Office of Chief Counsel
Internal Revenue Service
memorandum

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to: Paul A. Marmolejo
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from: Michael A. Swim
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subject: Section 530: Reasonable Reliance Safe Harbor

This responds to your request for assistance regarding the requirement under Section 530 of the Revenue Act of 1978 that a taxpayer have a reasonable basis for treating its workers as nonemployees. This advice may not be used or cited as precedent.

ISSUE

For purposes of Section 530, must the taxpayer demonstrate that it reasonably relied on the safe harbor prior to engaging the worker to perform services?

CONCLUSION

To satisfy one of the safe harbors of Section 530, the taxpayer must demonstrate that it actually and reasonably relied on the safe harbor in classifying the workers at issue as nonemployees for the period(s) at issue. Depending on the facts and circumstances of the case, a taxpayer may be able to show that it reasonably relied on the asserted safe harbor for its decision regarding the treatment of its workers as independent contractors sometime after it first engaged the workers but prior to the periods at issue.

FACTS

Several cases have arisen in which local governments are treating certain workers as independent contractors. The facts and circumstances vary from case to case. In some cases, the taxpayer/local government is asserting that it reasonably relied on industry practice for its classification of certain workers as independent contractors. At issue is whether the taxpayer/local government must demonstrate it reasonably relied on the asserted industry practice prior to first treating the workers as independent contractors.

LAW AND ANALYSIS

Employers are generally required to withhold and pay employment taxes on wages paid to its employees. For this purpose, "employment taxes" are the employer and employee shares of Federal Insurance Contributions Act (FICA) tax, Federal Unemployment Tax Act (FUTA) tax, and withheld income taxes. However, Section 530 of the Revenue Act of 1978, as amended, provides relief for employers who have treated workers as nonemployees for the tax periods at issue if certain requirements are met:.

1. The employer consistently treated the workers (and any individuals holding a substantially similar position) as nonemployees for employment tax purposes for those tax periods and all prior tax periods after 1978.
2. The employer filed all returns required for the workers for those periods and all periods after 1978 and the returns were all consistent with nonemployee status; and
3. The employer had a reasonable basis for treating the workers as nonemployees.

With regard to the third requirement, Section 530 provides three safe harbors for establishing reasonable basis. Specifically, Section 530(a)(2) provides that reasonable basis is established "if the taxpayer's treatment of such individual for such period was in reasonable reliance" upon any of the following:

1. Judicial precedent, published rulings, or technical advice or letter ruling to the taxpayer;
2. A past employment tax audit in which no assessment was made on account of improper classification of workers holding substantially similar positions; or
3. A long-standing recognized practice of a significant segment of the industry in which the worker worked.

The taxpayer may also establish another reasonable basis for its classification. H.R. Rep. No. 1748, 95th Cong., 2d Sess. 5 (1978), 1978-3 (Vol. 1) C.B. 629, 633; Rev. Proc. 85-18.

A specific issue in your cases involving certain workers has to do with timing; specifically, when must a taxpayer have known about and reasonably relied on a safe harbor (such as industry practice)? A few cases have considered the timing element in determining whether taxpayers satisfy the reasonable basis requirement to qualify for Section 530 relief.

Nu-Look Design

In Nu-Look Design, Inc. v. Commissioner, T.C. Memo. 2003-52, *aff'd*., 356 F.3d 290 (3d Cir. 2004)**,** the stipulation of facts established that Nu-Look, a subchapter "S" corporation, "operated as a residential home improvement company, providing carpentry, siding installation and general residential home improvement and construction services to the public." Stark was Nu-Look's sole shareholder and president, and he also managed the

company. He solicited business, performed necessary bookkeeping, otherwise handled finances, hired and supervised workers. Rather than pay Stark a salary or wages, Nu-Look distributed its net income during the years at issue to him "as Mr. Stark's needs arose...." Nu-Look reported on its Form 1120S tax returns net income matching what Stark reported as non-passive income on Schedule E of his Form 1040 tax returns. The Tax Court found that Stark performed more than minor services for Nu-Look and that he had received remuneration for those services. As a result, the court held that Stark was an employee of Nu-Look and held further that Nu-Look was not entitled to employment tax relief under Section 530.

