KM SYSTEMS, INC. v. U.S.

93 AFTR 2d 2004-2458

May 10, 2004.

ORDER

FREDA WOLFSON, Magistrate Judge.

This matter having been opened to the Court by Paul R. Fitzmaurice, counsel to KM Systems, Inc. ("KM Systems" or the "Company"), seeking summary judgment on the Company's claim that it had a reasonable basis for treating its cable installers as independent contractors in accordance with the safe harbor provision of Section 530(a)(2)(C) of the 1978 Internal Revenue Code ("Section 530"), and on its claim that the Company's cable installers were independent contractors under the common law test for determining employment status, and Lindsey W. Cooper, Jr., counsel to the United States (the "Government"), seeking partial summary judgment on the Company's complaint, for failure to meet the safe harbor requirements of Section 530(a)(2)(C); and the Court, having considered the moving, opposition and rely papers, and having heard oral argument on May 7, 2004, and it appearing that:

1. Summary judgment is appropriate where there is no genuine issue as to any material fact and the moving party is entitled to judgment as a matter of law. Fed.R.Civ.P. 56; Celotex Corp. v. Catrett, 477 U.S. 317, 323 (1986). A genuine issue of material fact is one that will permit a reasonable jury to return a verdict for the nonmoving party. Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 248 (1986). To show that a genuine issue of material fact exists, the nonmoving party may not rest upon mere allegations, but must present actual evidence in support thereof. Id. at 249 (citing First Nat. Bank of Ariz. v. Cities Serv. Co., 391 U.S. 253, 290 (1968)). In evaluating the evidence, the court must "view the inferences to be drawn from the underlying facts in the light most favorable to the [nonmoving] party." Curley v. Klem, 298 F.3d 271, 276-77 (3d Cir.2002) (quoting Bartnicki v. Vopper, 200 F.3d 109, 114 (3d Cir.1999)).

2. KM Systems contracts with various cable television systems in, or around, southern New Jersey to install cable television services in the systems' subscribers' homes. KM Systems Mem. Supp. Mot. Summ. J. at p. 2. The Company was formed by Francis Knoll ("Knoll"), Patricia Watson ("Watson") and George Murphy in 1987. Id. Since the Company's inception, the Company has treated its cable installers as independent contractors, not employees, for tax purposes.[1] Id. at p. 1; KM Systems Compl. at ¶¶ 18-19. Some time after the Company's incorporation, the Internal Revenue Service ("IRS") conducted an employment tax audit of the Company and re-classified the Company's cable installers as employees. KM Systems Compl. at ¶ 9. Consequently, the Company owed a total of $2,628.15 in taxes for the 1992 and 1993 tax years. KM Systems Compl. at ¶¶ 4, 11. KM Systems now argues that it is entitled to a refund of the federal

employment taxes paid as a result of the IRS reclassification of the Company's cable installers because (i) the Company reasonably relied on the long-standing practice in the cable installation industry of treating its workers as independent contractors within the meaning of Section 530(a)(2)(C), and (ii) the Company's cable installers were independent contractors under the common law test for determining worker status.

3. It is a well-established principle that the IRS Commissioner's determination of tax liability is entitled to a presumption of correctness, and that the burden is on the taxpayer to prove that the determination is erroneous. Boles Trucking, Inc. v. U.S., 77 F.3d 236, 239 (8th Cir.1996) (citations omitted). Furthermore, the taxpayer must prove, by a preponderance of the evidence, that its workers are or were independent contractors. Id. at 239-40; Prince Cable, Inc. v. U.S., 1998 WL 419979, No. 96-516, slip. op. at *3 (D. Del. Apr. 9, 1998).

