PRESENT LAW AND ISSUES RELATING TO CLASSIFICATION OF WORKERS AS EMPLOYEES OR INDEPENDENT CONTRACTORS

Scheduled for a Hearing

Before the

SUBCOMMITTEE ON OVERSIGHT

of the

HOUSE COMMITTEE ON WAYS AND MEANS

on June 4, 1996

Prepared by the Staff

of the

JOINT COMMITTEE ON TAXATION

June 3, 1996

JCX-23-96

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INTRODUCTION

The Subcommittee on Oversight of the House Committee on Ways and Means has scheduled a public hearing on June 4, 1996, on issues relating to the classification of workers as employees or independent contractors for Federal tax purposes.

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of present law and proposals and a discussion of issues related to the classification of workers as employees or independent contractors. Part I is a summary. Part II is a description of present law and background. Part III is a description of proposals (H.R. 1972 and H.R. 582), and Part IV is a discussion of issues.

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[1] This document may be cited as follows: Joint Committee on Taxation, Present Law and Issues Relating to Classification of Workers as Employees or Independent Contractors (JCX-23-96), June 3, 1996.

I. SUMMARY

Present Law and Background

A variety of relationships and job classifications exist in the American workplace. However, for Federal tax purposes, there are only two classifications: a worker is either an employee of the service recipient or an independent contractor (i.e., self-employed).

Significant tax consequences result from the classification of a worker as an employee or independent contractor. These differences relate to withholding and employment tax requirements, as well as the ability to exclude certain types of compensation from income or take tax deductions for certain expenses. Some of these consequences favor employee status, while others favor independent contractor status. For example, an employee may exclude from gross income employer-provided benefits such as pension, health, and group-term life insurance benefits. On the other hand, an independent contractor can establish his or her own pension plan and deduct contributions to the plan. An independent contractor also has greater ability to deduct work-related expenses.

Under present law, the determination of whether a worker is an employee or an independent contractor is generally made under a facts and circumstances test that seeks to determine whether the service provider is subject to the control of the service recipient, not only as to the nature of the work performed, but the circumstances under which it is performed. Under a special safe harbor rule (sec. 530 of the Revenue Act of 1978), a service recipient may treat a worker as an independent contractor for employment tax purposes even though the worker is in fact an employee if the service recipient has a reasonable basis for treating the worker as an independent contractor and certain other requirements are met. The Internal Revenue Service ("IRS") recently issued a draft training guide for field agents that provides current IRS views regarding worker classification issues and the interpretation of the common-law test, as well as section 530 of the Revenue Act of 1978.

There are two main sources of worker misclassification. First, because the test for determining whether a worker is an employee or an independent contractor is to some degree subjective, taxpayers attempting to classify workers may in good faith come to a different conclusion than the IRS. While section 530 was intended to reduce disputes between the IRS and taxpayers regarding classification issues, it, as well as the common law, has been a source of misclassification and disputes between taxpayers and the IRS. Misclassification may also be deliberate in order to take advantage of actual or perceived tax and nontax benefits of independent contractor status. One way to address the question of misclassification would be to provide clearer statutory standards for determining worker status.

An IRS survey of 1984 employment tax returns found that, based on the IRS initial determination (which is not necessarily the same as the final determination) nearly 15 percent of employers misclassified employees as independent contractors. When employers classified workers as employees, more than 99 percent of wage and salary income was reported. However, when workers were classified as independent contractors, 77 percent of gross income was reported when a Form 1099 was filed, and only 29 percent of gross income was reported when no Form 1099 was filed. The 1988 Taxpayer Compliance and Measurement Program ("TCMP"), which consists of extensive audits of individual tax returns, indicated that overall compliance for gross income reporting averaged 94 percent, while net income reporting average only 75 percent for filers of schedule C (Profit or Loss from Sole Proprietorship).

Proposals

Independent Contractor Tax Simplification Act of 1995 (H.R. 1972)

The Independent Contractor Simplification Act of 1995 (H.R. 1972)[2] would provide a statutory safe harbor for determining worker classification for employment tax purposes. If the standards set forth in the bill are met, the worker would not be treated as an employee and the service recipient (or payor) would not be treated as an employer.

