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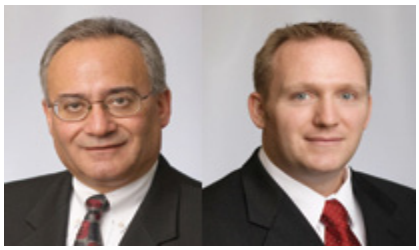
Law Firms Employing 'Independent Contractors': Beware

October 10, 2011 by Steven M. Packer and Brian K. Adams



Using independent contractors can be risky for many law firms, and remains an age-old concern for businesses in general. The stakes are high, and the classification determines whether an employer must pay and withhold federal income tax, Social Security and Medicare taxes and federal unemployment tax (FUTA) — and possibly incur state and local tax obligations. It is a complex issue whose determination hinges on the facts and circumstances of each case. Improper classification can result in significant penalties and financial hardship for the unwary business owner, particularly if there are a large number of misclassified workers over a period of several years.

This is an area the Internal Revenue Service closely monitors. Rest assured, the IRS will aggressively pursue collection activities against firms that inappropriately classify employees as independent contractors, and consequently fail to remit payroll taxes as required by law. As payroll taxes are deemed trust fund taxes, civil penalties may apply to those responsible for collection and remittance. Therefore, it is essential to understand the factors the IRS uses to accurately classify workers.

Who Is an Employee?

While no uniform definition of "employee" exists, a worker generally is considered an employee for federal tax purposes if the employer has the right to control and direct the worker regarding the job assigned and related performance. The employer does not have to actually direct or control how the services are performed; rather, it is enough if the employer has the right to do so. Other factors include whether the work is substantial, regular or continuous, and whether the services performed may require someone to comply with the employer's general policies.

The IRS uses the following three categories of factors — also known as the 20-factor test — to determine if a worker is an employee or an independent contractor:

- **Behavioral:** Does the company control or have the right to control what the worker does and how the worker does his or her job? Facts that indicate whether a business has a right to direct and control include instructions. Generally, an employee is told when to work; where to work; how to work; what tools or equipment to use; what workers to hire; what workers to assist with the work; where to purchase supplies and services; what work must be performed by specified individual; and what order or sequence to follow.An employee may be trained to perform services in a particular manner.
- **Financial:** Does the payer control the business aspects of the worker's job? Facts that indicate whether a business has a right to control the business aspects of the worker's job include the extent to which the worker has unreimbursed expenses; the extent of the worker's investment; the extent to which the worker makes services available to the relevant market; how the business pays the worker; and the extent to which the worker can realize a profit or loss.
- **Type of Relationship:** Are there written contracts or employee-type benefits? Will the relationship continue? Is the work performed by the worker a key aspect of the business? Some facts that indicate the nature of the relationship are written contracts describing the relationship the parties intended to create; demands for full-time work; whether the worker is provided with employee-type benefits; the permanency of the relationship; how integral the services are to the principal activity.

All three categories should be considered when businesses classify a worker as an employee or as an independent contractor. It is important to keep in mind that the specific facts of each case stand on their own and determine the weight the IRS may give to a particular factor. Although some factors may indicate the worker is an employee, other factors may signify that the worker is an independent contractor. No bright-line test or "set" number of factors must be satisfied to determine if the worker is an employee or an independent contractor, and no single factor stands alone in making the determination. Seeking counsel from experienced tax professionals when faced with this issue may be beneficial. The two cases discussed below highlight the manner in which these categories and related factors are applied.

The 'Cave' Case

In *Donald G. Cave Professional Law Corp. v. Commissioner of Internal Revenue*, T.C. Memo 2011-48, president and sole shareholder Donald Cave was an attorney who selected the associate attorneys, hired law clerks, set hours for support staff, determined bonuses, approved payroll and determined workers' payments and reimbursements.

