<sup>156</sup>*Id.*

<sup>157</sup>*Id.*

<sup>158</sup>Revenue Act of 1978, Pub. L. 96-600, § 530(a)(1)(B), 92 Stat. 2885.

there are situations where equitable relief is appropriate, but the facts preclude its application.<sup>159</sup> The CSP purportedly exists to reduce taxpayer burden when the employer does not qualify for § 530 relief.<sup>160</sup>

#### V. THE CLASSIFICATION SETTLEMENT PROGRAM

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.<sup>161</sup> 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;<sup>162</sup> reporting consistency and reasonable basis are met, but lacking substantive consistency;<sup>163</sup> and substantive consistency and reasonable basis are met, but there is no reporting consistency.<sup>164</sup>

##### A. Implementing the CSP

Executing the CSP is explicitly detailed in the Internal Revenue Manual.<sup>165</sup> The tax examiner<sup>166</sup> begins with an assessment of whether the employer qualifies for §

<sup>159</sup>For example, a business may have consistently complied with IRS requirements, but failed to file the appropriate tax forms one year. Even though the business had been compliant before and after the year in which they failed to file, they will be barred from receiving safe harbor for that year. *See also General Investment*, 823 F.2d 337 (holding the business was not entitled to § 530 relief for the year it failed to file information returns).

<sup>160</sup>*See* Revenue Act of 1978, Pub. L. 96-600, § 530(a)(1)(B), 92 Stat. 2885.

<sup>161</sup>MANUAL, *supra* note 10, § 4.23.6.2. When an IRS examiner selects a business for an employment tax examination because of the treatment of certain workers as independent contractors, the examiner must first determine whether the business is entitled to relief from retroactive and prospective liability for employment taxes under § 530 of the Revenue Act of 1978. To qualify for relief, the business must meet three requirements: reporting consistency, substantive consistency, and reasonable basis.

<sup>162</sup>*Id.* § 4.23.6.13.

<sup>163</sup>*Id.*

<sup>164</sup>*Id.*

<sup>165</sup>*Id.* § 4.23.6.1. The CSP establishes procedures under an optional classification settlement program that will allow businesses and tax examiners to resolve worker classification cases as early in the administrative process as possible, with the goal being to reduce taxpayer burden. The procedures are also intended to make sure relief under § 530 of the Revenue Act of 1978 is adequately and correctly applied where applicable. Under the CSP, examiners will be able to offer businesses under examination a worker classification settlement using a standard closing agreement. *Id.*

<sup>166</sup>*Id.* § 4.23.6.5. The Internal Revenue Manual describes the examiner's duty as follows:

The IRS examiner must begin by determining whether the business is eligible for relief under section 530 for the examination year. If the business is not eligible for relief under section 530, the examiner must initiate a single year examination. The last year audited is generally arbitrarily chosen as the year of examination. If the examiner determines that no reclassification issue exists, the CSP procedures will not apply.

If the examiner determines a reclassification issue does exist, examiners will then consider whether CSP applies. If the examination includes a proposal to reclassify workers as employees and the taxpayer has timely filed required Forms 1099, a CSP

530 relief.<sup>167</sup> If the employer qualifies for relief, she is allowed to continue the employment practices without a tax assessment.<sup>168</sup> If, however, the employer does not qualify for § 530 relief, the examiner will then determine whether the workers are employees or independent contractors.<sup>169</sup> Determining worker status is accomplished according to the IRS' method of employing the common law control test.<sup>170</sup> If no reclassification issue exists, no tax assessment is made.<sup>171</sup> If, however, there is a reclassification issue, the examiner then must determine whether the CSP applies.<sup>172</sup> The CSP will apply if the employer has failed to satisfy either the reasonable basis requirement or the substantive consistency requirement.<sup>173</sup> In either situation, however, reporting consistency must be met.<sup>174</sup> Simply put, the untimely filing of Form 1099 will act as an automatic bar to CSP settlement.<sup>175</sup>

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offer should generally be made (refer to the IRM 4.23.6.8, Cases Excluded from CSP, for cases which are specifically excluded from CSP).

To determine which CSP offer, if any, is appropriate, examiners should follow the procedures in IRM 4.23.6.13, Procedures for CSP. The examiner will need to consider the facts and circumstances of each case and make a CSP recommendation to their group manager for approval. The recommendation will be made on a Settlement Memorandum, as described in IRM 4.23.6.14.1.

