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Worker Classification

Maura K. Winston and Robert R. Martinelli of Morgan, Lewis & Bockius examine the Tax Court's ruling in *SECC Corp. v. Commissioner*. The court rejected the IRS's argument that it must issue a Notice of Determination of Worker Classification before the Tax Court can take jurisdiction of an employment tax case involving worker classification issues.

IRS May Not Preclude the Tax Court's Jurisdiction Where a Worker's Classification for Employment Tax Purposes Is at Issue

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In recent years, the Internal Revenue Service has been cracking down on employers who misclassify workers to avoid paying payroll taxes and other employment-related expenses, and the Service isn't alone in its efforts to curb this perceived abuse.

The IRS and the Department of Labor signed a memorandum of understanding in an effort to jointly address tax and labor issues resulting from the misclassification of workers.¹ This has led to a significant increase in worker classification audits by the Service and other government authorities.²

¹ Matthew Koch, "The Tax Risks of Misclassifying Employees," *The Nat'l Law Rev.*, June 6, 2014, available at <http://www.natlawreview.com/article/tax-risks-misclassifying-employees>.

² Matthew Koch, "The Tax Risks of Misclassifying Employees," *Nat'l Law Rev.*, June 6, 2014, available at <http://www.natlawreview.com/article/tax-risks-misclassifying-employees>; Angus Loten and Emily Maltby, "Payroll Audits Put Small Employers on Edge," *Wall Street J.*, March 13, 2013, available at <http://online.wsj.com/news/articles/SB10001424127887324392804578358473085106876>.

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The IRS hasn't limited audits to certain industries or revenue streams; large corporations, small businesses and nonprofit organizations alike have been targeted.³

This article seeks to explain how companies can obtain Tax Court jurisdiction to resolve employment tax issues stemming from the Service's reclassification of workers, without first having to pay the requisite employment taxes, penalties and interest, which would be required if resolution is sought in other forums.⁴

As expected, the Service's efforts have led to litigation where companies are seeking relief from worker classification determinations. For example, in *Kurek v. Commissioner*, T.C. Memo. 2013-64, 2013 BL 53668 (2/28/13), the Tax Court held that workers for a taxpayer's construction business were employees, not inde-

³ See "Worker Classification Has Been Critical Issue for Large Employers Since *Microsoft v. Vizcaino*," *The ERISA Industry Committee*, March 7, 2013, available at <http://www.eric.org/legal/worker-classification-has-been-critical-issue-for-large-employers-since-mic/>; see also *Kurek v. Commissioner*, T.C., No. 2013-64, T.C. Memo. 2013-64, 2/28/13; *Ungvar v. Commissioner*, T.C., No. 27494-11, T.C. Memo. 2013-161 (7/1/13).

⁴ When a taxpayer is assessed with an income tax deficiency, he or she can challenge the Service's assessment by paying the tax, requesting a refund from the Service and then filing suit (in the Court of Federal Claims or a district court) for a refund. Alternatively, he or she can challenge the deficiency without paying it by filing a petition with the Tax Court, as long as the Tax Court has jurisdiction to hear the case.

pendent contractors, which resulted in employment tax deficiencies. In *Ungvar v. Commissioner*, T.C. Memo. 2013-161, 2013 BL 175941 (7/1/13), a tax-exempt religious corporation petitioned for redetermination of an employment tax deficiency arising from reclassification of an individual as the taxpayer's employee and the Tax Court held that the individual wasn't the corporation's employee.

Historically, the only way to challenge a worker classification determination was to pay the tax assessed and file a claim for refund in a U.S. district court or the U.S. Court of Federal Claims. In the Taxpayer Relief Act of 1997 (Pub. L. No. 105-34), Congress created Internal Revenue Code Section 7436.⁵ Section 7436 provides the Tax Court with jurisdiction to review certain U.S. employment tax determinations.

As originally enacted, Section 7436 authorized the Tax Court to review only those determinations by the Service that a taxpayer's workers should be classified as employees for purposes of Subtitle C of the tax code or that the taxpayer for whom the services were performed isn't entitled to relief under Section 530 of the Revenue Act of 1978 (Pub. L. No. 95-600). The Community Renewal Tax Relief Act of 2000 (CRTRA; Pub. L. No. 106-554), however, amended Section 7436 to expand the Tax Court's jurisdiction in employment tax proceedings and authorized the court to determine the proper amount of U.S. employment tax due.⁶

Determining whether a company has properly classified its workers for employment tax purposes before it is required to pay taxes, penalties and interest is obviously preferred over having to first pay the tax, penalties and interest.

The IRS commissioner's "determination" of worker classification generally provides the predicate for the Tax Court's jurisdiction to hear worker classification cases under Section 7436(a).

Section 7436 sets forth several requirements that, if met, confer original jurisdiction on the Tax Court.⁷ For purposes of this discussion, the important provision on which to focus is that there must be a controversy in-

⁵ Unless otherwise stated, all "Section" references are to the Internal Revenue Code, as amended.

