

LEGAL UPDATE

CLIENT NEWSLETTER OF CARR, MORRIS & GRAEFF, P.C.

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INTERNATIONAL TAX ROLLOVERS FROM FOREIGN PENSION PLANS TO U.S. PLANS

On August 21, 2008, in a legal advice memorandum (AM2008-009) issued by the Office of Chief Counsel of the Internal Revenue Service (IRS), the IRS considered the question of tax-free rollovers from foreign pension plans to U.S. individual retirement accounts (IRA's) or other U.S. retirement plans. The IRS has received numerous inquiries from taxpayers and tax practitioners on this issue, so the Office of Chief Counsel decided to give written advice on the issue to the Director of Employee Plans at the Service.

Although legal advice memoranda, private letter rulings and technical advice memoranda are technically not binding precedent, they are quite useful to become familiar with the thinking of the IRS on particular issues, and are regularly used by tax practitioners for planning and advice purposes. The plan discussed here was a United Kingdom plan, but the legal analysis is applicable to plans established in any country with which the U.S. has a similar tax treaty.

As usual with complex international tax problems, the answer depends upon the interaction of the U.S. Internal Revenue Code and tax treaties the U.S. has with foreign countries, which sometimes supersede the Code. The facts themselves are simple. An individual who was a tax resident of the United States had a balance in a U.K. pension scheme, which he wanted to roll over, tax-free, into a

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EMPLOYMENT INDEPENDENT CONTRACTOR OR EMPLOYEE?

Current economic realities are causing employers to look to different ways to reduce expenses. Frequently, the largest single expense item facing an employer is payroll (wages and associated tax withholdings). Employers looking to reduce the tax withholding portion of the payroll expense often look to classify workers as *independent contractors*. However, this strategy can be risky as an employer is not permitted to simply classify a worker as an independent contractor, *even if* the worker voluntarily requests this classification.

Whether a worker is an employee or independent contractor is a question addressed by several federal and state laws. The distinction is important to many governmental entities, including (i) the Internal Revenue Service to determine whether the employer should withhold taxes (income, FICA and Medicaid) and pay the employer's share of the FICA and Medicaid taxes; (ii) the U.S. Department of Labor to determine whether the worker is subject to the wage payment laws of the Fair Labor Standards Act; (iii) state unemployment compensation boards to determine whether a worker is entitled to unemployment benefits and whether the employer is liable for the payment of state unemployment taxes; and (iv) state agencies enforcing worker's compensation insurance to determine whether an injured worker is eligible for worker's compensation and whether the employer must include the worker's wages in calculating worker's compensation premiums.

The Internal Revenue Service traditionally followed a twenty-factor test to determine whether a worker is an employee or independent contractor. While this twenty-factor test has been updated to focus on three key factors—Behavioral Control, Financial

Control and Intent of the Parties—it is still valuable to review the twenty factors in determining a worker's proper classification. The factors are:

1. Instructions. Individuals providing services who are required to comply with instructions concerning when, where and how the work is to be done are ordinarily employees.
2. Training. Training suggests that an employer wants the work performed in a particular manner and indicates an employee-employer relationship.
3. Integration. Integration of services performed by the worker into the business operations or the person requesting services suggests an element of control, the key indication of an employee-employer relationship. If the worker completes the task (start to finish) with no integration into other business operations, this is an indication of an independent contractor.
4. Services Rendered Personally. The requirement that a certain person perform the task suggests that an employer is interested in methods used as well as results. The issue here is whether the individual is free to subcontract the work to another. If the individual is free to delegate or subcontract the task, this shows that only results are of importance, not how the task is accomplished, and is an indication of an independent contractor relationship.
5. Hiring, Supervising and Paying Assistants. Freedom to hire, fire and pay assistants is a characteristic of an independent contractor.
6. Continuing Relationship. A continuing relationship suggests an employee-employer relationship. A continuing relationship may exist where work is performed at frequently recurring although irregular intervals.