Because the president made virtually all decisions and performed substantial services for the firm, the U.S. Tax Court agreed with the IRS and deemed him an employee for employment tax purposes. The Tax Court also ruled that both the associate attorneys and law clerks were employees for employment tax purposes. The associate attorneys had little professional experience and were recent law school graduates. Although the president did not require the associate attorneys to sign written employment contracts or non-competition agreements, the associates worked exclusively for the company and did not offer their services to other law firms or to the public while working for Cave.

The Tax Court looked to the 5th U.S. Circuit Court of Appeals in establishing factors to decide whether a worker is a common-law employee, such as the degree of control the principal has over the worker; the worker's opportunity for profit or loss; the worker's investment in facilities; the permanence of the relationship; and the skill required in the operation. The 5th Circuit concluded that no single factor is determinative, and all facts and circumstances need to be taken into account. (See its 1990 opinion in Breaux & Daigle .)

The Tax Court relied on the fact that the firm's president had the right to control the assignment of cases and reimbursement to associates. The president also managed their cases, and there was an expectation that the associates would assist the president on his cases. The Tax Court concluded that the associate attorneys did not have independence in managing their caseload since the president had the right to control and direct the matters.

When a worker provides his or her own tools to perform job functions, it generally indicates that the worker is an independent contractor. However, in Cave , the president provided the associate attorneys with all of the tools and facilities necessary to complete their work, including office space, secretarial services, computers and online legal research services. The fact that the workers had no investment in the facilities indicated an employment relationship, the Tax Court concluded.

As stated above, the associate attorneys were not required to sign employment contracts. The relationship between the president and the associates was continuous, permanent and exclusive, which the court said indicated an employment relationship.

Finally, the associate attorneys were hired to provide legal services to existing clients and to develop new clients. Therefore, the services performed by the associates generated fees for Cave and were the taxpayer's only source of income — and an integral factor indicating an employment relationship.

The Tax Court considered other factors, but deemed them neutral in the decision with respect to the employer/employee relationship. While these are only some of the factors that should be taken into account in determining the nature of an employment relationship, the Cave case illustrates the significance of considering the whole relationship.

The 'Western Management' Case

In another current case, *Western Management Inc. v. U.S.*, a lawyer, as alter ego of his law firm, and his spouse were both found personally liable for the firm's unpaid employment taxes. The U.S. Court of Federal Claims has held that the lawyer, the sole shareholder, president and secretary-treasurer of his firm could not relitigate a Tax Court decision that held his law firm liable for failing to withhold and pay employment taxes for the services he provided it. The law firm treated the attorney, its sole employee, as an independent contractor whose only source of income was legal services provided by its sole shareholder. This individual provided all services necessary to generate revenue, including hiring employees, check writing, determination of compensation levels, purchasing malpractice insurance and signing tax returns. Western Management treated the sole shareholder as an independent contractor and advanced funds to him as needed. WM did not withhold or pay any federal employment taxes on these distributions, classified the payments as "loans" on its books and did not file Forms 1099-MISC.

The Tax Court found that the shareholder was WM's employee and that his wages were subject to income tax withholding as well as FICA and FUTA taxes. He was clearly a "statutory" employee under Code Sec. 3121. He had sole authority to make major corporate decisions and served at all relevant times as WM's president and secretary-treasurer, ran all WM's business, performed substantial services for the firm in his official capacity and received remuneration for those services. (See *Western Management Inc. v. Commissioner of Internal Revenue*, T.C. Memo 2003-162).

Increased IRS Focus

The IRS is in its second year of an intensive employment tax research study of 6,000 randomly selected taxpayers as part of a national research program (NRP) aimed at investigating tax compliance issues related to employment taxes and independent contractor classification, among other tax reporting issues. These in-depth examinations, which are effectively audits, can be burdensome for those selected to be included in the study. Due to the initiative's broad scope, many lawyers and their clients may find themselves in the unenviable position of undergoing examination.

The IRS is using various data sources as part of the audit process — including information from Forms 1099 and W-2 filed with the IRS — to determine audit strategies concerning the compliance characteristics of firms filing employment tax returns. Although there are no surefire ways to avoid being targeted, businesses can take certain measures to help minimize risk.