Independent Contractor Tax Fairness Act of 1995 (H.R. 582)

The Independent Contractor Tax Fairness Act of 1995 (H.R. 582)[3] would establish a statutory safe harbor for determining worker classification. If these standards are met, the worker would not be treated as an employee and the service recipient would not be treated as an employer. The bill would also codify and modify section 530 of the Revenue Act of 1978. Worker classification under the bill would apply for all Federal tax purposes, not just for employment tax purposes. The bill would also increase the penalties assessed against service recipients for failures to furnish required information returns to independent contractors (Form 1099). The bill would require the Secretary to propose legislation providing objective criteria for determining whether a worker is an employee, and would require the Secretary to issue a report to Congress detailing the efforts being made in giving taxpayers maximum latitude in determining worker classification under the bill.

Issues

One of the issues associated with misclassification of workers is the potential revenue loss to the Federal Government that occurs when workers are classified as independent contractors rather than employees. One possible explanation for the revenue loss is that such workers are treated more favorably under the Internal Revenue Code than are employees.

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[2] H.R. 1972 was introduced on June 30, 1995, by Messrs. Christensen, Armey, DeLay, Bliley, Hyde, Kasich, Livingston, Crane, Thomas, Bunning, McCrery, Hancock, Camp, Ramstad, Zimmer, Sam Johnson (Texas), Ms. Dunn, Messrs. Portman, English, Ensign, and others.

[3] H.R. 582 was introduced on January 19, 1995, by Mr. Kim.

However, because some tax rules favor employee status, any revenue loss from favorable tax treatment for independent contractor status may be at least partially offset by other factors associated with independent contractor status. Another explanation is that there is revenue loss associated with lower compliance rates of independent contractors and service recipients compared to the compliance rates of employees and their employers. Many businesses also argue that the present-law penalties for misclassification of workers are too severe, particularly if the misclassification was inadvertent.

II. PRESENT LAW AND BACKGROUND

A. Classification of Workers

1. Common-law test

In general, the determination of whether an employer-employee relationship exists for Federal tax purposes is made under a common-law test. Treasury regulations provide that an employer-employee relationship generally exists if the person contracting for services has the right to control not only the result of the services, but also the means by which that result is accomplished. In other words, an employer-employee relationship generally exists if the person providing the services "is subject to the will and control of the employer not only as to what shall be done but how it shall be done."[4] Under the Treasury regulations, it is not necessary that the employer actually control the manner in which the services are performed, rather it is sufficient that the employer have a right to control.[5] Whether the requisite control exists is determined based on all the relevant facts and circumstances.

The Internal Revenue Service ("IRS") has developed a list of 20 factors that may be examined in determining whether an employer-employee relationship exists.[6] The 20 factors were developed by the IRS based on an examination of cases and rulings considering whether a worker is an employee. The degree of importance of each factor varies depending on the occupation and the factual context in which the services are performed. The factors are as follows: (1) whether the worker is required to comply with instructions about when, where, and how to perform the work; (2) whether the service recipient trains the worker; (3) the extent to which the worker's services are integrated into the business operations of the service recipient; (4) whether the services must be rendered personally; (5) whether the service recipient supervises the worker; (6) whether there is a continuing relationship between the worker and the service recipient; (7) whether the service recipient sets the hours of work of the worker; (8) whether the worker is required to devote substantially full time to the business of the service recipient; (9) whether the work is done on the premises of the service recipient; (10) whether the worker must perform services in the order set by the service recipient; (11) whether reports by

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[4] Treas. Reg. sec. 31.3401(c)-(1)(b). The Internal Revenue Service has ruled that control exercised to ensure that a worker complies with rules and requirements of outside regulatory bodies may be sufficient to establish an employer-employee relationship. PLR 9330007 (April 28, 1993).

[5] Treas. Reg. sec. 31.3401(c)-(1)(b). See also Gierek v. Commissioner, 66 T.C.M. 1866 (1993)(involving the classification of a stockbroker and stating that the key inquiry is whether the brokerage firm had a right to control, regardless of the extent to which such control was actually exercised).

[6] Rev. Rul. 87-41, 1987-1 C.B. 296.

the worker to the service recipient are required; (12) whether payment is by the hour, week, or month; (13) whether the service recipient pays the worker's business and/or traveling expenses; (14) whether the worker is required to furnish his or her own tools; (15) whether the worker invests in facilities used to perform the work; (16) whether the worker can realize a profit or loss as a result of the performance of the services; (17) whether the worker performs services for more than one service recipient; (18) whether the worker makes his or her services available to the general public; (19) whether the service recipient has the right to discharge the worker; and (20) whether the worker has the right to terminate the relationship without incurring liability.