4. Section 530 was created by Congress in 1978 "to alleviate what was perceived as overly zealous pursuit and assessment of taxes and penalties against employers who had in good faith, misclassified their employees as independent contractors." Boles Trucking, 77 F.3d at 239; see also McClellan v. U.S., 900 F.Supp. 101, 104-05 (E.D. Mich.1995); General Inv. Corp. v. U.S., 823 F.2d 337, 339 (9th Cir.1987). To be entitled to relief under the safe harbor provisions of Section 530, a taxpayer must demonstrate first that it did not treat an individual as an employee for employment tax purposes for any period, and second, that it filed all of the required federal tax returns on a basis consistent with the taxpayer's treatment of that individual. Section 530(a)(1). If these two requirements are met, then that individual "shall be deemed not to be an employee unless that taxpayer had no reasonable basis for not treating such individual as an employee." Id. (emphasis added). In the instant matter, KM Systems has met the consistency and filing requirements of Section 503(a)(1). Since its inception in 1987, the Company has always treated its cable installers as independent contractors and has filed all required federal tax returns on a basis consistent with its treatment of such contractors during 1992-1993, the tax periods in question. See KM Systems Mem. Supp. Mot. Summ. J. at p. 1; see also KM Systems Compl. at ¶¶ 18-19.

5. Section 530 further provides that reasonable reliance on any of the three safe harbors under Section 503(a)(2) shall be treated as a reasonable basis for not treating a worker as an employee. Moore v. U.S., 1992 WL 220913, No. 91-76, slip. op. at *7 (W.D. Mich. Jun. 29, 1992); Day v. Commissioner, 80 T.C.M. (CCH) 834 (2000); West Virginia Personn. Servs. v. U.S., 1996 WL 679643, No. 94-0604, slip. op. at *8 (S.D. W.Va. Sept. 16, 1996). Pertinent to the instant matter, the third safe harbor of the statute states that a taxpayer may rely on the "long-standing recognized practice of a significant segment of the industry in which such individual was engaged." Section 530(a)(2)(C); 26 U.S.C. § 3401 note.

6. However, the safe harbors provided by Section 530(a)(2) are not the exclusive ways for a taxpayer to meet the "reasonable basis" requirement. A taxpayer may be entitled to relief if the taxpayer can demonstrate, in some other manner, a reasonable basis for not treating the worker as an employee. Critical Care Register Nursing, Inc. v. U.S., 776 F.Supp. 1025, 1027 (E.D. Pa.1991); Prince Cable, 1998 WL 419979, at *5; Boles Trucking, 77 F.3d at 239; S. Rep. No. 104-281, at 24 (1996).

7. Congress has established that the requirements of Section 530 are to be liberally construed in favor of the taxpayer. Critical Care, 776 F.Supp. at 1027; Springfield v. U.S., 88 F.3d 750, 753 (9th Cir.1996); Boles Trucking, 77 F.3d at 240; H. R. Rep. No. 95-1748, at 631-32 (1978). Such liberal construction is necessary to provide interim relief to those taxpayers who exercised good faith in determining whether their workers were employees or independent contractors. See McClellan, 900 F.Supp. at 104-05; see also J&J Cab Serv., Inc. v. U.S., 1995 WL 214326, No. 93-234, slip. op. at *3 (W.D. N.C. Jan. 3, 1995); S. Rep. No. 104-281, at 21. Courts have held that a taxpayer may establish that it had a reasonable basis for not treating its workers as employees by utilizing the traditional common law rules for determining employment status. Critical Care, 776 F.Supp. at 1028; Moore, 1992 WL 220913, at *8; Hospital Resource Personn., Inc. v. U.S., 68 F.3d 421, 425 (11th Cir.1995).

8. However, Section 530 does not specifically state that there must first be a determination that a worker is an employee under the common law test before relief under the Section 530 safe harbors becomes available. S. Rep. No. 104-281, at 21; see also J&J Cab Service, 1995 WL 214326, at *4 (finding that "Section 530 relief may be granted irrespective of whether individuals were incorrectly treated as other than employees.") (citations omitted); Queensgate Dental Family Practice, Inc. v. U.S., 1991 WL 260452, No. 90-1291, slip. op. at *2 (M.D. Pa. Sept. 5, 1991) (disagreeing with government's contention that court must first evaluate whether plaintiffs were employees or independent contractors according to common law before applying Section 530).