The final decision regarding whether a CSP offer is appropriate will be made by the manager, after a discussion with the examiner and a thorough review of the case.

*Id.*

<sup>167</sup>MANUAL, *supra* note 10, § 4.23.6.2.

<sup>168</sup>*Id.* § 4.23.6.2. In cases where the business clearly meets the reporting and substantive consistency requirements and satisfies the reasonable basis test, the employer qualifies for relief under § 530. No assessment will be made and the business may choose to continue treating its workers as independent contractors.

<sup>169</sup>*Id.* § 4.23.6.2. If the business does not meet the relief provisions, the examiner must determine whether the workers are independent contractors or employees. As discussed previously, IRC 3121(d)(2) requires that the issue of worker classification be resolved using the common law standard. This requires the IRS to examine facts and circumstances to determine whether a business has the right to direct and control the details of the performance of its workers.

<sup>170</sup>*See supra* Part II.

<sup>171</sup>MANUAL, *supra* note 10, § 4.23.6.5.

<sup>172</sup>*Id.* § 4.23.6.5. If a reclassification issue does exist, examiners will then consider whether CSP applies. If the examination includes a proposal to reclassify workers as employees and the taxpayer has timely filed required Forms 1099, a CSP offer should generally be made.

<sup>173</sup>*Id.* § 4.23.6.13.3.

<sup>174</sup>*Id.*

<sup>175</sup>*Id.* § 4.23.6.8. The CSP program is only available for the worker classification issue. This precludes cases in which a threshold issue, such as the nature of a payment as dividends or wages, has not been resolved at the examination level. In addition, the CSP program is available only if the taxpayer timely filed Forms 1099. If the taxpayer did not timely file required Forms 1099, CSP is not available even if other forms were timely filed. *Id.*

### B. Potential Settlement Scenarios

There are two settlement offers an examiner can extend pursuant to the CSP, both of which assume that Form 1099 was timely filed.<sup>176</sup> The distinction between the two offers arises from the degree of certainty of being barred from § 530 relief.<sup>177</sup>

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.<sup>178</sup> This certainty 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.<sup>179</sup> 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.<sup>180</sup> 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.

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.<sup>181</sup> All examiners must ask the question, “Is the taxpayer entitled to § 530 relief?”<sup>182</sup> This second settlement offer only arises when the answer to this question is “maybe.”<sup>183</sup> The ambiguity may arise because of

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Further, the CSP program is not available for worker classification issues that are the subject of a prior closing agreement. *Id.*

<sup>176</sup>*Id.* § 4.23.6.8. Since it is a requirement that businesses file Form 1099, a CSP settlement offer presupposes such compliance.

<sup>177</sup>MANUAL, *supra* note 10, § 4.23.6.13.1. This is inferred from the language in the manual as it states, “[i]f the business meets the section 530 reporting consistency requirement but either *clearly* does not meet the section 530 substantive consistency requirement or clearly cannot meet the section 530 reasonable basis test, the offer will be a full employment tax assessment for the one taxable year under examination . . .” (emphasis added).

<sup>178</sup>*Id.*

<sup>179</sup>*Id.*

<sup>180</sup>*Id.*

<sup>181</sup>*Id.* If the business meets the reporting consistency requirement and has a colorable argument that it meets the substantive consistency requirement and the reasonable basis test, the offer will be an assessment of twenty-five percent of the employment tax liability for the audit year, computed using IRC section 3509, if applicable.

<sup>182</sup>*Id.* § 4.23.6.5.

<sup>183</sup>MANUAL, *supra* note 10, § 4.23.6.13.2. The CSP contains a settlement rubric. One column is entitled, “Is [taxpayer] Entitled to [§ 530] Relief?” The rubric literally lists “maybe” as the determination to this question resulting in a twenty-five percent tax assessment for one year.