In a recently-issued draft training guide for field agents,[7] the IRS grouped the relevant control factors under the common-law test into three categories: (1) behavioral control; (2) financial control; and (3) relationship of the parties. Behavioral control factors are described as those which illustrate whether there is a right to direct or control how the worker performs the specific task for which the worker was hired. Examples include instructions (e.g., directions as to how, when, or where to do the work, what tools or equipment to use, what workers to hire to assist with the work, where to purchase supplies and services, and how to receive compensation) and training.

Financial control factors are described as those which illustrate whether there is a right to direct or control how the business aspects of the worker's activities are conducted. Such factors include: (1) significant investment; (2) unreimbursed expenses; (3) services available to the public; (4) method of payment (i.e., flat fee versus payment based on time worked); and (5) opportunity for profit or loss. The IRS Training Guide states that a significant investment is not necessary for independent contractor status. However, in reviewing this control factor, the IRS Training Guide instructs that use of personal items for business purposes is less persuasive evidence than investment suited only for business purposes. For example, according to the IRS Training Guide, evidence of a significant investment in facilities generally would be lacking if a worker works from home using a personal computer or telephone or uses a personal vehicle for performing delivery services. On the other hand, according to the IRS, a significant investment in facilities may exist if the worker uses space which qualifies for the home office deduction, depending on the expenses of constructing and maintaining the space and the cost of the associated equipment.[8]

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[7] Employee or Independent Contractor?, (February 28, 1996)(hereinafter the "IRS Training Guide"). Although the IRS Training Guide has no value as precedent or administrative authority, it provides current IRS views respecting worker classification issues.

[8] This may be a difficult standard to meet in some cases. Under present law, a business deduction is generally allowed only with respect to a portion of a home that is used exclusively and regularly in one of the following ways: (1) as the principal place of business for a trade or business; (2) as a place of business used to meet with patients, clients, or customers in the normal course of the taxpayer's trade or business; or (3) in connection with the taxpayer's trade or business, if the portion so used constitutes a separate structure not attached to the dwelling

The relationship of the parties is described as factors reflecting how the worker and service recipient perceive their relationship. Relevant factors include: (1) whether the worker is provided employee benefits such as health insurance or a pension; (2) the existence of a written contract designating the worker as an independent contractor; (3) an expectation by the service recipient and the worker that the position is permanent; (4) the right to discharge a worker and terminate work without penalty; and (5) whether the services performed are part of the regular business activities of the service recipient.

The IRS Training Guide states that certain control factors, which were more significant in the past, hold less relevance today. The factors cited are: (1) working on a part-time basis; (2) a temporary relationship between the worker and the service recipient; (3) specified hours of work; and (4) whether or not the work is performed on the premises of the service recipient.

The IRS Training Guide stresses that there is no "magic number" of relevant factors which establish independent contractor status. Instead, the relative importance of each factor should be determined based on the facts of each case and taking into account the way the service recipient operates its business activities and the relationship between the worker and the service recipient.

2. Statutory employees or nonemployees

There are some workers who are treated by statute as either employees or independent contractors regardless of their status under the common-law test. For example, for employment tax purposes, the following are treated as employees: (1) corporate officers; (2) agents or commissioned drivers who deliver produce, meat products, bakery products, beverages (other than milk), or laundry; (3) a full-time life insurance salesmen; (4) individuals who works at home under the direction of the party that supplies the materials and supplies for the work; and (5) certain traveling salesmen.[9]

If certain requirements are satisfied, licensed real estate agents and "direct sellers" are treated as independent contractors for all Federal tax purposes.[10] A direct seller is defined as a person engaged in the trade or business of selling consumer products in the home or otherwise than in a permanent retail establishment. In order for this treatment to apply, substantially all the remuneration for the performance of services by the real estate agent or direct seller must be directly related to sales or other output rather than to the number of hours worked, the services must be performed pursuant to a written contract between the real estate agent or direct seller and the service recipient, and such contract must provide that the real estate agent or direct seller will not be treated as an employee for Federal tax purposes.

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unit. Sec. 280A.

[9] Sec. 3121(d).

[10] Sec. 3508.

With respect to direct sellers, proposed Treasury regulations define the term consumer product to be tangible personal property normally used for personal, family, or household purposes. The proposed regulations provide that the term does not include any product used in the manufacture of another product to be distributed in commerce or any product used only incidentally in providing a service (e.g., insecticide in a pest control business). However, two courts have held that the term consumer products should be construed to include both tangible consumer goods and intangible consumer services.[11]

3. Section 530 of the Revenue Act of 1978

In general

With increased enforcement of the employment tax laws beginning in the late 1960s, controversies developed between the IRS and taxpayers as to whether businesses had correctly classified certain workers as self employed rather than as employees. In some instances when the IRS prevailed in reclassifying workers as employees under the common-law test, the employing business became liable for substantial portions of its employees' employment and income tax liabilities (that the employer had failed to withhold and pay over), although the employees might have fully paid their liabilities for self-employment and income taxes.

