

PUBLICATION

Tax Court Distinguishes Employees from Independent Contractors

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In a recent memorandum decision, the U.S. Tax Court (Court) offered additional guidance to taxpayers tasked with making the often fact-intensive decision as to the proper classification of a worker as an employee or an independent contractor. Although the Court's decision relied almost exclusively on past precedent, the discussion provides additional color to the employee/independent contractor analysis and serves as a reminder as to the importance of proper classification.

The Decision

The Court's decision, which can be read in full at *John Keller, Action Auto Body v. Commissioner of Internal Revenue*, addresses the alleged misclassification of workers by a small business owner. The taxpayer petitioned the Court for review of a determination of worker classification issued by the Internal Revenue Service (IRS) for the 1998 tax year. The IRS asserted that the taxpayer was liable for over \$97,000 in taxes and over \$26,000 in penalties arising from the alleged misclassification.

The taxpayer was a 50 percent partner in an auto body repair business which had, during the tax year in question, ten workers (eight technicians and two secretaries), all of whom were classified as independent contractors. Despite the independent contractor designation, at no point did the business issue any worker a Form 1099, or much less did the business issue any W-2s or withhold income taxes as it would have with an employee.

To resolve the issue of whether the workers were independent contractors or employees, the Court focused on several common law factors set forth in the Internal Revenue Code (Code) and accompanying Treasury Regulations. The factors that are generally considered, and which were considered by the Court in this case, include the following (collectively, the Factors): (1) the degree of control exercised by the principal; (2) which party invests in work facilities used by the individual; (3) the opportunity of the individual to share in the profit or loss of the enterprise; (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 the parties believed they were creating. It is important to note that the Factors are in no way exclusive -- other relevant analytical characteristics may be considered, and no single characteristic is considered dispositive.

The Common Law Factors

(1) The Degree of Control Exercised by the Principal: The Court began by noting that the right of the principal to exercise control over the agent is frequently determined to be the "crucial test" for the employer-employee relationship. The first of the Factors does not require that the principal actually does direct the worker, but only that the principal have the right to do so. The Court determined that the business did not have the right to control the auto body technicians, but that sufficient right to control the business's secretaries existed to classify them as employees.

(2) Worker's Investment in Facilities: In analyzing the second of the Factors, frequently consideration is given to the extent a worker is made to provide his or her own tools or vehicle in the performance of the relevant services. Workers who do so tend more often than not to be independent contractors. Similarly, the fact that a

worker maintains a home office is also indicative of independent contractor status. In considering the current facts, the Court again found that, while the technicians were likely independent contractors under this analysis, the secretaries were not.

(3) Participation in Profit and Loss: The third of the Factors focuses on whether, and to what extent, the workers could participate in the profit or loss of the enterprise. Generally, an independent contractor's compensation is dependent solely upon their own efforts or skills, and not on the success or failure of the hiring entity. Many jurisdictions have also found, however, that commission-based wages are entirely consistent with an employer-employee relationship. In considering the current facts, the Court found that even though the technicians were paid on a commission basis, the majority of the technicians' compensation was derived from the revenue generated from the business's efforts. Although not free from doubt, the Court found this Factor likely weighed in favor of the employer-employee relationship insofar as the secretaries and one of the technicians.

(4) Right to Discharge Worker: The Court briefly addressed the fourth of the Factors, noting that employers may generally discharge employees at will. Because the taxpayer admitted to retaining such a right as to each of the ten workers, the Court found that this Factor weighed in favor of an employer-employee relationship.

(5) Workers Integral to the Business: The Court determined that the fifth Factor neither favored an employer-employee nor an independent contractor relationship. Generally, when workers are deemed to be an integral part of a business, an employer-employee relationship tends to exist. Because the founding partner in this business only expanded the business to absorb additional customer demand, the Court found it was possible for the business to survive without the additional eight technicians. Furthermore, the technicians' commission-based compensation provided a more fluid approach to the expansion and contraction of business, suggesting each technician was less than integral. Despite these facts, the Court found that releasing the technicians would have resulted in a significant decrease in the business volume, and therefore refused to weigh this Factor in favor of either result.

(6) Permanency of the Relationship: Similar to the fourth of the Factors, the Court accorded less weight to the sixth Factor in concluding that both independent contractors and employees may generally be terminated at will. Regardless, the Court found that the technician's relationship tended to weigh in favor of independent contractor status.

(7) Taxpayer's Presumed Relationship: In considering the final Factor (that is, the relationship the parties thought they created), the Court found that both the taxpayer and the workers presumed that the workers were operating as independent contractors (clearly weighing in favor of such a relationship). Consistent with their presumed independent contractor status, the Court found it noteworthy that the workers were neither afforded benefits commensurate with an employee-employer relationship nor had any of the discharged workers filed a claim for unemployment benefits.

Conclusion

Based on an extremely fact-intensive inquiry, the Court held that the majority of the technicians were likely independent contractors, but that the secretaries, as well as a worker who received weekly wages and appraised jobs for the taxpayer, were not. Although the business at issue in this case is an auto body shop, it is important to note that the Factors discussed above are generally examined whenever an inquiry into a worker's status is being made, regardless of the nature of the enterprise. It is also important to note that, in addition to assessing back employment taxes for the three workers who were determined to be employees, the Court also upheld the imposition of a rather large penalty prescribed under the Code related to the failure of the business to remit the employment taxes in question, as well as its failure to file the requisite tax returns.

Determining whether a worker is an independent contractor or an employee is clearly dependent upon a case-by-case analysis, and such a determination can obviously have serious and costly consequences. To discuss the Court's reasoning in the recent case summarized above, as well as the multitude of other guidance on the issue, please contact any of the attorneys in the Firm's Tax Department.