Are the Workers Employees?	Were Forms 1099 Timely Filed?	Is Tax Payer Entitled to § 530 Relief?	Type of CSP Offer
1. Yes	Yes	Yes	Tax Payer's Option
2. No	Yes/No	N/A	None
3. Yes	No	No	None

several reasons, including an ambiguous judicial opinion the employer agreed upon,<sup>184</sup> or because it is unclear if it is a practice of a *significant* segment of the industry.<sup>185</sup> Under the second settlement option, the employer is only assessed twenty-five percent of one year of the audit period, along with prospective compliance.<sup>186</sup>

If settlement is appropriate for the reasons stated above, the examiner is instructed that a CSP offer “should generally” be made.<sup>187</sup> 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.<sup>188</sup> The examiner should explain why an offer was made and what course of action was taken in the alternative.<sup>189</sup> If an offer was made, the offer must be approved by a group manager.<sup>190</sup> The group manager is delegated the authority to approve CSP offers to ensure that correct and consistent CSP determinations are made.<sup>191</sup>

4. Yes	Yes	No	One Year Tax
5. Yes	Yes	Maybe	25% Tax

<sup>184</sup>See *Lambert’s Nursery and Landscaping v. United States*, 894 F.2d 154 (5th Cir. 1990). In *Lambert*, Lambert’s Nursery periodically hired landscaping workers as independent contractors. It relied upon a prior judicial ruling that recognized occasional janitorial workers as independent contractors. The IRS argued against the analogy, but the appellate court sided with Lambert’s Nursery, stating that the manner of employment between the janitorial workers and the landscaping workers was similar enough that Lambert’s Nursery could have reasonably relied on the judicial precedent.

<sup>185</sup>See generally *General Investing*, 823 F.2d 337.

<sup>186</sup>MANUAL, *supra* note 10, § 4.23.6.2.

<sup>187</sup>*Id.* § 4.23.6.5. This automatically excludes those cases where Form 1099 was not filed as well as others the examiner deems to not be appropriate.

<sup>188</sup>*Id.* § 4.23.6.11.

<sup>189</sup>*Id.* The exact language in the manual states, “[o]n any case involving a determination that a worker was misclassified, the examiner must comment on CSP. The examiner should fully explain in his/her work papers that CSP was considered, whether or not an offer was made, what type of offer was made, if any, and why.” *Id.*

<sup>190</sup>*Id.* § 4.23.6.4.

<sup>191</sup>Specific group managers are delegated the authority to sign the CSP closing agreements. This authority should be exercised with care to ensure correct and consistent determinations are made. The following is a description of group managers’ duties under the CSP:

CSP settlements are intended to simulate the results that would be obtained under current law, if the businesses accepting those offers had instead exercised their right to an administrative and/or judicial appeal. Settlements should not be made simply to expedite case closing. In addition, all group managers must ensure that settlement offers are not made in an effort to induce businesses to change worker status when independent contractor status is correct, or when the taxpayer is clearly entitled to section 530 relief.

Group managers must ensure that the evaluation of whether the business was entitled to section 530 relief and the examination of the worker classification issue for a year was completed and fully developed to support the change in classification. An offer should not be made if additional audit work is needed for the year.

## VI. SHORTCOMINGS OF THE CSP

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.

On December 21, 2004, members of the tax section of the American Bar Association (ABA) submitted a letter to the Commissioner of Internal Revenue.<sup>192</sup> The letter outlined twelve substantive areas that could be improved in the CSP, along with numerous minor editorial recommendations.<sup>193</sup> While the ABA's letter is largely beyond the scope of this Note, there are related areas.<sup>194</sup> Specifically, the ABA made explicit recommendations with respect to the filing requirement of Form 1099.<sup>195</sup> While this Note agrees with many of the ABA's recommendations, key distinctions must be made between this Note's argument and the ABA's recommendations regarding the timely filing requirement.

A. *Untimely Filings*

The CSP unnecessarily precludes settlement when Form 1099 has not been timely filed. The CSP is not available "if the taxpayer did not timely file required forms 1099 . . . even if other forms were timely filed."<sup>196</sup> Although some scholars<sup>197</sup>

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Examiners should be advised that the examination for the year must be completed before a settlement offer can be approved. This situation may require group manager communication with the taxpayer, if an offer has already been discussed by the examiner. It is important that the group managers work with examiners to assure that premature offers are not made.

It is crucial that taxpayers are treated consistently under CSP. Group managers are responsible for assuring that examiners make offers in appropriate cases, explain the terms and conditions clearly to taxpayers, and correctly apply the settlement provisions so that taxpayers who are similarly situated receive the same CSP offer. Group managers should also work with examiners to explain the benefits of CSP to taxpayers.

*Id.* § 4.23.6.4.