In response to this problem, the Congress enacted section 530 of the Revenue Act of 1978 ("section 530").[12] That provision generally allows a taxpayer to treat a worker as not being an employee for employment tax purposes (but not income tax purposes), regardless of the individual's actual status under the common-law test, unless the taxpayer has no reasonable basis for such treatment. Section 530 was initially scheduled to terminate at the end of 1979 to give Congress time to resolve the many complex issues regarding worker classification. It was extended through the end of 1980 by P.L. 96-167 and through June 30, 1982, by P.L. 96-541. The provision was extended permanently by the Tax Equity and Fiscal Responsibility Act of 1982.[13]

Under section 530, a reasonable basis for treating a worker as an independent contractor is considered to exist if the taxpayer reasonably relied on (1) past IRS audit practice with respect to the taxpayer, (2) published rulings or judicial precedent, (3) long-standing recognized practice in the industry of which the taxpayer is a member, or (4) if the taxpayer has any "other

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[11] R Corp. v. U.S., 74 AFTR 2d 94-5620 (M.D. Fl. 1994); Cleveland Institute of Electronics, Inc. v. U.S., 787 F.Supp. 741 (N.D. Ohio 1992). In light of these cases, the IRS Training Guide states that agents should not pursue cases based on the distinction between tangible and intangible products pending finalization of the regulations and further consideration of the issue by the IRS.

[12] P.L. 95-600.

[13] P.L. 97-248.

reasonable basis" for treating a worker as an independent contractor. The legislative history states that section 530 is to be "construed liberally in favor of taxpayers."[14]

The relief under section 530 is available with respect to an individual only if certain additional requirements are satisfied. The taxpayer must not have treated the individual as an employee for any period, and for periods since 1978 all Federal tax returns, including information returns, must have been filed on a basis consistent with treating such individual as an independent contractor. Further, the taxpayer (or a predecessor) must not have treated any individual holding a substantially similar position as an employee for purposes of employment taxes for any period beginning after 1977.

Under section 1706 of the Tax Reform Act of 1986, section 530 does not apply in the case of an individual who, pursuant to an arrangement between the taxpayer and another person, provides services for such other person as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work. Thus, the determination of whether such individuals are employees or self employed is made in accordance with the common-law test.

Section 530 also prohibits the issuance of Treasury regulations and revenue rulings on common-law employment status. Taxpayers may, however, obtain private letter rulings from the IRS regarding the status of workers as employees or independent contractors.

The IRS Training Guide provides that a taxpayer does not have to make a claim for relief under section 530 for it to apply.[15] The IRS Training Guide instructs agents to explore the applicability of section 530 even if the taxpayer does not raise the issue.

Status of worker

There is nothing in the language of section 530, or its legislative history, requiring that there first be a determination that a worker is an employee under the common-law test before the relief under section 530 becomes available. However, it is the position of the IRS that section 530 can only apply after such a determination is made. The IRS does not require the taxpayer to concede or agree to a determination that the worker is an employee.[16]

Most court decisions do not directly address whether an initial determination of worker

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[14] H. Rept. No. 1748 (95th Cong., 2d Sess., 5 (1978)).

[15] IRS Training Guide, at 3-33.

[16] IRS Training Guide, at 3-5 and 3-6; TAM 9443002 (December 3, 1993).

classification is necessary before applying section 530.[17] However, those courts that have explicitly considered the question have held that section 530 relief is available irrespective of whether the workers are employees or independent contractors under the common law.[18] Although the courts in the cases cited in the IRS Training Manual in support of the IRS' position did determine worker status before applying section 530, it is unclear whether such determination was made because the court believed a threshold determination was required or merely as a natural consequence of the court's disposition of the case (i.e., the taxpayers first argued that the workers were not employees under the common law test, or in the alternative, section 530 provided relief).[19]

Reasonable basis

Judicial or administrative precedent

Under section 530, reliance on judicial precedent, published rulings, technical advice with respect to the taxpayer, or a letter ruling to the taxpayer is deemed a reasonable basis for treating a worker as an independent contractor. If a taxpayer relies on this safe harbor, the IRS will look to see whether the facts of the judicial precedent or published ruling are sufficiently similar to the taxpayer's facts.[20]

Prior audit

Under the prior-audit rule, reasonable reliance is generally found to exist if the IRS failed to raise an employment tax issue on audit, even though the audit was not related to employment tax matters. According to the IRS, an "audit" must involve an examination of the taxpayer's books and records; mere inquiries from an IRS service center or a "compliance check" to

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[17] See e.g., REAG, Inc. v. U.S., 801 F.Supp. 494 (W.D. Okla. 1992); Critical Care Register Nursing, Inc. v. U.S., 776 F.Supp. 1025 (E.D. Pa. 1991).