9. Under the third safe harbor of Section 530(a)(2), a taxpayer must show reasonable reliance on a long-standing industry practice of a significant segment of the industry in which the taxpayer was engaged. Section 530(a)(2)(C); 26 U.S.C. § 3401 note. Such reliance must have occurred during the tax period in question. See Prince Cable, 1998 WL 419979, at *5. Since the scope of the relevant industry is neither defined by Section 530 nor addressed in the legislative history of the statute, courts have relied on Congress' overall purpose in passing the legislation to determine that the relevant industry segment need not be nationwide.[2] See In re McAtee, 115 B.R. 180, 183-84 (N.D. Iowa 1990); see also General Inv., 823 F.2d at 340.

10. Here, the Government contends that KM Systems is not entitled to relief under the third safe harbor provision of Section 530(a)(2) because the Company's founders' "self-serving statements and subjective understandings" of the industry practice do not constitute a reasonable basis for not treating the Company's cable installers as employees. Gov. Mem. Supp. Mot. Part. Summ. J. at 9. For the reasons stated below, this Court finds the Government's argument unconvincing.

11. Several courts have considered a taxpayer's personal experience as insufficient evidence of the "long-standing recognized practice of a significant segment of the industry" within the meaning of Section 530(a)(2)(C). See Day v. Commissioner, 80 T.C.M. (CCH) 834 (2000); West Virginia, 1996 WL 679643, at *9; Moore, 1992 WL 220913, at *8. However, such cases are factually distinguishable from the present matter.

12. In West Virginia, the court held that a taxpayer's understanding that its workers were treated as independent contractors at the time the taxpayer acquired an interest in the business was not determinative of protection under the third safe harbor of Section 530.

West Virginia, 1996 WL 679643, at *9. However, despite the equivocal nature of the taxpayer's testimony (when asked about the basis of his knowledge regarding the industry practice, the taxpayer replied, "I believe that they're independent contractors. Just a gut feeling." Id. at *2), the West Virginia court determined that the taxpayer's testimony was sufficient to create a genuine issue of material fact as to whether the taxpayer met the "reasonable basis" requirement of Section 530. Id. at *9. Therefore, the court denied the summary judgment motions for both the taxpayer and the government. Id. at *10. Similarly, in Day, the taxpayer asserted that he had a reasonable basis for treating his drivers as independent contractors because he was an independent contractor when he worked for other trucking companies. Day, 80 T.C.M. (CCH) 834 (2000). The Day court found that such personal experience, by itself, was not sufficient evidence of the industry practice within the meaning of Section 530(a)(2)(C). Id. The court also pointed out that although the taxpayer had the opportunity, he never questioned the company's former workers, all of whom were employed as truck drivers at other times for other trucking companies, about their worker status. Id.; see also Henderson v. U.S., 1992 WL 104326, No. 90-1064, slip. op. at *4 (W.D. Mich. Feb. 18, 1992) (finding that taxpayer's understanding that workers treated as independent contractors for at least 15 years prior to taxpayer's purchase of business not determinative of protection under Section 530(a)(2)(C)).