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EVIDENCE/MALPRACTICE **EXPERT WITNESS** **SPECULATION** **UNACCEPTABLE**

The D.C. Court of Appeals veritably jumped at an opportunity recently to reinforce what would seem to be a fundamental principle of the law of evidence—even an expert witness’s rank speculation is unacceptable.

In *Giordano v. Sherwood*, D.C.C.A. No. 05-CV-651 (Apr. 2, 2009), the District of Columbia’s highest court reviewed a \$600,000 jury verdict rendered in a medical malpractice case. Plaintiff had undergone knee surgery. Unusual, extreme post-operative pain was diagnosed as Reflex Sympathetic Dystrophy (“RSD”). When that condition worsened, she was referred to a vascular surgeon, who treated her to increase blood flow to her leg. Although blood flow was increased, the patient/plaintiff suffered numerous new symptoms, including nausea, vomiting, constipation and pain in her groin, hip, lower back and sciatic tissues. She sued the vascular surgeon for malpractice, essentially alleging that his negligence worsened her condition.

The case on appeal turned on the adequacy of plaintiff’s expert witness. Plaintiff relied primarily on a vascular surgeon, whose overall conclusion was that “some standard had been breached to cause the neurological dysfunction” experienced by plaintiff. The witness was more than willing—and, surprisingly, allowed—to draw inferences regarding the operation and to speculate on seemingly unrelated neurological developments. The expert could not identify a specific breach of an applicable standard of care and could only infer a causal connection to the patient’s maladies. The testifying expert even went so far as to draw inferences from his stereotypes of the “personalities” of physicians in different specialties.

The appellate court referenced overwhelming precedent for the proposition that expert testimony must be well founded and not mere speculation. Plaintiff in a malpractice case must prove negligence (*i.e.*, breach of the applicable standard of care) and that the breach *caused* the damage alleged. The case for causation may not be based solely on a proximate temporal connection. In other words, the fact that a poor outcome followed a procedure in time does not alone prove that the procedure caused that outcome. In this case defendant presented persuasive evidence

that the condition troubling plaintiff after the operation could not have been related to the procedure and, in fact, may have been evident before the procedure. The testimony of plaintiff’s expert witness—inferring causation from the lack of any other explanation—was deemed insufficient as a matter of law. Thus, defendant physician was granted judgment.

LAWRENCE CARR

INTERNATIONAL TAX

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U.S. IRA or another U.S. pension plan. (The typical fact pattern involves an individual who has worked in the U.K., participated in a U.K. plan, and returned to the U.S. or an individual who moved to the U.S. for the first time having participated in a U.K. plan.) The question was whether under the Code as modified by the U.S.-U.K. income tax treaty of 2001 (as amended by a 2002 protocol), such a tax-free rollover was permissible.

Section 402(c)(4) of the Code defines “eligible rollover distributions” as those to an employee from a “qualified trust.” In other words the tax-free rollover is permissible to a qualified U.S. plan (IRA or pension plan) if the funds come from another qualified plan. Clearly, a foreign plan is not a “qualified trust” since it has been established under foreign law. Moreover, it has neither sought nor received qualification from the IRS, assuming a foreign plan were able to apply for and receive such qualification.

The taxpayer argued, however, that Article 18, paragraph 1 of the U.S.-U.K. income tax treaty superseded the Code because Article 18(1) states that where an individual who is a resident of a “Contracting State” (the U.S. in this case) is a participant in a “pension scheme” established in “the other Contracting State” (the U.K. in this case), income earned by the pension scheme may be taxed only to the extent that it is paid to the individual from the pension scheme *and not transferred to another pension scheme*.

In other words, taxpayer maintained, Article 18(1) of the treaty allowed him to avoid taxation of the income from the U.K. pension plan because it allowed him to transfer his balance to another pension plan in the U.S. According to taxpayer’s view Article 18(1) overrides the Code’s requirement that the distribution qualify as an “eligible rollover distribution” because it provides an independent basis for treating the distribution as a rollover.