[18] See e.g., Lambert's Nursery and Landscaping, Inc. v. U.S., 894 F.2d 154 (5th Cir. 1990)("It is not necessary to determine whether [taxpayer's] workers were independent contractors or employees for employment tax purposes."); J & J Cab Service, Inc. v. U.S., 75 AFTR2d No. 95-618 (W.D. N.C. 1995)("Section 530 relief may be granted irrespective of whether individual were incorrectly treated as other than employees"); Queensgate Dental Family Practice, Inc. v. U.S., 91-2 USTC No. 50,536 (M.D. Pa. 1991)(disagreeing with the IRS' contention that the court must first determine worker classification before applying section 530).

[19] See e.g., Overeen v. U.S., 91-2 USTC No. 50, 459 (W.D. Okla. 1991); Galbraith and Green, Inc. v. U.S., 80-2 USTC No. 9,629 (Az. 1980).

[20] See e.g., TAM 9443002 (December 3, 1993); TAM 9330007 (April 28, 1993).

determine whether a taxpayer has filed all returns will not suffice.[21] In order to rely on a prior audit, the IRS requires that the taxpayer must have treated the workers at issue as independent contractors during the period covered by the prior audit.[22] The audit of another party engaged in the same industry will not bring a taxpayer within the prior audit safe harbor, although the audit may provide the taxpayer with a reasonable basis for treating a worker as an independent contractor under the any "other reasonable basis" provision.[23]

Industry practice

A taxpayer is treated as having a reasonable basis for treating a worker as an independent contractor if the taxpayer reasonably relied on long-standing recognized practice of a significant segment of the industry in which the taxpayer is engaged. In applying this safe harbor, a number of issues arise including the definition of: (1) a long-standing practice, (2) the taxpayer's industry, and (3) a significant segment of the industry.

Section 530 does not specify a period of time in order for a practice to be long standing. The IRS Training Guide provides that a practice is most clearly long standing if the industry has treated workers as independent contractors since 1978.[24] According to the IRS Training Guide, the safe harbor is not met if the industry only recently began to treat workers as independent contractors. One court has held that seven years qualifies as long standing.[25]

The IRS Training Guide recognizes that a taxpayer may use the industry practice safe harbor even if it began business after 1978.[26] However, the IRS Training Guide provides that if the industry practice changed by the time the taxpayer joined the industry, the taxpayer cannot rely on the former practice. There is no authority addressing how the industry practice safe harbor would apply in the case of a new industry, although given the IRS position with respect to new businesses, the safe harbor may be available to the businesses in the new industry, provided the other requirement for the safe harbor are satisfied.

A taxpayer's industry generally consists of businesses competing for the same customers

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[21] IRS Training Guide, at 3-17.

[22] IRS Training Guide, at 3-19.

[23] Hospital Resource Personnel, Inc. v. U.S., 74 AFTR2d 94-5017 (S.D. Ga. 1994), aff'd in part, vacated in part, 68 F.3d 421 (11th Cir. 1995).

[24] IRS Training Guide, at 3-23.

[25] REAG, Inc. v. U.S., 801 F.Supp. 494 (W.D. Okla. 1992).

[26] IRS Training Guide, at 3-23.

and providing the same or a similar product or service.[27] Further, what constitutes the taxpayer's industry will generally be determined by reference to the geographic or metropolitan area in which the taxpayer conducts its business.[28]

Neither section 530, nor the legislative history, provides a clear standard as to what constitutes a significant segment of a taxpayer's industry. The IRS Training Guide provides that the determination will be based on the facts and circumstances, including the percentage of employers and workers subject to the practice.[29] In a recently issued Technical Advice Memorandum, the taxpayer (a courier company) conducted two surveys of businesses in the industry.[30] In the first survey, 21 out of 24 businesses surveyed (88 percent) used independent contractors exclusively, and one other used both employees and independent contractors. In another survey of additional businesses (conducted because the initial survey did not cover the taxpayer's entire customer sales area), 16 out of 20 businesses surveyed (80 percent) used independent contractors exclusively, while two others used both employees and independent contractors. Of the top 16 courier businesses, the IRS found that five used independent contractors exclusively (31 percent), and five others used both employees and independent contractors. The IRS concluded, based on these facts, that the "courier industry used contradictory practices," and thus the taxpayer could not rely on the safe harbor.[31]