<sup>192</sup>Letter from American Bar Association, Section of Taxation, to the Honorable Mark W. Everson, Commissioner of Internal Revenue (December 21, 2004) (on file with author), available at <http://www.abanet.org/tax/pubpolicy/2004/041221emt.pdf> [hereinafter ABA Letter].

<sup>193</sup>*Id.*

<sup>194</sup>*Id.*

<sup>195</sup>*Id.*

<sup>196</sup>MANUAL, *supra* note 10, § 4.23.6.8.

<sup>197</sup>Harrington, *supra* note 51, at 87. Harrington further writes:

In the independent contractor area, Congress has acknowledged that a problem exists with the Service's intensive audits of the businesses served by independent contractors. Section 530, enacted as a temporary measure in 1976 to ameliorate the situation then, is now a permanent provision. Yet dissatisfaction with both § 530 and the unwieldy subjective common law test indicate that a more certain and objective approach is needed. The best approach is for the Service to focus its efforts on seeing Form 1099 is consistently filed by the businesses using independent contractors'



argued for emphasis on the filing of Form 1099 to provide a clear, objective criterion for determinations, this condition of CSP settlement elevates form over substance and should be abandoned.

Concerning the requirement of timely filing Form 1099, the ABA makes three recommendations, all of which seek to clarify—not modify—the current CSP. First, the ABA recommends the IRS clarify that “non-issuance of IRS Form 1099s by an employer disqualifies it from the CSP for only those workers for whom the Form 1099s were not filed.” The second recommendation is that the IRS clarify that “non-issuance of Form 1099s to workers for whom no Form 1099s were required (e.g., incorporated entities) does not disqualify an employer from the CSP for those workers.” Finally, the ABA recommends that the IRS clarify that:

[L]ate-filed Form 1099s may be considered “timely filed” if they represent a de minimis number of all Forms 1099 or if an auditor concludes that any late filing was due to inadvertence, excusable neglect, or good cause, that the late-filing taxpayer acted in good faith, *and that the taxpayer filed the Form 1099s prior to any contact from an IRS examiner.*<sup>198</sup>

This Note does not disagree with these recommendations, but argues that they do not go far enough. The ABA seeks only for the IRS to clarify existing CSP policy in this regard. It does not suggest modifications. The ABA recommendations offers support only to those taxpayers who have filed their Forms 1099 late. Nowhere in the recommendations does it recommend modification of the CSP to include some relief to those small business owners who have failed to file Forms 1099 altogether *before* contact from an IRS examiner.

The CSP does state, however, that “a de minimis failure to timely file Forms 1099 should not affect the taxpayer’s eligibility for CSP.” To illustrate the point, the manual offers the following example:

Your recent review of a retail outlet revealed the taxpayer had treated one class of 150 workers as independent contractors. You inspected Forms 1099 and determined that all required Forms 1099 were timely filed except for three which were missed by the processing department. Here the taxpayer’s failure to timely file a de minimis number of Forms 1099 would not indicate that the taxpayer has clearly failed the reporting consistency requirement. You will continue your analysis to determine whether the taxpayer meets the substantive consistency and reasonable basis test.<sup>199</sup>

Here, the example illustrated two percent failure rate as an acceptable failure to timely file a de minimis number of Forms 1099. This example is inherently problematic because it places a higher burden as the size of the business decreases. If the same number of Forms 1099 were not timely filed—three—but the number of

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services along with matching the Form 1099s with the independent contractors’ tax returns.

*Id.*

<sup>198</sup>ABA Letter, *supra* note 192, at 3 (emphasis added).

<sup>199</sup>MANUAL, *supra* note 10, § 4.23.6.13.1.

employees were reduced by half, the rate would double. At a more extreme level, if an employer has hired four independent contractors and fails to not timely file just one of these, the failure rate is at twenty-five percent. The mathematical reality is that the CSP permits a greater number of non-compliant activities for larger companies than smaller ones.