The IRS disagreed with taxpayer. It held that to qualify as a tax-free rollover a transfer must satisfy the rollover requirements under the domestic laws of both the transferor pension plan and transferee pension plan. Thus, a transfer from a pension scheme established in the U.K. to a pension scheme established in the U.S. would have to satisfy the rollover requirements under the domestic laws of both countries. By way of contrast, if a U.S. resident transferred his or her account in a U.K. scheme to another U.K. scheme in accordance with the applicable provision of U.K. law, Article 18(1) of the treaty would require the IRS to refrain from taxing the distribution and accept the transfer as a legitimate, tax-free rollover under U.K. law. In this case, however, both schemes had to comply with U.S. law and only the U.S. scheme did, thereby precluding a tax-free rollover.

It is hard to argue with the Service’s analysis and conclusion, since the U.K. plan was not a “qualified plan” under U.S. law. There is, however, a larger policy question which should be resolved by Treasury regulation if possible or legislation if not. The fact pattern in this case is increasingly common. Many American executives and technical personnel transfer to live and work in the U.K. and Continental Europe and *vice-versa*. Such exchanges should be facilitated to the extent possible in that they benefit the companies that typically make such transfers, the receiving countries and the forwarding countries. Transfers of technology and capital, which assist the economic growth of all concerned, only occur in the context of transfers of executive, scientific and engineering personnel.

Such personnel, however, are likely to resist any transfers which might result in early taxation of earnings in retirement account plans. Since income tax treaties do not afford relief there are at least three ways to solve the problem. One is to promulgate a regulation which allows foreign plans to “qualify” under U.S. law. Another is to promulgate a regulation which allows the employee to prove the foreign scheme is a “qualified trust” because it meets U.S. legal requirements for qualification. A last resort would be to amend the Code to permit rollovers from foreign schemes which are not designed for or result in tax avoidance. Doubtless the Treasury can come up with other practical ways to solve this problem in the interest of increasing and facilitating our international trade and investment.

NÉSTOR CRUZ

EMPLOYMENT*Continued from page 1*

7. Set Hours of Work. Fixed hours of work suggest control over the individual's work. An irregular work schedule or a requirement of performing a set number of hours per week suggests an employee-employer relationship.
8. Full Time Required. This impliedly restricts the worker from performing services for others and indicates an employer-employee relationship.
9. Working on Employer's Premises. This suggests an employee-employer relationship, especially if the work could be done elsewhere.
10. Set Order or Sequence. If a worker must perform services in the order or sequence set by the person for whom services are performed, that factor shows that the worker is not free to follow the his own pattern of work but must follow the established routines and schedules of the controlling person—his employer. The person who has the right to fix the order or sequence in which the work is performed is in control even if that person does not actually exercise his authority. Such authority alone suggests an employer-employee relationship.
11. Required Reports. A requirement that the worker submit regular oral or written reports to the person for whom services are performed indicates a degree of control and an employment relationship.
12. Payment by Hour, Week or Month. Payment by hour, week or month generally indicates an employment relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed upon as the cost of the job. Payment made by the job (or "phases" of a job) or on a straight commission basis generally indicates that the worker is an independent contractor.
13. Reimbursement of Business or Travel Expenses. If the person for whom services are performed pays the worker's business and/or travel expenses, the worker is ordinarily an employee. The party who retains the power to control expenses generally retains the right to regulate and direct the worker's business activities.
14. Furnishing Tools and Materials. If the person for whom services are performed furnishes tools, materials and other equipment, this fact would tend to show the existence of an employee-employer relationship.
15. Significant Investment. If the worker invests in facilities and equipment that are used by the worker in performing services, and such facilities and equipment are not typically maintained by the person for whom services are performed, that factor tends to indicate that the worker is an independent contractor. On the other hand lack of investment in facilities indicates dependence on the person for whom services are performed and accordingly the existence of an employee-employer relationship.
16. Realization of Profit or Loss. A worker who can realize a profit or suffer a loss as a result of his or her services (in addition to the profit or loss ordinarily realized by the worker) is generally an independent contractor.
17. Working for More Than One Firm at a Time. If a worker performs more than *de minimis* services for a number of unrelated persons or firms at the same time, that factor generally indicates that the worker is an independent contractor. It is possible, though, for a worker to perform services for more than one person and be an employee of some or all of these parties. Each relationship would be judged on its own merits.
18. Making Services Available to General Public. The fact that the worker makes his or her services available to the general public on a regular and consistent basis indicates an independent contractor relationship.
19. Right to Discharge. The right to discharge a worker is a factor indicating that the worker is an employee of the party with discharge authority. An employer exercises control through