Courts have generally taken a broader view of what constitutes a significant segment of a taxpayer's industry. In one case, the IRS argued that significant segment of the industry means more than 50 percent of the industry.[32] However, that court held that a significant segment is less than a majority of the firms in an industry. Another court held that if 15 out of 84 industry respondents (18 percent) treated workers as independent contractors that would constitute a

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[27] See Sanderson III v. U.S., 862 F.Supp. 196 (N.D. Ohio 1994)(court held that relevant industry was owner-operated truckers rather than trucking industry as a whole); IRS Training Guide, at 3-22.

[28] See General Investment Corp. v. U.S., 823 F.2d 337 (9th Cir. 1987)(court held the taxpayer's industry consisted of small mining business located in the taxpayer's county, rather than all mining businesses throughout the county); TAM 9443002 (December 3, 1993).

[29] IRS Training Guide, at 3-24.

[30] TAM 9619001 (January 29, 1996).

[31] See also Springfield v. U.S., 873 F.Supp.1403 (S.D. Cal. 1994)(where various segments of an industry are using contradictory practices, the law dictates that there is no longstanding industry practice).

[32] In re Bentley, 73 AFTR2d No. 94-667 (Bkrtcy. E.D. Tenn. 1994).

significant segment of the industry.[33]

Even if a taxpayer can establish a long-standing recognized practice of a significant segment of the industry, the IRS requires the taxpayer to show that it had knowledge of the practice at the time it began treating workers as independent contractors.[34] For instance, the IRS Training Guide states that "[i]f the taxpayer relied on a survey, the survey must focus on the treatment of the workers at the time the taxpayer started treating its workers as independent contractors, not the treatment of workers at the time of the examination."[35]

Other reasonable basis

Even if a taxpayer is unable to rely on one of the three safe harbors described above, a taxpayer may still be entitled to relief under section 530 if the taxpayer has any other reasonable basis for treating a worker as an independent contractor. Such an other reasonable basis is by definition subjective.

Under case law, reliance on the advice of an attorney or an accountant may constitute a reasonable basis for treating a worker as an independent contractor.[36] The IRS appears to agree with this position, provided there is a showing that the attorney or accountant was knowledgeable about the law and the facts in rendering the advice.[37]

Taxpayers have generally successfully argued that reliance on the common-law test can constitute a reasonable basis for purposes of applying section 530.[38] However, the IRS does not concur with this view.[39]

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[33] REAG, Inc. v. U.S., 801 F.Supp. 494 (W.D. Okla. 1992).

[34] TAM 9619001 (January 29, 1996).

[35] IRS Training Guide, at 3-26.

[36] See e.g., Smoky Mountain Secrets, Inc. v. U.S., 910 F.Supp. 1316 (E.D. 1995); In re Arndt, 72 AFTR2d No. 93-5325 (Bkrtcy. M.D. Fl. 1993).

[37] IRS Training Guide, at 3-28; see also In re McAtee, 66 AFTR2d No. 94-667 (Bkrtcy. N.D. Iowa 1990)(taxpayer could not rely on advice of accountant where it is not established accountant had expertise in employment tax matters).

[38] See e.g., Critical Care Register Nursing, Inc. V. U.S., 776 F.Supp. 1025 (E.D. Pa. 1991); American Institute of Family Relations v. U.S., 79-1 USTC No. 9,364 (C.D. Cal. 1979).

[39] IRS Training Guide, at 3-29.

Burden of proof

The IRS Training Guide states that the burden of proof is on the taxpayer to demonstrate that it had a reasonable basis for treating a worker as an independent contractor.[40] However, in light of the Congressional instruction in the legislative history to construe section 530 liberally, courts appear to be split as to whether a less stringent burden applies.

In McClellan v. U.S.,[41] the court held that section 530 requires the "taxpayer to come forward with an explanation and enough evidence to establish prima facie grounds for a finding of reasonableness. . . . [T]his threshold burden is relatively low, and can be met with any reasonable showing. Once the taxpayer has made this prima facie showing, the burden then shifts to the IRS to verify or refute the taxpayer's explanation." By contrast, in Boles Trucking, Inc., v. U.S.,[42] the court held that the burden is on the taxpayer to show, based on a preponderance of the evidence, that it had a reasonable basis for treating workers as independent contractors.