⁶ See CRTRA Section 314(f).

⁷ Section 7436 provides:

If in connection with an audit of any person, there is an actual controversy involving a determination by the Secretary as part of an examination that—

(1) one or more individuals performing services for such person are employees of such person for purposes of subtitle C, or

(2) such person is not entitled to the treatment under subsection (a) of section 530 of the Revenue Act of 1978 with respect to such an individual,

upon the filing of an appropriate pleading, the Tax Court may determine whether such a determination by the Secretary is correct and the proper amount of employment tax under such determination.

volving a determination by the Service. The IRS commissioner's "determination" of worker classification generally provides the predicate for the Tax Court's jurisdiction to hear worker classification cases under Section 7436(a).⁸

The Service believes that a document called a Notice of Determination of Worker Classification contains the requisite determination to invoke the Tax Court's jurisdiction.⁹ The IRS takes the position that a Notice of Determination of Worker Classification is the only means by which the Service can make the appropriate determination, thus conferring jurisdiction on the Tax Court under Section 7436.¹⁰

IRS Notice 2002-5, 2002-1 C.B. 320, provides guidance on how employers are to petition the Tax Court for review of an employment tax determination under Section 7436. Notice 2002-5 contemplates that when the Service makes an employment tax determination under Section 7436, the Service will issue the taxpayer a Notice of Determination of Worker Classification. It is up to the discretion of the Service to make such determinations and then issue the Notice of Determination of Worker Classification.

Notice 2002-5 confirms that this piece of paper is required to access the Tax Court by stating that the Notice of Determination of Worker Classification is a "jurisdictional prerequisite" to seeking review of the Service's employment tax determination.

Until recently, the Tax Court seemed to accept the Service's premise that the Notice of Determination of Worker Classification was a jurisdictional prerequisite. However, in *SECC Corp. v. Commissioner*, 142 T.C. No. 12, 2014 BL 94325 (4/3/14), the Tax Court, relying on other recently issued cases, confirmed its long-standing edict that its jurisdiction is governed by statute.¹¹

'SECC Corp. v. Commissioner'

SECC employed 117 to 145 workers, paid to perform cable splicing services.¹² SECC treated its workers as employees and independent contractors (i.e., as lessors to SECC of tools and vehicles they were required to provide in connection with providing services for the company).¹³ SECC reported taxable hourly wages for its workers on Forms W-2, Wage and Tax Statement.¹⁴

⁸ *SECC Corp. v. Commissioner*, T.C., No. 3937-12, 142 T.C. No. 12, slip op. at 10 (4/3/14).

⁹ The more traditional way of invoking the Tax Court's jurisdiction is by filing a petition after being issued a statutory notice of deficiency.

¹⁰ See *Staffmore, LLC v. Commissioner*, T.C., No. 13101-12, T.C. Memo. 2013-187 (8/15/2013); *Micom, Inc. v. Commissioner*, Docket No. 14629-12, Order dated May 20, 2013; *Jalbert Wilson, Inc. v. Commissioner*, Docket No. 3821-10, Order dated March 8, 2010; *Speedusny.com v. Commissioner*, Docket No. 9493-09, Order dated July 8, 2009.

¹¹ See *Corbalis v. Commissioner*, 142 T.C. No. 2 (1/27/14); *Gray v. Commissioner*, 138 T.C. 295 (2012), *aff'd*, 723 F.3d 790 (7th Cir. 2013); *Cooper v. Commissioner*, 135 T.C. 70 (2010); *Wilson v. Commissioner*, 131 T.C. 47 (2008); *Craig v. Commissioner*, 119 T.C. 252 (2002); *Lunsford v. Commissioner*, 117 T.C. 159 (2001).

¹² *SECC Corp. v. Commissioner*, 142 T.C. No. 12, slip op. at 3 (4/3/14).

¹³ *Id.*

¹⁴ *Id.*

SECC reported equipment lease payments on Forms 1099-MISC, Miscellaneous Income.¹⁵

The IRS audited SECC and issued a 30-day letter. The Service concluded that SECC was liable for FICA taxes and penalties as a result of classifying payments to workers as wages.¹⁶ The 30-day letter stated that the Examination Division had made a “final determination on this issue” but also stated that “[t]hese changes to your employment taxes are not based on a worker classification determination.”¹⁷ Thereafter, the Service informed SECC that employment tax liabilities would be assessed as determined during the examination.¹⁸

The Service didn’t issue SECC a Notice of Determination of Worker Classification. Nevertheless, SECC filed a petition in the Tax Court seeking review of the Service’s determinations from the examination.

