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## Changes Likely for Section 530 Relief in Employee vs. Independent Contractor Classifications

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*Taxpayers who have been relying upon Section 530 to provide relief with respect to their classification of service providers as independent contractors rather than employees should take note of the fact that Section 530 is now under attack from Congress and the Obama Administration.*

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### Background of Section 530

Section 530 of the Revenue Act of 1978 ("Section 530") may provide relief to certain taxpayers when those taxpayers are audited for classifying workers as independent contractors. Since its passage, Section 530 has been relied on by various industries and companies in independent contractor classification disputes with the IRS. Once an employer obtains relief under Section 530 with respect to a certain class of workers, the IRS cannot reclassify such workers as employees. Additionally, the IRS is also not permitted to classify newly hired workers in that same class of workers as employees; rather it must allow the employer to continue to classify all such workers as independent contractors.

In order to obtain relief under Section 530, a taxpayer must meet each of three requirements. First, the taxpayer must have a reasonable basis for treating a worker as an independent contractor rather than an employee; a reasonable basis can be demonstrated by many means, including reliance on judicial precedent or a published ruling, reliance on a ruling issued to the taxpayer, a significant segment of that taxpayer's industry is treating similar workers as independent contractors, or reliance on the results of an employment tax audit with respect to that taxpayer. Second, the taxpayer must have substantive consistency with respect to the manner in which it treats its independent contractors, which is established by consistently and without exception treating all workers performing similar tasks as contractors, rather than employees. Finally, the taxpayer must achieve reporting consistency, which is satisfied by reporting all compensation paid such workers on all applicable federal information returns (Forms 1099) consistent with its treatment of each worker as an independent contractor.

### Legislation to Limit Section 530 Relief

The Taxpayer Responsibility, Accountability and Consistency Act of 2009 (S. 2882, H.R. 3408) would amend the tax code to require employers to file more information with the IRS when employers claim independent contractor status for workers and would substantially limit the safe harbor provision of Section 530, generally prospectively. This proposed legislation specifies that the reasonable reliance requirement can only be achieved if the taxpayer's contractor classification had been approved by a private letter ruling issued to such taxpayer or by a past employment tax audit. The proposed legislation also provides the IRS with greater means by which to reclassify independent contractors as employees and increases penalties for failure to file correct tax return information or comply with other information reporting requirements.

The Employee Misclassification Prevention Act (S. 3254, H.R. 5107), introduced in April 2010, does not amend or end Section 530, but it nevertheless impacts worker classification and enforcement. This law would amend the Fair Labor Standards Act of 1938 to require companies to notify both employees and non-employees of their classification, and to require companies to keep detailed records of non-employees who perform labor or service for remuneration. Specifically, employers subject to the FLSA would be required to keep records of all workers' hours worked, payments, and classifications. Civil penalties would be \$1,100 per worker and up to \$5,000 per worker for willful violations of the law. Although these proposals do not limit or eliminate Section 530, they provide a special penalty for entities which misclassify employees as independent contractors. There is also a provision to increase federal monitoring of state audit efforts to identify misclassification.

### Obama 2011 Budget Would Effectively Eliminate Section 530 Relief

The Obama Administration's 2011 budget proposals, announced on February 1, 2010, include substantial modification of Section 530 relief, allowing "530 protected" workers to be reclassified as employees on a going-forward basis. In addition, the IRS would be permitted to issue generally applicable guidance on the proper classification of workers under common law standards—something the IRS has been prohibited from doing since 1978. Under the budget proposals, there are also competitive grants to increase states' incentives and capacity to address worker misclassifications. Although the budget announcement seems to use confusion and harm to workers as the primary justifications for such changes, a subsequent Department of Labor announcement notes that the budget proposals regarding reducing misclassification and limiting Section 530 relief would increase Treasury receipts by more than \$7 billion over 10 years.

On July 6, 2010, the Congressional Research Service issued a report on the above-described legislative and budget proposals. The report analyzes the benefits and costs of curtailing misclassification of workers, but states no position on whether the benefits outweigh the costs.

### IRS Steps to Study Classification Compliance

In September 2009, the IRS announced that it will embark on an Employment Tax National Research Project (the "Project"), which is the first such project in 25 years. According to the official announcements, the Project, which began in February of 2010, is being undertaken to gather statistical information to determine overall compliance with independent contractor classification laws, to evaluate taxpayer compliance failures in the context of employment taxes, and in turn, to determine how to best address the employment tax gap. These audits will be comprehensive in scope and, if a taxpayer is selected, the audit will require very significant production of information from that taxpayer, including most records pertaining to employment tax returns. The Project will audit 6,000 companies in three phases over the next three years, 2,000 companies per year.

The Project does not seem—at least officially—to have been undertaken as part of a Treasury campaign to end or undercut substantially Section 530. However, it would seem likely that the information being gathered in the Project might eventually be used as part of such a campaign, if Section 530 still exists in its present form two or three years from now.

### **Taxpayers Should Review Compliance With Current Section 530 Requirements—And Consider Alternatives**

Taxpayers who are currently relying on Section 530 relief should review with counsel whether they have continued to meet the ongoing requirements for such relief, particularly if their workforce or industry has undergone significant changes in recent years. If there is a question as to whether the Section 530 relief requirements have been met, it may be possible to take appropriate corrective measures in advance of an IRS audit.

Moreover, in light of the legislative and administrative developments discussed above, taxpayers who have been relying on Section 530 relief should begin considering alternative approaches, such as outsourcing non-employee workers to a third-party staffing firm or requiring such workers to form their own entities to employ themselves. Section 530 is clearly under attack, and it is likely that Section 530 relief will be eliminated or at least significantly restricted in the near future.

Pillsbury has created an Employment Tax Audit Task Force to focus on the IRS' Employment Tax National Research Project, and related tax, executive benefits, and employment law issues. This advisory is one of a series of alerts and advisories which have been, and will continue to be, issued by our Task Force.

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If you need more information on Section 530, or on the subject of employee versus independent contractor classification issues in general, please contact the Pillsbury attorney with whom you regularly work or the attorneys named below:

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