"Does the Agreement Still Apply?" Construing Closing Agreements When Circumstances Change

By: Steven M. Hogan

We all know that our clients are sometimes audited by the IRS. One way that an audit can end is through a closing agreement that settles the matter. Usually that is the end of it, and both the taxpayer and the IRS go on their respectively merry ways.

In the context of worker classification audits, a closing agreement may have more practical consequences for a taxpayer than other types of closing agreements. Specifically, the closing agreement may address how certain categories of workers must be classified in the future for purposes of federal employment taxes.

While this might not be an issue for a taxpayer that never changes its operations, it is a fact that taxpayers in a dynamic economy can and will change the way they relate to their workers over time. Changes will inevitably come to job descriptions, contract language, and perhaps even the market sector that the taxpayer operates in.

With changing circumstances, a taxpayer that entered into a closing agreement with the IRS may wonder whether that closing agreement has continuing validity in relation to new types of worker relationships and contract provisions.

This article addresses the extent to which closing agreements in worker classification audits will bind taxpayers in the future when circumstances change.[1]

A. Worker Classification, In General

Worker classification audits generally focus on determining whether certain workers who were treated as independent contractors for federal employment tax purposes should have been classified as employees. This issue is critical because it controls the question of which party (the employer or the worker) is directly responsible for remitting federal employment taxes to the government.[2]

Stated simply, if a worker is an employee, the employer is responsible for remitting employment taxes. However, if a worker is an independent contractor, the worker is responsible for remitting employment taxes to the federal government.

The determination of whether a worker is an "employee" for employment tax purposes requires an intensive, fact-based inquiry into the nature of the working relationship. The IRS focuses its analysis on the level of control that the employer exerts over the worker that performs the services at issue. *See* I.R.M. § 4.23.5.7.1(2) ("Control Test") (primary method of analysis "is to consider every piece of information in a case that helps to decide the extent to which the taxpayer does or does not retain the right to control the worker.").

Because the analysis is inherently fact-based, reasonable minds can reach differing conclusions about whether a particular worker should be classified as an employee or an independent contractor.

B. Closing Agreements are Contracts

The fact that reasonable minds can differ on the issue of worker classification means that audits focusing on this issue are prime candidates to be resolved through a closing agreement that avoids litigation.

In a worker classification audit, the closing agreement may often come about through the IRS's Classification Settlement Program ("CSP"). The CSP is a specific program targeted toward reaching closing agreements in worker classification audits.

As part of the CSP, the IRS has promulgated Forms 14490, 14491, and 14492 as standard forms to settle worker classification cases. I.R.M. § 4.23.6.15.3(1)(b). Closing agreements that are memorialized through the standard forms will state what periods they apply to. The author has seen such agreements state that they apply to the period under audit, and to "all periods thereafter."[3]

The IRS's authority to enter into closing agreements is granted by section 7121 of the Internal Revenue Code ("IRC"). Such agreements entered into under IRC 7121 can be written to apply to periods subsequent to the date of the closing agreement. *See* Treas. Reg. § 301.7121-1(b)(3) ("Closing agreements with respect to taxable periods ending subsequent to the date of the agreement may relate to one or more separate items affecting the tax liability of the taxpayer.").

Closing agreements entered into under IRC 7121 are contracts between the IRS and the taxpayer. *Ellinger v. U.S.*, 470 F.3d 1325, 1336 (11th Cir. 2006) ("Closing

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agreements are 'contracts in the ordinary legal sense of the term,' and, as such, are 'governed by . . . federal common law contract principles,'" quoting *U.S. v. Nat'l Steel Corp.*, 75 F.3d 1146, 1150 (7th Cir. 1996)). Such closing agreements are strictly construed, and apply only to matters "specifically spelled out" within them. *Ellinger*, 470 F.3d at 1336-37 (quoting *Geringer v. C.I.R.*, T.C. Memo. 1991-32 (1991)).