1. An Equitable Approach: *Medical Emergency Care Ass'n. v. Commissioner of Internal Revenue*

Since the CSP exists before the court process, there is no case law that speaks to it directly. Section 530 case law, however, is instructive. In 2003, the United States Tax Court held in *Medical Emergency Care Ass'n. v. Commissioner of Internal Revenue* that the untimely filing of information returns does not preclude petitioner from qualifying for relief pursuant to § 530.<sup>200</sup> Medical Emergency Care Association was a medical service corporation that contracted with Chicago area hospitals to furnish professional emergency medical services and full-time physician staffing.<sup>201</sup> The corporation hired physicians to staff hospital emergency rooms as independent contractors.<sup>202</sup> Hiring physicians as independent contractors in similar situations was a longstanding, recognized practice of a significant segment of the emergency room industry.<sup>203</sup> Additionally, the contractor physicians, or any other worker in a substantially similar position, were never treated as employees.<sup>204</sup>

Although Medical Emergency Care Association demonstrated that it had a reasonable basis for treating the physicians as independent contractors and treated them substantively consistent with that classification, it failed to timely file the correct informational tax return.<sup>205</sup> Because of Medical Emergency Care's deficiency in reporting consistency, the IRS determined that § 530 was not appropriate and notified the company that the workers should be reclassified as employees and that they were liable for back employment taxes for its physician contractors.<sup>206</sup> The court stated that the primary issue in this case was whether timely filing is required by § 530.<sup>207</sup>

The court based its decision on two related points.<sup>208</sup> First, the language of § 530 speaks to failing to file forms altogether, not untimely filings.<sup>209</sup> Second, the IRC contains an explicit penalty regime for untimely filings; therefore, a timely filing

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<sup>200</sup>120 T.C. 436, 445 (2003).

<sup>201</sup>*Id.* at 437.

<sup>202</sup>*Id.* at 437-38.

<sup>203</sup>*Id.* at 438.

<sup>204</sup>*Id.*

<sup>205</sup>*Med. Emergency Care*, 120 T.C. 436, 438.

<sup>206</sup>*Id.* at 441.

<sup>207</sup>*Id.* at 440.

<sup>208</sup>*Id.*

<sup>209</sup>*Id.* at 443.

requirement should not be implied into § 530 so as to bar relief to a tax payer who has filed the correct form, albeit late.<sup>210</sup> The court stated:

Nothing in the language or legislative history of section 530 leads us to the conclusion that denial of section 530 relief was meant to be an additional penalty for the failure to timely file information returns, particularly under the circumstances in this case. Rather, as discussed above, section 530 was enacted to protect taxpayers from having to litigate the status of individual workers under the common law employment rules. The Commissioner is entitled to require timely filing and to impose a penalty, when appropriate, for failure to timely file, but not the penalty he seeks to impose here.<sup>211</sup>

## 2. *Medical Emergency Care* and the CSP

If the CSP does not abandon the requirement of the timely filing of Form 1099, the decision in *Medical Emergency Care* undermines the very purpose of the CSP's existence. The CSP was created to reduce taxpayer burden in situations where an employer is precluded from § 530 relief. *Medical Emergency Care* held that the timely filing of tax forms does not bar an employer from § 530 while the CSP requires the timely filing of tax forms.<sup>212</sup> If the CSP is to provide taxpayers an opportunity for settlement when no § 530 relief can be achieved, it is patently illogical to maintain a higher standard in the CSP than exists in § 530.

### B. *Limited Settlement Options*

The CSP provides too few settlement options.<sup>213</sup> Although the manual states that, "under the CSP, a series of graduated settlement offers will be available,"<sup>214</sup> in reality, no such series of graduated settlement offers exists.<sup>215</sup> There are only two offers an examiner can extend in accordance with the CSP: (1) a full tax assessment for one year;<sup>216</sup> and (2) a tax assessment of twenty-five percent of one year.<sup>217</sup> In both cases prospective compliance is also required.<sup>218</sup> While a series of graduated settlement offers is exactly what the situation calls for, two possible offers are insufficient to qualify as a series of graduated settlement offers.

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<sup>210</sup>*Id.*

<sup>211</sup>*Id.* at 444.

<sup>212</sup>*Id.* at 445.

<sup>213</sup>MANUAL, *supra* note 10, § 4.23.6.13.3.

<sup>214</sup>*Id.* § 4.23.6.13.1.

<sup>215</sup>*Id.*

<sup>216</sup>*Id.*

<sup>217</sup>MANUAL, *supra* note 10, § 4.23.6.13.1.

<sup>218</sup>*Id.*

### C. Discretion of Examiner

The CSP allows too much discretion on the part of the examiner in determining a CSP settlement offer. The examiner must make critical determinations throughout the examination process.<sup>219</sup> The CSP rightfully grants the examiner some flexibility in tailoring the process to an individual business as it states that “[e]very settlement offer will be based on a full examination of the facts and circumstances for the year under examination.”<sup>220</sup> Despite the necessary flexibility, however, the CSP grants too much discretion to the examiner in several areas.

