Office of Chief Counsel
Internal Revenue Service

Memorandum

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to: MILTON BLOUKE
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from: Joseph W. Spires
Acting Chief, Employment Tax Branch 1
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subject:

This Chief Counsel Advice responds to your request dated August 22, 2003. In accordance with I.R.C. 6110(k)(3), Chief Counsel Advice may not be used or cited as precedent.

LEGEND

Taxpayers =
Janitorial Service =
Third-party =
Year 1 =
Year 2 =
Year 3 =
Year 4 =
Year 5 =
Year 6 =

ISSUES

Whether the taxpayers may reasonably rely on a prior audit for section 530 relief under the Revenue Act of 1978, when taxpayers were involved in a fraudulent scheme to evade paying employment taxes for Years 1 through 3.

CONCLUSIONS

The taxpayers may not reasonably rely on a prior audit for section 530 relief under the Revenue Act of 1978, when taxpayers were involved in a fraudulent scheme to evade paying employment taxes for Years 1 through 3.

FACTS

The taxpayers, a husband and wife, operated a janitorial service as a cash basis sole proprietorship beginning in Year 1. It appears that the taxpayers wanted to treat their workers as independent contractors but without much success. The workers would not cooperate by attaining the necessary business licenses. To make it appear that workers were independent contractors, they had the workers submit invoices for payment. Towards the end of Year 2, as the janitorial service contracted for larger jobs, the taxpayers devised a scheme to make it appear that the workers were the employee of a third-party.

The janitorial service gross receipts increased 1400 percent because the taxpayers were able to low ball contracts with large retail stores throughout the state. When it became apparent that the taxpayers would need to hire more workers, the taxpayers had a third-party nominee or co-conspirator serve ostensibly as a subcontractor employing the workers as common law employees so that the janitorial service did not have to pay employment taxes.

To accomplish this scheme, the taxpayers had the third-party resurrect a defunct corporation in Year 2 and began hiring workers and invoicing the janitorial service for their pay. The third-party paid the workers but did not withhold both federal income taxes and employee employment taxes and pay employer employment taxes. The subcontracts between the janitorial service and the corporation were fictions in that all control over the workers remain with and was exerted by the taxpayers. During Year 3 through Year 6, the taxpayers failed to pay over a half million dollars in employment taxes.

Near the end Year 3, the Service issued a letter to the janitorial service indicating that it was conducting an “employment tax compliance check.” The letter indicated that the Service would be looking at employment tax returns and income tax returns. The letter also stated that “We will also gather information on your categories of workers, treatment of these workers, and your basis for the determination of the independent contractor status.” The Service did interview the taxpayers and look at the janitorial service’s employment tax records. Based on the information provided, the Service closed the “compliance check” indicating in its records “no audit potential.” The taxpayers now claim that this compliance check was a prior audit entitling the taxpayers to section 530 relief.

LAW AND ANALYSIS

Section 530 provides businesses with relief from federal employment tax obligation if certain requirements are met. It addresses controversies involving whether individuals are employees for purposes of employment taxes.[1] In the instant situation, the Service's review of tax Years 1 and 2 constitutes a prior audit safe haven under 530(a)(2)(B) so long as the review is detailed enough to be considered an audit and the taxpayer has reasonably relied on it. It is undisputed that under the facts provided to us, this review constitutes a prior audit. The issue remaining here is whether the taxpayers have reasonably relied on this prior audit as a safe haven.

The term "reasonable reliance" is not defined in section 530. But one legislative report observes that a taxpayer will not be considered to have acted in good faith, if the treatment of individuals as independent contractors would, on the basis of the pertinent facts and circumstances constitute negligence, intentional disregard of rules and regulations, or fraud. See S. Rep. No. 95-1263, 95th Cong., 1st Sess. (1978) at page 211.

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[1] Section 530 of the Revenue Act of 1978 provides in relevant part:

(a) TERMNATION OF CERTAIN EMPLOYMENT TAX LIABILITY.—

(2) STATUTORY STANDARDS PROVIDING ONE METHOD OF SATISFYING THE REQUIREMENTS OF PARAGRAPH (1).—For purposes of paragraph (1), a taxpayer shall in any case be treated as having a reasonable basis for not treating an individual as an employee for a period if the taxpayer's treatment of such individual for such period was in reasonable reliance on any of the following:

(A) Judicial precedent, published rulings, technical advice with respect to the taxpayer, or a letter ruling to the taxpayer;

(B) A past IRS audit of the taxpayer in which there was no assessment attributable to the treatment (for employment tax purposes) of the individuals holding positions substantially similar to the position held by this individual: or

(C) long-standing recognized practice of a significant segment of the industry in which such individual was engaged.