Consistency requirements

Reporting consistency

To be entitled to relief under section 530, the taxpayer must not have treated the worker as an employee for any period, and, for periods since 1978, all Federal tax returns, including information returns, must have been filed on a basis consistent with treating such worker as an independent contractor. For example, withholding income and employment taxes from a worker's remuneration would not be consistent with treatment as an independent contractor, and the taxpayer must file a Form 1099 (if required) with respect to the worker as opposed to a Form W-2.[43] If a taxpayer does not file the required information return for a period it will not be entitled to section 530 relief for such period.[44] Further, the courts have generally held that since 1978 (or such shorter period as the taxpayer has been in business) Federal tax reporting with respect to the worker (and all similarly situated workers) must have been consistent with

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[40] IRS Training Guide, at 3-25.

[41] 900 F.Supp. 101 (E.D. Mich. 1995). See also REAG, Inc. V. U.S., 801 F.Supp. 494 (W.D. Okla. 1992)(a taxpayer need only show a substantial rational basis for its decision to treat the workers as independent contractors).

[42] 77 F.3d 236 (8th Cir. 1996). See also Springfield v. U.S., 873 F.Supp.1403 (S.D. Cal. 1994)(taxpayer has the burden to show it satisfies the requirements of section 530).

[43] Rev. Proc. 85-18, 1985-1 C.B. 518.

[44] General Investment Corp. V. U.S., 823 F.2d 337 (9th Cir. 1987); Rev. Rul. 81-224, 1981-2 C.B. 197.

independent contractor treatment.[45] The filing of consistent Federal tax returns for the period of examination will not be sufficient.

Consistency among similarly situated workers

In order for section 530 to apply, the taxpayer (or a predecessor) must not have treated any worker holding a substantially similar position as an employee for purposes of employment taxes for any period beginning after 1977. Whether workers are similarly situated is dependent on the facts and circumstances. The IRS Training Guide states that a "substantially similar position exists if the job functions, duties, and responsibilities are substantially similar and the control and supervision of those duties and responsibilities is substantially similar."[46]

There have been a few court decisions addressing this issue. For example, in REAG, Inc. v. U.S.,[47] the court held that the position of appraisers who were owner-officers of the business was not substantially similar to appraisers who were not owners since the owner-officers had managerial responsibilities. By contrast, in Lowen Corp. V. U.S.,[48] the court found that all workers engaged in the business of selling real estate signs had substantially similar positions even though some were salaried and had to file daily reports while others were paid by commission and did not have to file such reports.

4. Recent IRS developments

Classification settlement program

On May 10, 1996, new procedures for the IRS classification settlement program ("CSP") were issued.[49] The CSP establishes an optional settlement program that is designed to allow resolution of worker classification cases as early in the administrative process as possible and to ensure that section 530 is properly and consistently applied. The CSP will allow examining agents to offer service recipients a worker classification settlement using a standard closing agreement.

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[45] Henry v. U.S., 793 F.2d 289 (Fed.Cir. 1986); In re McAtee, 66 AFTR2d No. 94-667 (Bkrtcy. N.D. Iowa 1990).

[46] IRS Training Guide, at 3-10.

[47] 801 F.Supp. 494 (W.D. Okla. 1992). The IRS has nonacquiesced. IRS Training Guide, at 3-13.

[48] 785 F.Supp. 913 (D. Kan. 1992).

[49] Internal Revenue Service, "Classification Settlement Program," as reported in Tax Notes Doc. No. 96-14207 (May 10, 1996).

Under the CSP, the examining agent is to gather the facts necessary to determine whether an improper classification has occurred, whether section 530 is available, and whether the taxpayer is eligible for a CSP offer. The agent then is to consult with the examination group manager, who is responsible for confirming whether the taxpayer is eligible for a CSP settlement offer. If the offer is made and accepted by the taxpayer, the parties will sign a CSP closing agreement based on a standard closing agreement provided by the IRS National Office.