First, the CSP retains too much discretion in deciding whether a CSP should be made after it has been determined that the employer is eligible. The language in the examiner’s manual states that “[i]f the examination includes a proposal to reclassify workers as employees and the taxpayer has timely filed required Forms 1099, a CSP offer *should generally* be made.”<sup>221</sup> While this language seems favorable to employers, it is, in fact, too vague and should be amended because it leaves open the possibility of the examiner withholding a CSP settlement where the employer may qualify.

Perhaps the most problematic area where the examiner has too much discretion involves what the manual refers to as the “reasonable basis argument.”<sup>222</sup> A reasonable basis argument exists when an employer has satisfied the reporting and substantive consistency prongs, but there is some dispute over the basis for treating the workers as independent contractors.<sup>223</sup> As stated previously in this Note, a reasonable basis can be based on a judicial precedent, a prior audit, a long-standing practice of a significant segment of the industry.<sup>224</sup>

These reasonable basis arguments are considered “typically the most difficult”<sup>225</sup> and require “significant development and legal research.”<sup>226</sup> An often occurring

<sup>219</sup>The manual lists the following responsibilities as adhering to the examiner:

The IRS examiner will first determine whether the business is eligible for relief under section 530 for the examination year. Where the business is not eligible for relief under section 530, the examiner will initiate a single year examination. Generally, this will be the most recent filed year.

If the examiner determines that no reclassification issue exists, the CSP procedures will not apply.

If a reclassification issue does exist, examiners will then consider whether CSP applies. If the examination includes a proposal to reclassify workers as employees and the taxpayer has timely filed required Forms 1099, a CSP offer should generally be made.

To determine which CSP offer, if any, is appropriate, examiners should follow the procedures in IRM 4.23.6.13, Procedures for CSP.

MANUAL, *supra* note 10, § 4.23.6.5.

<sup>220</sup>*Id.* § 4.23.6.13.

<sup>221</sup>*Id.* § 4.23.6.5 (emphasis added).

<sup>222</sup>*Id.* § 4.23.6.13.5

<sup>223</sup>*Id.*

<sup>224</sup>*See supra* Part IV.C.

<sup>225</sup>MANUAL, *supra* note 10, § 4.23.6.13.5.

argument is that of a long-standing practice of a significant segment of the industry.<sup>227</sup> The examiner must determine, in his own judgment, what “long-standing” means, as well as “significant.” If the percentage of the industry treating workers as independent workers is over 25%, it is “significant.” There is discretion, however, if the percentage is slightly below 25%. The direction the manual provides in this regard is that “significant” is not satisfied if “the percentage of the industry treating workers as independent contractors is more than de minimis but less than 25% and less than what the examiner considers significant.”<sup>228</sup> This Note recognizes that the discretion granted the examiner here is favorable to an employer because it allows the examiner to determine a percentage as “significant” that may fall below the 25% threshold, provided that the percentage is not de minimis.<sup>229</sup> It may, however, lead to inconsistent results to have deviations from the bright line rule, 25%, based on what someone thinks as significant.

## VII. POSSIBLE SOLUTIONS

The CSP should abandon its requirement for the filing of Form 1099 as an essential prerequisite for participation in the CSP. In this regard, the reasoning in *Medical Emergency Care* should be applied to the CSP in two scenarios, untimely filings and no filings. The court in *Medical Emergency Care* flatly rejected the requirement for *timely* filing, but stated that filing, albeit late, was still required.<sup>230</sup> The CSP explicitly requires timely filing,<sup>231</sup> while § 530 has no such provision and the Tax Court has held that timely filing is not required for § 530 relief.<sup>232</sup> Since the CSP operates only when § 530 relief has not been met, it is absurd to impose a higher standard in the CSP than exists in § 530. For this reason, the requirement of the timely filing of informational tax returns should be removed from the CSP. This proposal only affects untimely filings, not the complete failure to file.

Complete failure to file informational forms, however, should not act as a total bar to CSP settlement opportunities. As stated in *Medical Emergency Care*, the IRS has a penalty regime for filing non-compliance.<sup>233</sup> It would be more in keeping with the intent of the CSP—to settle issues early in the administrative process to eliminate taxpayer burden—to allow the penalty provisions in the Internal Revenue Code to operate exclusively and not use withholding a CSP settlement as an additional penalty. Moreover, the CSP allows for recovery when an employer has no reasonable basis for treating an employee as an independent contractor. With respect to no filings, this Note proposes a CSP settlement of a tax assessment for one year, the same settlement offered to parties who have not met either of the other two categories of § 530 relief.