13. Here, KM Systems offered more than the limited personal experiences of the founders in the cable installation business as evidence of the industry practice. Before the formation of the Company, Knoll and Watson each had work experience with numerous cable installation companies that treated cable installers as independent contractors. As a cable installer, Knoll worked as an independent contractor for Cable Installation Services ("CIS") for approximately four years and also worked as an independent contractor for various other cable installation companies in Maryland, Delaware and Pennsylvania. Knoll Dep. 23. Watson worked at Audubon Cable for seven years, and she testified that Audubon always treated its cable installers as independent contractors. Watson Dep. 18. In addition, Knoll testified that he knew of other cable installation companies existing at the time he was working with CIS, specifically DC Wiring, Prince Cable, Starview Cable and ACI, and that none of these companies treated its cable installers as employees. Knoll Dep. 13. Knoll even testified that he had asked DC Wiring and Starview Cable whether they treated cable installers as independent contractors. Knoll Dep. 32. Although the record is unclear as to when Knoll's conversations with those companies occurred, it is reasonable to assume that the discussions took place sometime before the Company's formation since Knoll testified that DC Wiring was no longer in operation when KM Systems was formed in 1987, Knoll Dep. 32, and Watson testified that Starview Cable went out of business around the mid 1980's. Watson Dep. 17. Furthermore, Watson testified that as a dispatcher for Audubon's installation department, she had contact with approximately thirty subcontractors, thirty in-house installers and forty technicians. Watson Dep. 11; Answer to First Set of Interrogs. No. 1. Watson also worked closely with the owner of Best Cable, an installation company that provided cable installation services to Audubon, and she testified that through her daily contact with the contractors, she knew exactly how such contractors were paid. Watson Dep. 20. The founders' extensive experiences and contacts within the cable installation industry in the southern New Jersey area demonstrate that they had more than a vague, general understanding of the industry practice. Therefore, the Court finds that KM Systems had a reasonable basis

for treating its cable installers as independent contractors at the time of the Company's formation.

14. Moreover, based on the testimony provided by KM Systems, it is reasonable to conclude that KM Systems had further knowledge regarding the industry practice after 1987. Knoll testified that from being in the industry from 1980 to the present, he was not aware of any cable installation company that did not treat cable installers as independent contractors. Knoll Dep. 31 (emphasis added). In addition, Watson testified that she became aware of companies like Prince Cable, DC Wiring, LDW, and ACI after KM Systems was formed. Watson Dep. 24. Although the record does not indicate whether Watson specifically knew that these companies treated their cable installers as independent contractors, the testimony of KM Systems' cable installers corroborates the founders' understanding of the industry practice and supports an inference that the Company reasonably relied on the founders' and the Company's cable installers' understanding of the practice in treating cable installers as independent contractors. For example, Joseph Reily testified that "everyone" who does cable installation work, including those at Prince Cable, is an independent contractor. Reily Dep. 119-20. In addition, several of the Company's cable installers testified that at their previous places of employment at various other cable installation companies, they were all treated as independent contractors. Krumin Dep. 86; Polin Dep. 14; Reily Dep. 119; Witt Dep. 11-12. Even if the personal experiences of the founders, standing alone, do not meet the requirements of Section 530(a)(2)(C), the founders' experiences "nevertheless gather some strength" when considered in conjunction with the corroborating testimony of the Company's cable installers, and establish that the Company had a reasonable basis for treating its installers as independent contractors during the tax years in question. See West Virginia, 1996 WL 679643, at *9.

15. This is not a case where the taxpayer's reasonable reliance was based on the practices of only one other similarly situated company. See Overeen v. U.S., 1991 WL 338327, No. 90-1920, slip. op. at *3 (W.D. Okla. Sept. 4, 1991). In Overeen, the court found that taxpayer was not entitled to the protection of Section 530(a)(2)(C) because the taxpayer relied on the practices of only one other company. There was also evidence contradicting the taxpayer's position because the government talked with several other companies in the relevant region which treated their workers as employees, not independent contractors. Id. Here, Knoll and Watson had direct, relevant experience in several companies that treated their cable installers as independent contractors. They also knew how other cable installation companies treated their workers based on their contacts with various cable installers who worked as independent contractors in southern New Jersey. The Court finds that this evidence does not demonstrate such a "limited understanding of the cable installation industry," Gov. Mem. Supp. Mot. Summ. J. at 9, that it justifies denying relief to KM Systems under Section 530(a)(2)(C).

16. Nor is this a case where the taxpayer treated its workers as independent contractors merely for convenience reasons. See Moore, 1992 WL 220913, at *8 (finding that taxpayer not entitled to statutory safe harbor because taxpayer treated its workers as independent contractors "to avoid burdensome paperwork, because it was convenient and easy and because [taxpayer] never expected his business to grow..."). In the present matter, there is nothing in the record that demonstrates that the Company treated its cable installers as independent contractors solely for convenience reasons.