As contracts, closing agreements are applicable to the IRS and to the taxpayer that signs the agreement.

C. What Happens When Circumstances Change?

Because a closing agreement can apply to <u>future</u> periods, a question will inevitably arise as to how the closing agreement operates on different facts over time. Fortunately, the IRS has issued guidance on this topic that can help guide a taxpayer through this issue.

At times, the IRS Office of Chief Counsel issues advice memoranda on pending issues that are subsequently published in redacted form. IRC §6110(b)(1)(A) ("written determinations" published in redacted form by the IRS include "Chief Counsel advice"). Though these Chief Counsel Advice ("CCA") memoranda cannot be cited as precedent pursuant to IRC 6110(k)(3), they are persuasive documents that show how the IRS approaches issues of law in given factual situations.[4]

Relevant to the issue at hand, the IRS issued a CCA memorandum in 2009 concluding that when the facts surrounding a taxpayer's treatment of its workers substantively changed through adjustments to the relevant contracts, a prior closing agreement as to the status of those workers did not apply to the changed working relationship. IRS CCA 200948043 (Aug. 6, 2009) (the "2009 CCA").

The 2009 CCA states that during a prior audit, the IRS and a taxpayer entered into a closing agreement under IRC 7121 regarding worker classification. 2009 CCA, at 5. The closing agreement provided that the IRS would not reclassify the taxpayer's independent contractors as employees. *Id*. The closing agreement applied on a going-forward basis with no ending date. *Id*. at 5-6.

The 2009 CCA then analyzes whether the prior audit's closing agreement would be applicable in a subsequent audit of the taxpayer where the operative facts had changed. *Id*. at 20-21. The 2009 CCA concluded that, because the operative contract documents had substantively changed, the prior closing agreement no longer applied. *Id*.

Specifically, the IRS reasoned as follows:

> The [redacted data] Closing Agreement is clear and unambiguous on its face. It binds the Service as to its determination and agreement that the relationship between Taxpayer and the Category A Workers is not inconsistent with an independent contractor relationship so long as the Taxpayer and the Category A Workers operate in accordance with the terms of the [redacted data] Agreement. **<u>The closing agreement only applies to operations under the provisions of the [redacted data] Agreement.</u>** The scope of a closing agreement is limited by statute. **<u>The closing agreement does not extend to a situation where Taxpayer and the Category A Workers operate under the terms of another (or altered) agreement.</u>** In other words, the closing agreement binds the Service for the finite time frame in which Taxpayer and the Category A Workers agreed to operate and did in fact operate in accordance with the terms of the [redacted data] Agreement. **<u>Over the years, Taxpayer has changed the terms of the agreement it uses with Category A Workers from what was in the [redacted data] Agreement, mainly by addenda. The differences between the [redacted data] Agreement and the agreements in use in [redacted data] were substantive, not superficial. In light of these changes, the [redacted data] Closing Agreement no longer applies.</u>** The addenda to the [redacted data] Agreement and the new and [redacted data] agreements executed between Taxpayer and the Category A Workers constitute a modification of the terms of [redacted data] Agreement. **<u>The changes were not merely cosmetic changes to names or addresses, but rather changes to terms and conditions of the agreement.</u>** For example, one modification changed the compensation structure by altering the financial rewards available to the Category A Workers depending on the type of [redacted data] used. Another change shortened the [redacted data] agreements' duration from a maximum term to a maximum [redacted data] term, which meant that Taxpayer effectively had the power to dismiss Category A Workers without cause sooner than under the previous agreement. And yet another change added an additional duty, requiring Category A Workers to cooperate in taxpayer's defense of legal claims or have to indemnify Taxpayer for the claims. **<u>These were changes to the substantive terms of the [redacted data] Agreement. Under the legal standards applicable to closing agreements, any substantive change from the specific facts described terminates the future application of the [redacted data] Closing Agreement.</u>**