Businesses should consider reviewing their current payroll practices, specifically focusing on the areas identified by the NRP initiative. Documentation and record-keeping procedures should be assessed and updated if necessary. Businesses may also want to review their three most recent years' employment tax returns, including Forms 1099 and all supporting documents and records. In many cases, the company's third-party payroll administrator can assist with this process.

Taxpayers may also wish to engage a tax professional to conduct a "simulated audit" for the purposes of reviewing record-keeping policies and existing tax positions and obtaining guidance on correcting problems or deficiencies that would be likely targets in the event of an actual IRS examination.

VOLUNTARY Classification Settlement Program

The fourth quarter is particularly opportune for reviewing employment data to ascertain whether employees are properly classified, while there is still time to make required changes and potentially avoid both employee misclassification issues and the wrath of the IRS. This is particularly true now, as the IRS recently partnered with the U.S. Department of Labor to allow eligible employers relief from past federal payroll tax liabilities if they prospectively treat workers who have been improperly classified as independent contractors as employees.

In Announcement 2011-64, issued by the IRS on Sept. 21, employers who participate in the Voluntary Classification Settlement Program (VCSP) will enjoy partial relief from federal employment taxes, provided they agree to prospectively treat improperly classified workers as employees for all

future tax periods. To participate in the VCSP, the taxpayer has to meet certain eligibility requirements that are outlined below; apply to participate in the VCSP; and enter into a closing agreement with the IRS. To be eligible participants in the VCSP, a taxpayer must meet the following requirements:

- The taxpayer must have consistently treated the workers as non-employees.
- The taxpayer must have filed all required Forms 1099 for the workers for the previous three years.
- The taxpayer cannot currently be under audit by the IRS or under audit concerning classification of the workers by the U.S. Department of Labor or by a state government agency.

As a result of their participation, employers who agree to prospectively treat workers as employees for future tax periods will pay only 10 percent of the employment tax liability that may have been due on compensation paid to the workers for the most recent tax year; will not be liable for any interest and penalties on the liability; and will not be subject to an employment tax audit with respect to employees improperly classified in prior years.

In addition, a taxpayer participating in the program must agree to extend the statute on assessment of employment taxes for three years for the first, second and third calendar years beginning after the date on which the taxpayer has agreed to begin treating any improperly classified workers as employees.

Taxpayers who wish to participate in the VCSP are required to submit the recently published Form 8952 (Application for Voluntary Classification Settlement Program) at least 60 days before they want to begin treating the workers as employees. The IRS will contact the taxpayer once it has reviewed the Form 8952 and verified the taxpayer's eligibility.

The VCSP offers employees who have misclassified their workers as non-employees with an opportunity to voluntarily correct this issue prospectively with limited exposure for the past liabilities associated with worker misclassifications. In addition, the impact of reclassifying workers as employees may have a significant impact on the taxpayer's ERISA covered plans in that such plans may need to be amended to cover reclassified workers for the prospective period only. All taxpayers who classify workers as non-employees should consider reviewing that classification and determining whether a filing under the VCSP is appropriate.

Documentation Vital

It is vital to document the factors considered and the conclusions reached when classifying a worker, particularly in light of the IRS's continued focus in this area. Employers may also want to seek the guidance of a qualified tax professional to discuss these complex rules and factors, and to determine if filing a VCSP application is appropriate.

As required by U.S. Treasury Regulations, the reader should be aware that this communication is not intended by the sender to be used, and it cannot be used, for the purpose of avoiding penalties under U.S. federal tax laws.

Steven M. Packer is a manager in the Tax Accounting Group of Duane Morris, where he devotes his practice to federal, state and local income taxation; generally accepted accounting principles analysis; financial reporting; fraud and embezzlement detection; and investigative accounting. He is a past president of the Pennsylvania Institute of CPAs Greater Philadelphia chapter.

Brian K. Adams is a manager in the Tax Accounting Group of Duane Morris. He devotes his practice to tax compliance and planning activities, including implementation of tax minimization strategies, for a diverse client base that includes closely held businesses; multistate corporations and partnerships; and high-net-worth individuals.

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