17. Furthermore, unlike in Overeen where the government provided evidence that contradicted the taxpayer's understanding of the industry practice, the Government here has not provided any evidence of any cable installation companies in the southern New Jersey region that have treated cable installers as employees. In General Inv., in holding that the taxpayer had a reasonable basis for treating its workers as independent contractors, the court noted that the government "failed to present evidence of employment practices that cast doubt on [the taxpayer's] evidence." General Inv., 823 F.2d at 341; see also Springfield, 88 F.3d at 754 (finding that taxpayer provided sufficient proof regarding industry practice and that government provided nothing to contradict taxpayer's evidence). Without any evidence contradicting the Company's understanding of the industry practice, it is reasonable for this Court to conclude that, as a matter of law, there are no genuine issues of material fact as to whether the Company had a reasonable basis for treating its cable installers as independent contractors within the meaning of Section 530(a)(2)(C).

18. It is also important to note that the primary purpose behind the safe harbor provisions of Section 530 is to protect those taxpayers who in good faith mistakenly determined that their workers were not employees for tax purposes. See Boles, 77 F.3d at 240; see also McClellan, 900 F.Supp. at 104-05. Therefore, the statute is to be liberally construed in favor of the taxpayer. Id.; Overeen, 823, F.2d at 340. In fact, even the IRS has embraced Congress' liberal construction directive in its procedural guidelines for Section 530. See Rev. Proc. 85-18 § 3.01(c) (stating that taxpayer who fails to meet any of three safe harbors of Section 530 may nonetheless be entitled to relief if taxpayer demonstrates another reasonable basis for not treating individual as employee). In the context of this clear Congressional directive, it is doubtful that Section 530 was meant to create significant barriers for taxpayers by requiring the taxpayer to conduct "due diligence" or gather very detailed or specific information about the relevant industry practice in order to justify the treatment of the taxpayer's workers for tax purposes. Such requirements would be antithetical to the purpose of the statute.

19. Therefore, this Court finds that KM Systems has sufficiently demonstrated that it had a reasonable basis for treating its cable installers as independent contractors for the purpose of Section 530(a)(2)(C) for the two tax years in question. Because KM Systems is entitled to relief under Section 530(a)(2)(C), it is unnecessary for the Court to determine whether the Company's cable installers were independent contractors under the common law test for determining worker status. However, even if this Court were to address the common law issue, the determination of whether the Company's cable installers were independent contractors under the common law test would be a highly factual inquiry; therefore, the Court would leave the issue as a question of fact for the jury to determine at trial.[3] Accordingly,

ORDERED that the Government's motion for partial summary judgment is DENIED; and it is further

ORDERED that KM Systems' motion for summary judgment on its claim that it is entitled to relief under Section 530(a)(2)(C) is GRANTED; and it is further

ORDERED that KM Systems' motion for summary judgment on its claim that its cable installers are independent contractors under the common law test for determining worker status, is DENIED as moot.

[1] The Court notes that the Government does not dispute the fact that the Company has consistently treated its cable installers as independent contractors for tax purposes.

[2] The Court notes that neither party has disputed the fact that the relevant industry segment within the meaning of Section 530(a)(2)(C) is the cable installation companies in the southern New Jersey region.

[3] An analysis under the common law test requires a highly factual inquiry of the Company's practices because the parties disagree as to whether KM Systems had the requisite right to control and direct the cable installers in the details and means by which the installers accomplished their work. The disputed facts regarding control include, among others, whether the Company's training sessions, pricing system and rules regarding work attire suggest that the relationship between KM Systems and its cable installers was more akin to an employer/employee relationship. Gov. Resp. to Mot. for Summ. J. at 10-12; KM Systems Rep. Supp. Mot. Summ. J. at 12-13. Clearly, such disputes are questions of fact that must be left for a jury to determine at trial.