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<sup>226</sup>*Id.*

<sup>227</sup>TRAINING MATERIALS, *supra* note 87, at 1-26.

<sup>228</sup>MANUAL, *supra* note 10, § 4.23.6.13.5 (emphasis added).

<sup>229</sup>*Id.*

<sup>230</sup>*Med. Emergency Care*, 120 T.C. 436, 444.

<sup>231</sup>MANUAL, *supra* note 10, § 4.23.6.13.8.

<sup>232</sup>*Med. Emergency Care*, 120 T.C. 436, 444

<sup>233</sup>*Id.*

The CSP should also expand its current potential offers to reflect a more graduated series of offers as well as to accommodate scenarios where an employer has failed to file Form 1099. Instead of using § 530 as a dichotomous indicator of relief, it would be reasonable to base CSP settlement offers on the elements achieved within § 530.<sup>234</sup> Basing settlement offers on the elements of § 530 that an employer has met could yield a truer graduated series of offers, provided greater weight is given to different elements.

For example, if an employer has timely filed Form 1099 and they have a reasonable basis for treating the worker as an independent contractor, a settlement of fifty percent tax assessment of one year would reward an employer's legitimate reliance on either a judicial precedent, a prior audit, or a significant segment of the industry. If, however, the employer has no reasonable basis for treating employees as independent contractors, though he has established substantive consistency, an offer of a tax assessment of one year would be appropriate, as exists under the current CSP.

Additionally, settlement offers should be created to accommodate scenarios where an employer has either failed to file Form 1099 altogether, or has filed the forms untimely. In the event of an untimely filing, a full year tax assessment would be appropriate because any information sought by the IRS by Form 1099 has been received. If, on the other hand, an employer has failed to file Form 1099 entirely, the IRS should impose a penalty, but still allow a settlement offer of one year. Further, it should be noted that if an employer has untimely filed Form 1099, but has established substantive consistency and has a reasonable basis, following *Medical Emergency Care*, the employer would qualify for § 530 relief, and would have no need of the CSP.

The IRS should also make CSP offers mandatory for employers who qualify for CSP participation. At present, offers are generally made, but there is still the

<sup>234</sup>The following table reflects a more graduated series of settlements and allows for CSP participation despite failure to file Form 1099.

Are Workers Employees?	Forms 1099 Timely Filed?	Substantive Consistency?	Reasonable Basis?	Type of CSP Offer
1. Yes	Yes	Yes	Yes	§ 530 Relief
2. Yes	Yes, but untimely	Yes	No	1 Year Tax
3. Yes	No	Yes	Yes	1 Year Tax + Penalty
4. Yes	Yes, but untimely	Yes	Yes	530 Relief
5. Yes	Yes, but untimely	No	Yes	75% Tax
6. Yes	No	Yes	No	None
7. Yes	Yes, but untimely	No	No	1 Year Tax
8. Yes	No	No	No	None
9. Yes	Yes	No	Yes	50%
10. Yes	Yes	Yes	No	75%

possibility of arbitrary decisions based on an examiner or group manager idiosyncrasies. Making a settlement offer mandatory for those who qualify would eliminate the issue altogether and ensure a more standardized application of the CSP. Since accepting a CSP offer is always optional for an employer, it would be consistent to allow the discretion to be with the employer entirely and have the settlement offer be mandatory for those who qualify.

#### A. IRS Concerns

The IRS is charged with the collection of federal taxes for the United States government.<sup>235</sup> With this charge, the IRS has a legitimate interest in insuring that it establishes policies and regulations that will further the goal of collecting federal taxes.<sup>236</sup> This Note recognizes that eliminating the filing requirement for CSP settlement may be a concern for the IRS, in that it may encourage employers to be less compliant with IRS regulations if they knew non-compliance may still be awarded with a settlement offer.