Under section 1122 of the Small Business Protection Act, a taxpayer may rely not rely on an audit commenced after December 31, 1996, for purposes of subparagraph (B) above unless such audit included an examination for employment tax purposes of whether the individual involved (or an individual holding a position substantially similar to the position held by the individual involved) should be treated as an employee of the taxpayer.

Thus, for audits that began before January 1, 1997, the prior IRS audit does not have to have been an audit for employment tax purposes as long as the audit entailed no assessment attributable to the business's treatment, for employment tax purposes, of workers holding positions substantially similar to the position held by the workers whose treatment is at issue.

In Marlar v. United States, 151 F.3d 962 (9th Cir. 1998), the Court of Appeals for the Ninth Circuit addressed the meaning of reasonable reliance in the context of the industry practice safe haven under section 530(a)(2)(C). In that case, a dance club had treated its dancers as lessees rather than as employees relying on the industry practice safe haven. The lower court granted plaintiff's motion for summary judgment for section 530 relief finding, in part, that it was undisputed that the industry treats dancers as lessees and because plaintiff had relied on this practice. On appeal to the Ninth Circuit, the Government contended that section 530 requires that reliance on industry practice be reasonable, and that there is at least a genuine factual issue in this case as to whether plaintiff's reliance was reasonable. The Ninth Circuit agreed that under section 530, any reliance on industry practice must be "reasonable." The court pointed to the text in 530(a)(2) which unmistakably requires "reasonable reliance," not mere reliance. The court also cited S. Rep. No. 95-1263, supra, stating that the plain language of the statute is supported by the safe-harbor's legislative history. Thus, the court agreed with the Government's construction of the statute, although on the facts of this case, it concluded that there was no genuine issue that plaintiff's reliance was in fact reasonable.

In MacKenzie v. United States, 777 F.2d 811 (2d Cir. 1985), the taxpayers appealed several convictions concerning the filing of fraudulent tax returns, conspiracy to defraud, and aiding and assisting the filing of fraudulent returns that were all in connection with paying employees without withholding taxes. They contended, in part, that the purpose for which section 530 was adopted offered them a safe haven defense.[2]

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[2] They state that: The agreement terminates pre-1979 employment tax liabilities of taxpayers who had a reasonable basis for treating workers…other than as employees and who file all required federal tax returns for periods after December 31, 1978; (2) extends relief prospectively through 1979 for taxpayers having a reasonable basis for their classification of workers; and (3) prohibits the issuance of regulations and Revenue Rulings on common law employment status before 1980.

However, the court at page 815 more fully explains the purpose of Section 530 by quoting the United States Court of Claims' summary of the history of the passage of section 530 set forth in Ridgewell,'s Inc., 228 Ct. Cl. 393, 655 F.2d 1098 (1981) at 1101:

As the section title indicates, section 530 was aimed at controversies between taxpayers and the IRS as to whether certain individuals had the status of employees of the taxpayers. In the late 1960's, the IRS increased its enforcement of the employment tax laws. This led to many controversies with taxpayers when IRS proposed to reclassify individuals from independent contractor status to employee status and the taxpayers complained that the reclassifications involved changes in IRS's position on how the common law rules applied to particular individuals. During the 1976 Tax Reform Act conference, House and Senate conferees requested that IRS "not apply any changed position or any newly stated position in this general subject area to past, as opposed to future taxable years" until the Joint Committee on Taxation had a change to study the problem. Congress then went further by enacting section 530 wherein interim relief was provided to taxpayers involved in such controversies so that Congress would have more time to formulate a comprehensive solution.

The court concluded that a limited “safe haven” was set up for those employers who manifested a “reasonable basis” for their treatment of employees as independent contractors. It surely intended no safe haven for bad faith or fraudulent employers.[3]

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

[redacted]

This writing may contain privileged information. Any unauthorized disclosure of this writing may undermine our ability to protect the privileged information. If disclosure is determined to be necessary, please contact this office for our views.

cc: Division Counsel/Associate Chief Counsel (Tax Exempt & Government Entities)

[3] The court also cites to S. Rep. No. 1263, supra.