the threat of dismissal, which causes the worker to obey the employer's instructions. An independent contractor, on the other hand, cannot be fired so long as the result of the worker's efforts meets the contract specifications.

20. Right to Terminate. If the worker has the right to end his or her relationship with the person for whom services are performed at any time without incurring liability, that factor indicates an employee-employer relationship. However, an independent contractor relationship is suggested if the worker's termination of services may result in liability to the person for whom the services were performed.

Judicial guidance is also available in the determination of employee *vice* independent contractor. Courts look to an "Economic Reality Test" when attempting to classify a worker as either employee or independent contractor. The key element of the Economic Reality Test is whether the worker is economically dependent on the employer to whom he renders services. In applying this test, courts generally focus on five factors:

1. The degree of control exerted by the alleged employer over the worker.
2. The worker's opportunity for profit or loss.
3. The worker's investment in the business.
4. The permanence of the working relationship.
5. The degree of skill required to perform the work.

As there is no *bright line* test to aid in the determination of employer *vice* independent contractor, it is helpful to review both the Internal Revenue Service guidance and the judicially formulated Economic Reality Test. As the proper classification of a worker has ramifications throughout the relationship, it is important to properly classify workers when the relationship is first established. While savings may be realized by the proper classification of a worker as an independent contractor, these saving will quickly be lost when confronted with claims from a misclassified worker.

PHILIP SCHWARTZ

**CARR, MORRIS
& GRAEFF, P.C.**

Carr, Morris & Graeff, P.C., was established in 1982 by the named principals—Lawrence Carr, Roy Morris and Stephen Graeff. It is a diversified firm structured primarily to meet the legal needs of businesses and their principals.

The firm strives to provide full service representation to its corporate and individual clients. It is designed to provide such service by organization and presentation of an array of attorneys with diverse backgrounds in specialized areas of the law as well as a generalized background which enables them to look beyond a narrow specialty or need. The academic and cultural backgrounds of the attorneys of the firm are as diverse as their experience and specializations.

Carr, Morris & Graeff, P.C., specializes in the following areas: Corporate/General Business; Taxation/Estate Planning; Civil/Commercial litigation; Employment/Labor; Discrimination and Wage-Hour; Criminal; and Alternative Dispute Resolution.

The firm maintains its office in Tysons Corner, Virginia—the business hub of the metropolitan region. It has attorneys admitted to all of the local judicial jurisdictions.

STAFF NOTES

Néstor Cruz published an article titled “The Sources of Cuban Official Conduct” in the February, 2009 issue of *Cuban Affairs*, the Journal of the Cuban Studies Institute at the University of Miami. The title of the article is borrowed from Ambassador George F. Kennan’s 1946 “long telegram” from Moscow.

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Back In the saddle. Roy Morris’s fractured collarbone has healed sufficiently to allow him to again bicycle to work. Although the ride to Tysons Corner is a tad longer, it’s less perilous than braving downtown traffic.

* * *

Observations from the ‘burbs. Early returns are all favorable. Clients find us more readily accessible. *Free parking, what’s that all about?* Easy access to the beltway and I-66 make it easy to reach any area courthouse—altho, no, we are no more immune to the vagaries of Washington traffic than anyone else. Eating is always a concern...but it will take months to try every restaurant and carry-out in our new neighborhood.

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