



A Defining Issue—Who is An Employee
Podcast of September 30, 2006



Feed address for Podcast subscription:

<http://feeds.feedburner.com/EdZollarsTaxUpdate>

Home page for Podcast: <http://ezollars.libsyn.com>

©2006 Edward K. Zollars, CPA

The TaxUpdate podcast is intended for tax professionals and is not designed for those not skilled in independent tax research. All readers and listeners are expected to do their own research to confirm items raised in this presentation before relying upon the positions presented.

The Podcast and this document may be reproduced freely so long as no fee is charged for the use of this document. Such prohibited use would include using this podcast or document as part of a CPE presentation for which a fee is charged.

This podcast is sponsored by Leimberg Information Services, located on the web at <http://www.leimbergservices.com>. Leimberg Information Services offers email newsletters on tax related matters, as well as access to a library of useful information to tax practitioners that subscribe to their services.

Employee vs. Independent Contractor

An issue that is often of interest to clients is the question of whether individuals doing work for a business client is an employee or an independent contractor—or whether an individual client who has a relationship with some business is an employee of that entity or is truly an independent contractor. The question was addressed this week by the Tax Court in the case of *Orion Contracting Trust v. Commissioner*, TC Memo. 2006-211.

Both the entity receiving the services and the individual have an interest in the answer, and either party may prefer one or the other finding. Generally, though, the IRS has a clear preference to treat relationships as employer/employee relationships. A partial reason is because the IRS has a much better insuring that the proper amount of employment income is reported on a W-2 rather than when such amounts are earned in a

nonemployment relationship. To some extent that is because taxes are generally withheld from wages, making it far more likely the person will file their tax return.

The advantage to the service recipient of having the individual found to be an independent contractor generally revolves around a savings of payroll taxes. At first glance, it appears just the opposite is true for the service provider, since the provider now has responsibility for self-employment taxes. But there are advantages to being a contractor rather than an employee.

First, the independent contractor can deduct his/her business expenses in computing adjusted gross income, while employees are forced to deduct expenses as miscellaneous itemized deductions. Second, while the self-employment tax is at a higher rate, the employee would pay a lower rate on his/her gross earned income while the contractor can offset the gross income with his expenses. As well, the contractor can establish a retirement plan (SEP, solo-401(k), etc.) based on his income independent of the offerings of the service recipient, while an employee is limited to the offers of the employer.

The Orion Case

In Orion we have a taxpayer that got involved with an organization known as American Asset Protection who appeared to have “reorganized” the taxpayers’ business activities under a trust as part of what appears to have been a marketed “tax plan” for the business, which was controlled by two individuals. According to the court, the trust ran “a construction and remodeling business doing work repairing and patching concrete, mixing and applying concrete, and other construction work.” Part of the contract with American Asset Protection included a provision that they would prepare independent contractor agreements for those individuals that worked for Orion, though it doesn’t appear that such contracts were actually prepared in this case.

The business engaged the services of a number of individuals who performed both skilled and unskilled labor, many for the entire three years under examination. While some of these individuals provided a few of their own tools, Orion provided the other supplies and materials needed to complete the job, including the concrete itself, and decided which location to send each individual to in order to perform the services.

Orion claimed these individuals were independent contractors and accordingly the trust did not file Forms W-3, W-2 or 941 for the periods in question. Interestingly enough, though, Orion also failed to prepare Forms 1096 and 1099 for these payments as well, and the court notes they often paid the individuals either by check or with cash. Then again, the trust failed to file any Forms 1041 either, and the two owners did not file their 1997 and 1998 income tax returns.

The IRS examined the returns in question and after a number of steps was able to obtain the records of the company. Part of the examination focused on the status of these individuals, with the IRS finding that the service providers were employees and issuing its assessment of taxes on July 28, 2004.

The trust challenged the assessment before the tax court, asserting that:

- The workers were not employees of the trust
- The statute of limitations on any assessment of tax was closed;
- The failure to file payroll tax returns was not fraudulent.

The Tax Court would disagree with the first two points, only agreeing with the taxpayer on the third issue.