The parties each filed a motion to dismiss for lack of jurisdiction. Both parties argued that issuance of a Notice of Determination of Worker Classification is required to give the Tax Court jurisdiction under Section 7436.¹⁹ The Service argued that because the commissioner didn’t issue the appropriate notice, the Tax Court doesn’t have jurisdiction to hear issues related to worker classification.²⁰ The Service argued that dismissal would deprive the court of jurisdiction over the case, leave the May 9, 2011, assessment in place, and allow the Service to proceed with collection.²¹

SECC argued that failure to issue a Notice of Determination of Worker Classification means that the assessment is invalid and the Service may not collect the disputed employment taxes unless and until a Notice of Determination of Worker Classification is sent.²²

The Tax Court disagreed with both parties’ assertions that it has jurisdiction under Section 7436 only when the Service issues a Notice of Determination of Worker Classification.²³ The court followed the legislative history stating: “The House report made clear that determinations for purposes of section 7436 may be made in nontraditional ways. The Senate committee report states that ‘[a] failure to agree’ would be considered a determination”²⁴

The Tax Court ultimately concluded that the Service’s use of the phrases “we were unable to reach an agreement” in a letter to the taxpayer, and the fact that employment tax liabilities “as determined by Appeals” would be assessed, was enough to be a determination for purposes of Section 7436.²⁵

Thus, it appears that, so long as there is a controversy during exam (i.e., the issue is raised on audit), and a determination involving worker classification, the Tax Court will have jurisdiction to redetermine tax liabilities and the taxpayer won’t have to prepay taxes and file a refund claim.

The Tax Court further stated that “a taxpayer who files a refund claim and one month later gets an infor-

mal ‘decision’ by the IRS under section 6532(a)(1)[A] may file suit, even without receiving a formal notice of disallowance under section 6532(a)(1)[B].”²⁶

The features of these rules are similar to the features of Section 7436(a) and (b). Section 7436(b)(2) provides a hard-and-fast 90-day deadline for filing suit that commences only “if the Secretary sends by certified or registered mail notice * * * of a determination”; yet Section 7436(a) permits the filing of suit simply upon the existence of “an actual controversy involving a determination”—without regard to certified mailing and without regard to any formal “notice.” Thus, a taxpayer who is the subject of a “determination” by the IRS under Section 7436(a) can file suit without receiving a notice of determination under Section 7436(b)(2).²⁷

The concurring opinion made a critical point about the potential for abuse should the Service be allowed to decide unilaterally whether to issue a Notice of Determination of Worker Classification, thus precluding the court’s jurisdiction as mandated by statute.²⁸ The concurring opinion was concerned that if it adopted the Service’s position, “the Commissioner, by refusing to issue a notice of determination, would be able to deny the taxpayer access to this Court, which he may be tempted to do whenever he feels his chance of success on a worker classification or [Revenue Act of 1978 Section 530] issue is better in either the District Court or the Court of Federal Claims than in this Court.”²⁹

The Tax Court felt that there was no basis in Section 7436 to grant the commissioner this unilateral discretion, and further that it would thwart the obvious congressional intent embodied in that provision to permit taxpayers to litigate in the Tax Court worker classification and Revenue Act of 1978 Section 530 issues that the commissioner has raised on audit.³⁰

The dissent was concerned that the concurring opinion hadn’t made clear “what the Court thinks a ‘determination’ is.”³¹ Confusion about what constitutes a determination under Section 7436 opens the door to potential litigation on this issue.

Because this case involves both a concurring and dissenting opinion, it is possible that the Service will seek an appeal with the U.S. Court of Appeals for the Ninth Circuit. Further, should this case get appealed and overturned in the Ninth Circuit, the Tax Court will follow its decision in the SECC case in all other cases in which an appeal would fall outside of the Ninth Circuit.

Morgan Lewis Perspective

The SECC case confirms that the Tax Court, as it has always done, will follow the statute in determining whether it has jurisdiction to hear a case and will disregard the Service’s procedures that seek to preclude the Tax Court’s jurisdiction.

The Service can no longer withhold jurisdiction from the Tax Court based on issuing a specific piece of paper (i.e., a Notice of Determination of Worker Classifica-

¹⁵ Id.

¹⁶ Id. at 5.

¹⁷ Id.

¹⁸ Id. at 7. Indeed, the Service later sent SECC a notice of adjustment assessing tax, penalties and interest.

¹⁹ Id. at 10.

²⁰ Id.

²¹ Id. at 8.

²² Id.

²³ Id. at 11.

²⁴ Id. at 13 (footnotes omitted).

²⁵ Id. (footnotes omitted).

²⁶ Id. at 15.

²⁷ Id. at 19.

²⁸ The concurring opinion was joined by 11 judges.

²⁹ SECC Corp. v. Commissioner, 142 T.C. No. 12, slip op. at 27 4/3/14).

³⁰ Id.

³¹ Id. at 32.

tion) in cases where the Service determines a company may owe additional employment tax, penalties and interest based on the classification of its workers for federal employment tax purposes under Subtitle C of the Internal Revenue Code. Instead, the Tax Court will de-

cide its jurisdiction based on whether or not a worker's classification for employment tax purposes was at issue during any stage of an examination, and whether there was some form of determination made by the Service on that issue.