The Tax Court in Nu-Look stated with regard to reasonable reliance:

> Moreover, even if we were to assume arguendo that the cited cases could offer a reasonable basis for treating an officer as a nonemployee, petitioner has failed to establish reliance on the claimed precedent as a factual matter. To fall within the safe harbors of Section 530(a)(2), the taxpayer must have relied on the alleged authority during the periods in issue, at the time the employment decisions were being made. The statute does not countenance *ex post facto* justification. *See* 303 W. 42nd St. Enters., Inc. v. IRS, 181 F.3d 272, 277, 279 (2nd Cir. 1999, (reversing and remanding because it was "unclear from the record whether * * * [the taxpayer] in fact relied on any specific industry practice in reaching its decision to treat its * * * [workers] as non-employee tenants, let alone whether such reliance was reasonable"); Select Rehab, Inc. v. U.S. 205 F.Supp. 2d 376, 380 (M.D.Pa. 2002) ("The taxpayer must show that it relied upon those grounds [alleged as a reasonable basis], and that the reliance was reasonable."); W.Va. Pers. Servs., Inc. v. U.S., 78 AFTR 2d 96-6600, at 96-6608, 96-2 USTC par. 50,554, at 85919 (S.D.W.Va. 1996) ("The plain meaning of Section 530(a)(2) is that only evidence known to and relied upon by the taxpayer is relevant. Facts that are learned after the incorrect treatment of the employees * * * are not facts that a taxpayer relied upon in making its original decision regarding how to treat its employees.").

These cases cited establish a clear standard that the taxpayer cannot retroactively justify its earlier treatment and satisfy the reasonable basis requirement of Section 530.

The Tax Court in Nu-Look pointed up the timing question when it stated that the taxpayer's claim of reliance was not credible, noting that at trial, the president testified but presented no evidence that he was aware of the case on which he claimed to have relied or that anyone had ever discussed the case with him. Further, although the accountant who advised the taxpayer was not allowed to testify (because the taxpayer did not list him as a witness in the trial memorandum), the Tax Court noted that the accountant had testified at another trial that he was unaware of the case until 2001, long after the periods at issue in Nu-Look (1996, 1997, 1998). While the Third Circuit did not address the timing issue, it affirmed the opinion of the Tax Court in Nu-Look.

Peno Trucking, Inc.

A more recent case considering the standard for establishing "reasonable reliance" is Peno Trucking, Inc. v. Commissioner, T.C. Memo 2007-66, *rev'd,* 296 Fed Appx. 449 (6th Cir 2008) (opinion not recommended for full-text publication). The Tax Court held that the drivers of taxpayer's trucks were employees of taxpayer and held further that taxpayer was not entitled to relief from the resulting employment tax liabilities under Section 530 for the years at issue in the Notice of Determination of Worker Classification (NDWC): 1997, 1998, and 1999. The taxpayer argued that it had relied upon two state workers' compensation decisions which had been issued with respect to its own workers.

In the first decision, involving a claim for workers' compensation by a driver named Chatfield, the Ohio Industrial Commission (OIC) disallowed Chatfield's claim in a 1995 order stating that he was not an employee; the order did not state a basis for the determination. In a 1996 order from the court of common pleas, the Bureau of Workers' Compensation (BWC) dismissed Chatfield's appeal without prejudice. Thus, the two Chatfield decisions were issued before the years at issue in the NDWC.

In the second decision, involving a claim for workers' compensation by a driver named Jamison, the BWC denied Jamison's claim in a 1997 order, basing its decision on a signed agreement between Peno Trucking and Jamison. In a subsequent 1997 order, the OIC vacated the previous BWC order and found without stating the grounds for its decision that Jamison was an independent contractor. In 1998, the court of common pleas entered an order of voluntary dismissal without prejudice of Jamison's appeal. The Jamison decisions were issued during the years at issue in the NDWC.

The Tax Court concluded that Section 530 did not provide relief to the taxpayer because the record did not indicate that the taxpayer relied on those adjudications at the time it made its employment decision.[1] Specifically, the Tax Court held that taxpayer "failed to establish that it relied upon judicial precedent or otherwise provided a reasonable basis to disregard [the FICA and FUTA requirements]." The Tax Court relied on Nu-Look Design in stating the requirement that a "taxpayer must have relied on the alleged authority during the periods in issue, at the time the employment decisions were being made." In reaching its decision, the Tax Court addressed the taxpayer's alleged reliance on both the 1995 and 1997 decisions of the OIC to justify its treatment of its drivers as independent contractors:

> Only the BWC's vacated order in the Jamison case indicated the grounds for its decision: 'The signed agreement by and between Peno Trucking Inc. and the Injured Worker dated 3/3/97.' Moreover, nothing in the record indicates the rulings concerning Jamison and Chatfield were relied upon at the time petitioner's employment decisions were made.

[1] In addition, the Tax Court noted that the two state workers' compensation claim adjudications did not evaluate the employment relationships through a common law analysis.

The taxpayer appealed the decision of the Tax Court. In an unpublished opinion, the 6th Circuit agreed that the drivers were employees, considering each of the seven factors used by the Tax Court in determining whether an employee/employer relationship exists. However, the 6th Circuit granted relief from employment taxes under Section 530 based on a finding that it was reasonable for Peno Trucking to have relied and that "Peno Trucking could have in fact relied," in making its employment decision for the years in question, on the 1995 OIC decision that Chatfield was an independent contractor. The 6th Circuit noted that the Peno Trucking owner/vice president testified that he had relied on the decision.[2] The court acknowledged that Peno Trucking could not have relied on the 1997 Jamison decisions because they were rendered "too late to have actually served as the basis for Peno Trucking's employment decision."