The Opinion

The Court first dealt with the issue of the statute of limitations. The Court noted that the trust had not filed any payroll tax reports. As such, the court noted, the statute had not begun to run and therefore could not have expired. Note that if the trust had filed such forms for other individuals, then the Tax Court would have come to a different conclusion.

In this case the court's first footnote suggests the taxpayers were posing various tax protestor positions, but the result is a useful reminder of the risk of taking a position that no returns are necessary if there is a reasonable chance the IRS might see things differently. Prudence may dictate that it's useful to have at least some employees.

In moving on to the issue of whether the individuals were employees, the Court articulated seven criteria it would consider in making that call:

“(1) The degree of control exercised by the principal; (2) which party invests in the work facilities used by the individual; (3) the opportunity of the individual for profit or loss; (4) whether the principal can discharge the individual; (5) whether the work is part of the principal's regular business; (6) the permanency of the relationship; and (7) the relationship that the parties believed that they were creating.”

In this case, the Court found that the overwhelming evidence indicated these individuals were employees. The court noted that while there's no “scoring” system and all of these criteria are important, the first one (level of control exercised) is generally given great weight in the final decision. In this case, the owners clearly exercised great control over the activities of the individual in question.

As well, the court noted that the individuals were performing exactly the type of service that the trust did in its business activities, many of the individuals appeared to have a permanent relationship with the trust, and there was virtually no risk of loss to the corporation.

The only factors the court found that suggested an independent contractor were the general indication that the trust intended to create an independent contractor relationship and that a few tools were provided by employees. The Court noted “While evidence of

the parties' understanding of the relationship is one factor we consider, it is not enough to overcome the weight of the other factors which clearly evidence an employer-employee relationship.”

A taxpayer can still be allowed to treat a personal as an independent contractor if the taxpayer qualifies for relief under Section 530 of the Revenue Act of 1978. However, the court notes that in this case:

Petitioner does not articulate a basis for relief under sec. 530 of the Revenue Act of 1978, Pub. L. 95-600, 92 Stat. 2885. Even if petitioner had sought sec. 530 relief, such relief would be denied because petitioner did not file any returns with respect to the individuals in question as required by sec. 530(a)(1)(B).

The fact that the corporation failed to file Forms 1099 blocked this option even if the taxpayers may have otherwise qualified for this relief.

Is This Fraud?

The Court finally turned to the question of whether the fraud penalty should be imposed. The IRS argued that the failure to file payroll tax returns was very persuasive evidence of fraudulent intent in this area. The Court didn't agree in the end, deciding that the failure to file payroll tax forms by itself was not necessarily evidence of fraud.

The Court did note:

Respondent first argues that petitioner's failure to file any employment tax returns for the workers in question is evidence of fraud. The failure to file tax returns, even over an extended period, does not per se establish fraud. *Marsellus v. Commissioner*, 544 F.2d 883, 885 (5th Cir. 1977), affg. T.C. Memo. 1975-368. However, an extended pattern of failing to file tax returns may be persuasive circumstantial evidence of fraud. *Id.*; *Grosshandler v. Commissioner*, 75 T.C. 1, 19 (1980).

However, in this case the Court decided that:

We find that petitioner's failure to file employment tax returns as evidence of fraud is mitigated by the technical nature of the question of the employees' status in this case. We do note that petitioner also failed to file the required Forms 1099 for each of the alleged independent contractors who was paid more than \$600. While this failure is inconsistent with petitioner's position concerning the status of the workers, we do not find it evidence of fraud. Accordingly, we find petitioner's failure to file employment tax returns is not compelling evidence of fraud on these facts.

The Court also dealt with the IRS's claim that the taxpayers' lack of cooperation in the examination process also served as evidence of fraud.

We find petitioner's conduct with respect to the IRS, both before and after the employment tax examination began, to be less than cooperative, but there is no evidence that petitioner destroyed any evidence or attempted to mislead respondent

The Court also notes that since the IRS had not argued for a lesser penalty (such as for negligence) in the alternative, the Court did not consider that issue once it had decided the fraud penalty did not apply.