2009 CCA, p. 21 (emphasis added).

Under this analysis, when the contract terms between

a taxpayer and its workers change substantively, an IRS closing agreement on worker classification from a prior audit will no longer be dispositive as to the proper classification of those workers. The IRS has confirmed this analysis in an Internal Revenue Manual provision that governs worker classification audits where a prior closing agreement is in place. The relevant provision states that when "the right to direct and control the workers under the common law factors has materially changed," the auditor should treat the examination as a new worker classification exam without regard to the terms of the settlement agreement. I.R.M. §4.23.6.18.1.1.[5]

Therefore when the facts of a working relationship substantively change through revised contract terms, a prior closing agreement will no longer necessarily govern the classification of those workers.

D. How Much Change is Enough?

The question this article cannot answer is to what level a taxpayer's operations must change in order for a prior closing agreement to no longer apply. In the area of worker classification, the answer may be different for various categories of workers. Some worker categories may never change, others may no longer exist over time, and new categories may emerge as the taxpayer's business evolves.

The practitioner would be well advised to review the closing agreement at issue carefully in light of the taxpayer's current operations in order to determine how the taxpayer should proceed.

Conclusion

Though a closing agreement in a worker classification audit may state that it applies indefinitely into the future, such agreements will not bind taxpayers forever when circumstances change. Taxpayers finding themselves in new situations may find that they have a reasonable basis to argue that their prior closing agreement is not necessarily dispositive of how its current workers are to be categorized. The facts are dispositive, of course, so prudent counsel is always advised.

About the Author:

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Endnotes

1 Though this article focuses specifically closing agreements in worker classification audits, the principles articulated herein may also apply to any closing agreement issued under the authority of IRC 7121. Because the author has not exhaustively researched that issue, this article stops short of stating that this is the case. Further research and comment on this issue is welcomed and invited.

2 This article uses the term "employment taxes" to refer to taxes remitted under the Federal Insurance Contributions Act ("FICA"), the Federal Unemployment Tax Act ("FUTA"), and federal withholding tax. The Treasury Regulations relevant to FICA and FUTA use materially similar terms to define who an "employee" is under their provisions. *See* Treas. Reg. § 31.3121(d)-1(c)(2) (FICA); Treas. Reg. § 31.3306(i)-1(b) (FUTA); Treas. Reg. § 31.3401(c)-1(b) (withholding tax).

3 Settlement of a worker classification audit does not have to come about through the CSP, of course, though it is common for the CSP to be the vehicle settlement.

4 An example of this is found in Treasury Regulation 1.6662-4(d)(3)(iii), which lists a number of non-precedential written determinations that can be relied on by taxpayers to establish "substantial authority" for return positions in a manner that may allow taxpayers to avoid penalties for substantial underpayments. The IRS has also published a Notice instructing its attorneys to avoid litigation positions that conflict with Chief Counsel Advice. *See* IRS CCN CC-2003-014 (May 8, 2003) (Though CCAs are not final guidance, "[g]ood judgment dictates, however, that Chief Counsel attorneys should coordinate with the Associate Chief Counsel office with subject matter jurisdiction over the issue if a Chief Counsel attorney proposes to take a position that conflicts with any PLR, TAM or CCA addressing the issue.").

5 This provision governs "CSP follow-up" exams. The full text of this provision states: "If the right to direct and control the workers under the common law factors has materially changed, the examiner must address this as a worker classification exam and follow all appropriate procedures including consideration of whether the taxpayer is entitled to Section 530 relief, whether the reduced rates under IRC 3509 are applicable, and whether the taxpayer is entitled to a new CSP offer." I.R.M. § 4.23.6.18.1.1.

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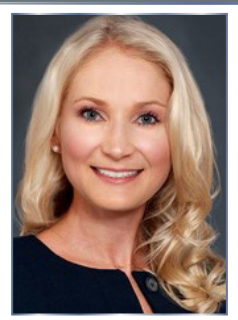

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