The 6th Circuit distinguished Nu-Look, stating that the taxpayers in that case applied the logic of other cases to their own, whereas in Peno Trucking the taxpayer received official determinations as to the status of its truckers. The 6th Circuit found that the taxpayer "could have" relied on one of those determinations--the 1995 OIC decision--in making its employment decision to treat the truckers as independent contractors for the years in question--1997 through 1999 – because the decision was rendered prior to the beginning of the periods at issue, i.e., 1997 to 1999. While it appears that the Tax Court did not believe the testimony of the taxpayer's owner/vice president regarding his reliance, the 6th Circuit is correct in that it is chronologically possible for the taxpayer to have relied on the 1995 Chatfield decision. [3]

The 6th Circuit in Peno Trucking described the Section 530 safe harbor reliance requirement in this way:

> . . . courts have construed this "reasonable basis" standard as requiring reliance in-fact. *See, e.g.,* 303 West 42nd St. Enters. v. IRS*,* 181 F.3d 272, 277 (2d Cir.1999) (focusing its inquiry on whether there the appellant "in fact relied on" the grounds alleged); Nu-Look Design, Inc. v. Comm'r, 85 T.C.M. (CCH) 927, 2003 WL 548583, at 8, 2003 Tax Ct. Memo LEXIS 48, at 21

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[2] Peno Trucking was incorporated in 1993 and appears to have treated its drivers as independent contractors since its inception.

[3] In reaching its conclusion that the 1995 decision of the OIC could serve as precedent as contemplated in Section 530, the 6th Circuit made findings not based on the evidence before it, including that the Ohio Board of Worker's Compensation uses a similar common law test as that used for federal employment tax purposes. Because the court found that the burden of proof had shifted to the government (a decision with which we disagree), the government was apparently obliged to but could not show at oral argument that it was not the same standard. Although the 1995 OIC order did not state the basis for its determination and notwithstanding the absence of anything in the record to show that the OIC applied the common law analysis in its decision to deny workers' compensation benefits to the applicants, the court found that the taxpayer could have reasonably relied on the 1995 OIC decision to justify its employment tax treatment for the years at issue. Again, we note that the court did not recommend its opinion for full-text publication.

(2003) ("The statute does not countenance ex post facto justification.").

Thus, Section 530(a)(2) requires that the taxpayer actually and reasonably relied on the asserted "reasonable basis" for treating its workers as independent contractors. The courts have consistently held that taxpayers cannot offer *ex post facto* justification for prior treatment. Peno Trucking does not change this requirement; rather, the court emphasizes it. Although we do not agree with the 6th Circuit's view of the facts in the case as establishing that the taxpayer reasonably relied on the 1995 OIC decision to treat its drivers as independent contractors for employment tax purposes, the court did not change the requirement that the taxpayer demonstrate reliance in fact on the asserted reasonable basis in classifying its workers and that such reliance be reasonable.

Furthermore, as to the timing of the reliance, Peno Trucking is consistent with the standard set forth in Section 530(a)(2) and the earlier cases. In determining whether a taxpayer receives Section 530 relief for a tax period, the taxpayer must, among other things, show that it has a reasonable basis for its treatment of the workers as independent contractors. A taxpayer will satisfy this requirement by showing that its treatment for such period was in reasonable reliance on one of the safe harbors. The principle that "[t]he statute does not countenance *ex post facto* justification" means the taxpayer must demonstrate actual and reasonable reliance prior to the period for which employment decisions are made. This standard is most clearly met when the taxpayer can demonstrate actual and reasonable reliance on the asserted reasonable basis prior to engaging the services of the workers at issue or substantially similar workers—in other words, prior to the initial employment decision being made. However, the taxpayer may be able to satisfy the reasonable basis requirement by establishing that it actually and reasonably relied upon the asserted basis prior to making the employment decisions regarding the workers' status for later periods. This is the situation in Peno Trucking where the OIC decisions would not have even existed prior to the establishment of the relationship with the workers at issue. The 1995 OIC decision was rendered after Peno Trucking made its initial determination to treat the workers as independent contractors but prior to the years being considered by the Tax Court.

With regard to your cases involving certain local government workers, we note that the local governments assert that they relied on long-standing practice of the industry.

We suggest that the facts and circumstances of these cases be further developed especially with regard to whether the taxpayers may be attempting to rely in the audit on what appears to be an *ex post facto* justification. The taxpayers must demonstrate reliance in fact, i.e., that the alleged "industry practice" was known to the taxpayers prior to the time the decision regarding whether to treat the workers as independent contractors was made for the periods at issue and that the alleged "industry practice" was reasonably relied upon for that decision.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

We understand in one particular case [redacted]

[redacted]

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Please call me or Linda Conway at 202-622-0047 if you have any further questions.