WORKER CLASSIFICATION: HOMECARE PROVIDER DEMONSTRATED REASONABLE BASIS FOR CLASSIFICATION OF COMPANIONS AS INDEPENDENT CONTRACTORS

Posted on **May 23, 2016** by **Jim Malone**

Cases challenging the classification of workers as independent contractors have been a significant enforcement priority for both the IRS and the Department of Labor. On May 10th, the United States District Court for the Eastern District of Pennsylvania granted summary judgment to a business seeking a refund of employment taxes it paid after the IRS challenged the classification of its workers as independent contractors. *Nelly Home Care, Inc. v. United States*, Nos. 15-439 & 15-444, 2016 U.S. Dist. LEXIS 61524 (E.D. Pa. May 10, 2016). The case is of particular interest because the taxpayer did not qualify for one of the statutory safe harbors under Section 530 of the Revenue Act of 1978 but nonetheless prevailed by demonstrating "other reasonable basis" to support the classification decision.

Helen Carney formed two different entities for her homecare service business; the first, Nelly LLC, was formed in 2004, while the second, Nelly Home Care, Inc., was a successor formed in 2009. *Nelly Home Care*, 2016 U.S. Dist. LEXIS 61524 at *2. Nelly held itself out as providing a match-making service between home care workers and elderly customers who required assistance. Ms. Carney offered testimony that her companies did not provide supervision or instructions on how to

care for the customers, although she did provide orientations on particular facilities. *Id*. at *3. Instructions came from the host facilities where the customers resided. *Id*. Although the workers were classified as independent contractors, Ms. Carney maintained workers compensation insurance to cover them. *Id.*

Before starting her business, Ms. Carney had worked as a home care worker at a facility known as Beaumont, which was the primary host facility where Nelly served clients. While there, Ms. Carney learned that two providers were treating their workers as independent contractors. *Id.* at *4. When she started Nelly, Ms. Carney had her attorney prepare an independent contractor agreement based upon a model she had acquired from Bayada, a company providing similar services. *Id.*

After forming Nelly, Ms. Carney surveyed other providers and learned that seven of twenty similar businesses treated their companions as independent contractors, although many were not in the same metropolitan area. *Id.* At a seminar, Ms. Carney was advised by officials from the Pennsylvania Department of Health that a home care registry such as hers was defined as a business that supply "independent contractors to provide home care services." *Id.* at *5 (quoting 28 Pa. Code § 611.5).

The IRS audited Mrs. Carney and her husband twice. In 2007, it audited their 2004 and 2005 returns, and it requested information about Nelly LLC, including copies of agreements with the workers. *Id.* at *5-*6. While the 2007 audit resulted in a significant increase in tax liability, no action was taken on the classification of Nelly LLC's workers; the IRS indicated that the records were sought to verify claimed deductions for contract labor and other expenses. *Id.* at *6. The IRS conducted second income tax audit in 2011 for the Carneys 2008 return but no adjustments were made. *Id.*

In 2011, the IRS conducted employment tax audits for Nelly LLC and Nelly Home Care, Inc. which resulted in a determination that the workers were misclassified for tax years 2008-2012. After paying a portion of the assessment, the two companies filed suit for a refund and then moved for summary judgment. *Id*. at *7-*8.

Section 530 of the Revenue Act of 1978, as amended, will permit a business to escape liability in a worker classification case by demonstrating that there was a reasonable basis for the classification decision. To qualify for relief under Section 530, the business must establish "reporting consistency," meaning that it filed 1099s for the workers. Rev. Ruling 81-224, 1981-2 C.B. 197. The business must also demonstrate "substantive consistency" meaning that the relevant workers were not treated as employees and others in similar functions were not treated as employees. *See* Rev. Proc. 85-18, § 3.03, 1985-1 C.B. 518. In *Nelly Home Care*, these requirements were not challenged by the government. 2016 U.S. Dist. LEXIS 61524 at *9, n. 3.

Once the consistency requirements are met, then the business needs to demonstrate that there was a reasonable basis for its classification decision. As the court explained in *Nelly Home Care*, there are a series of safe harbors:

- Prior case law, IRS rulings and taxpayer-specific technical advice;
- A prior audit by the IRS; or

- Industry practice.

Id. at *9 (citations omitted). The failure to qualify for one of the safe harbors is not fatal; the taxpayer can also prevail by demonstrating another reasonable basis for the classification decision. Id. at *10 (citing *Critical Care Register Nursing, Inc. v. United States*, 776 F. Supp. 1025, 1027 (E.D. Pa. 1991)).

Initially, Nelly argued that it qualified for the prior audit safe harbor. The district court rejected this argument, given that the relevant audits focused on personal income tax issues, not employment taxes. *Id.* at *11-*12. This holding is correct, as Section 530 was amended in 1996 to permit reliance upon an audit only if the audit addressed employment taxes for the relevant workers or those in substantially similar positions. *See* Small Business Job Protection Act of 1996, Pub. L. 104-188, § 1122, 110 Stat. 1755, 1766 (1996).

Next, the taxpayer asserted that it qualified under the safe harbor for a long-standing practice of a significant portion of the home care industry, arguing that Ms. Carney had asked three home care providers how they classified their workers and was told that two treated them as independent contractors. 2016 U.S. Dist. LEXIS 61524 at *12-*13. The district court rejected this argument for two reasons:

- First, Nelly failed to show that the two firms that treated workers as independent contractors represented a significant segment of the industry;
- Second, Nelly failed to show that the practice was a long-standing one. *Id*. at *13-*14.

The court also rejected the taxpayer's effort to rely upon a subsequent survey it had conducted because too many of the companies involved were from outside the metropolitan area. *Id.* at *14.

Nonetheless, the district court granted the taxpayer's motion for summary judgment, as it concluded that Nelly had a reasonable basis for classifying the workers as independent contractors. The court cited a variety of factors, including Ms. Carney's experience in working as a home health aide, her discussions with other aides and providers, her independent research and the fact that an attorney prepared an independent contractor agreement for her. *Id.* at *15.

The court also cited the prior audit from 2007, which had included some examination of independent contractor agreements; in the court's view, the fact that the IRS "undertook an in-depth analysis of Nelly LLC's business practices" meant that "it was reasonable for Carney to interpret the IRS's silence on the independent contractor classification as acquiescence." *Id.* at *15-*16.

The court's ruling on the taxpayer's reasonable basis argument is debatable, particularly its comments on the prior audit supplying a reasonable basis. It will be interesting to see if this opinion is upheld on appeal.

A Note on Section 530. Section 530 is not codified. The statute and its amendments can be found as follows:

- Enacted, Revenue Act of 1978, Pub. L. 95-600, § 530, 92 Stat. 2763, 2885-86 (1978);

- Amended, Pub. L. 96-167, § 9(d), 93 Stat. 1275, 1278 (1979);
- Amended, Pub. L. 96-541, § 1(a), 94 Stat. 3204 (1980);
- Amended, Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248, § 269 96 Stat. 324, 551-53 (1982);
- Amended, Tax Reform Act of 1986, Pub. L. 99-514, § 1706, 100 Stat. 2085, 2781 (1986);
- Amended, Small Business Job Protection Act of 1996, Pub. L. 104-188, § 1122, 110 Stat. 1755, 1766-68 (1996).

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