In their letter to the IRS, members of the ABA tax section addressed these fears as they encouraged the IRS to be more lenient in *late* filed Forms 1099.<sup>237</sup> The letter states, “we believe that there should be other circumstances . . . under which a taxpayer would not lose the opportunity to qualify for the CSP due to late filed Form 1099s. We recognize the theoretical possibility that intentionally non-compliant taxpayers might try to take advantage of this limited exception . . . .”<sup>238</sup> The letter justifies the risk of abuse by stating that a policy of being more permissive for late filings would “bring more taxpayers into the CSP program.”<sup>239</sup>

Eliminating the filing requirement for CSP settlement completely could also work to bring more taxpayers into the CSP program. The small business owner who has failed to file Form 1099 has no incentive to correct the misclassification with the IRS under the CSP at present because the employer faces the same ultimate consequences as if he were to take his chances and wait to be audited. Eliminating the filing requirement may be an adequate incentive for employers to volitionally correct their misclassification problems if they knew they could be in a better situation than they would be in if they were audited.

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<sup>235</sup>IRS, *The Agency, Its Mission and Statutory Authority*, <http://www.irs.gov/irs/article/0,,id=98141,00.html> (last visited Feb. 10, 2007).

<sup>236</sup>The mission of the IRS is stated as follows:

Provide America’s taxpayers top quality service by helping them understand and meet their tax responsibilities and by applying the tax law with integrity and fairness to all.

This mission statement describes our role and the public’s expectation about how we should perform that role. In the United States, the Congress passes tax laws and requires taxpayers to comply.

The taxpayer’s role is to understand and meet his or her tax obligations. The IRS role is to help the large majority of compliant taxpayers with the tax law, while ensuring that the minority who are unwilling to comply pay their fair share.

*Id.*

<sup>237</sup>ABA Letter, *supra* note 192, at 3.

<sup>238</sup>*Id.*

<sup>239</sup>*Id.* at 4.

Additionally, this Note is not proposing a scenario where an employer who deliberately committed fraud on the IRS be permitted to participate in a settlement offer. Substantive consistency<sup>240</sup> and a reasonable basis<sup>241</sup> would be required in the absence of reporting consistency in order to qualify for the CSP. A posture of permitting settlement with employers who have treated similarly situated workers consistently and have had a reasonable basis for doing so, should allay potential IRS concerns that employers who have tried to blatantly cheat the federal government might be able to participate in the CSP.

This Note agrees with the court in *Medical Emergency Care*<sup>242</sup> that the penalty regime written into the Internal Revenue Code can act as an adequate deterrent for not complying with IRS regulations. The IRS should rely on its penalty scheme instead of withholding a settlement program that was intended to ease taxpayer burden as an additional penalty for non-compliance.

It would be in keeping with the IRS' goal of collecting federal taxes if it allowed the existing penalty scheme for failing to file correct forms to act as a deterrent to employers from misclassifying workers and permitted settlement offers even in the absence of filing Form 1099. Such a stance could likely bring more employers into compliance with IRS regulations.

#### VIII. CONCLUSION

Correctly classifying workers can be a daunting task for employers of all sizes, as well as the IRS.<sup>243</sup> The problem is compounded for small businesses with limited resources to secure adequate legal services to ensure correct worker classification.<sup>244</sup> When misclassification occurs and an employer does not qualify from statutory relief otherwise, the CSP can be a positive program for a small business to relieve taxpayer burden where appropriate. However, the CSP is inadequate in its present form because it unnecessarily conditions settlement on the filing of informational tax returns.<sup>245</sup> The CSP would more effectively achieve its goal of relieving taxpayer burden among small businesses by omitting the requirement of timely filing returns and allow some degree of settlement in the complete absence of filing, insofar as the employer has treated similarly situated workers consistently<sup>246</sup> and has a reasonable basis<sup>247</sup> for treating the workers as independent contractors. Additionally, more types of settlement offers should be permitted to allow for a more graduated series of settlements and extending settlement offers should be mandatory to all employers who qualify. By adopting the propositions set forth in this Note, the IRS may encourage more compliance with IRS regulations.

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<sup>240</sup>See *supra* Part IV.A.

<sup>241</sup>See *supra* Part IV.C.

<sup>242</sup>120 T.C. 436, 443 (2003).

<sup>243</sup>See *supra* Part III.

<sup>244</sup>See generally CRAIN & HOPKINS, *supra* note 6.

<sup>245</sup>See *supra* Part VI.A.

<sup>246</sup>Revenue Act of 1978, Pub. L. 96-600, § 530, 92 Stat. 2885.

<sup>247</sup>*Id.*