Taxpayers may qualify for a series of graduated settlement offers under the CSP depending upon the facts of their case. If the taxpayer meets the section 530 reporting consistency requirement, but either has not treated similarly situated workers as independent contractors or clearly cannot satisfy the reasonable basis requirement under section 530, the offer will be a full employment tax assessment[50] for one taxable year. If the taxpayer meets the reporting consistency requirement and has a colorable argument that it treated similarly situated workers as independent contractors and satisfies the reasonable basis test, the offer will be an assessment of 25 percent of the income tax withholding[51] and Federal Insurance Contributions Act ("FICA") tax liability for the audit year, along with 100 percent of the Federal Unemployment Tax Act ("FUTA") tax liability for the applicable year. In accepting either settlement, the taxpayer must agree to reclassify its workers prospectively.

If a taxpayer clearly meets all the consistency requirements and satisfies the reasonable basis test under section 530, no assessment will be made and the taxpayer may continue treating its workers as independent contractors. If the taxpayer wishes to begin treating its workers as employees, the taxpayer is not treated as giving up its claim to section 530 relief for prior years.

Participation in the CSP is entirely voluntary, and a taxpayer may accept a CSP settlement offer at any time during the examination process. If a taxpayer chooses to decline a CSP offer, the taxpayer retains all rights to a conventional administrative appeal with the IRS or to judicial review.

The CSP is being implemented on a two-year trial basis, beginning on March 5, 1996. The CSP will be available to any taxpayer with an open case in either IRS Examination or Appeals on March 5, 1996, or who has a case initiated during the two-year period thereafter.

Early referral to appeals

The IRS recently established a procedure under which a taxpayer could request early referral to Appeals of any developed, unagreed issue (subject to certain exceptions) that is under

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[50] Employment tax liability will be determined under the special rules for determining a taxpayer's employment tax liability for certain employment taxes (sec. 3509), if applicable. A discussion of these special rules is located at II.C. below.

[51] Id.

the jurisdiction of the district director arising from an examination.[52] The procedure was developed to resolve cases more expeditiously through Examination and Appeals working simultaneously. After issuing this early referral procedure, the IRS announced that it would apply the procedure to employment tax issues on a one-year test basis.[53]

According to the IRS announcement, issues considered appropriate for early referral include those that, if resolved, can reasonably be expected to result in quicker resolution of the entire case and that both the taxpayer and the district director agree should be referred to Appeals early. Examples of employment tax issues considered appropriate for early referral include worker classification issues, such as whether a worker is a common-law employee or independent contractor, whether a worker is a statutory employee or statutory nonemployee, or whether section 530 applies.

Once the issue is approved for transfer to Appeals, the procedure is similar to the procedure that is followed when a proposed notice of deficiency is issued (i.e., a "30-day letter"). The district director will prepare and send to the taxpayer an employment tax report for each approved early referral issue that identifies the amount of employment taxes in dispute, describes the issues, and describes the district director's position. The taxpayer is required to respond in writing to the director's report in a manner similar to what would be provided in an Appeals protest. The taxpayer's response must be submitted to the case manager within 30 days of the date of the district director's report, but the 30-day requirement may be extended with the case manager's consent. After the taxpayer has filed its response, the early referral file is sent to Appeals and the issues are handled essentially according to Appeals' normal operating procedures. If an agreement is not reached at Appeals with respect to an issue, Appeals will close the early referral file and return jurisdiction to Examination.[54] Appeals will not reconsider an early referral issue if the entire case is later referred to Appeals, unless the circumstances relating to the early referral issue have changed substantially.

B. Consequences of Worker Classification

1. Reporting and withholding requirements

<u>Income tax withholding and reporting</u>

The Code requires that employers making payments of wages to employees withhold Federal income taxes from those wage payments in accordance with tables or computational procedures prescribed by the IRS (sec. 3402). Each employee must file with his or her employer a Withholding Allowance Certificate (Form W-4) on which the employee claims a specific

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[52] Rev. Proc. 96-9, 1996-2 I.R.B. 15.

[53] Announcement 96-13, 1996-12 I.R.B. 33.

[54] Rev. Proc. 96-9, 1996-2 I.R.B. 15, section 6.03.

number of withholding allowances based on family size, employment status, itemized deductions, and other matters. The employer then utilizes tables issued by the IRS to compute the correct amount of Federal income tax withholding. This computation is based on the number of withholding allowances claimed, the taxpayer's wages, and the frequency of payroll payments. The amount of wages paid and the amount of income taxes withheld must be reported to the IRS and to the employee on Form W-2 (sec. 6051).

No income tax withholding is required on payments made to independent contractors.[55] Independent contractors are required to make quarterly estimated tax payments.

Reporting requirements with respect to independent contractors

The Code contains a number of information reporting requirements. One requires that a person engaged in a trade or business who makes payments during the calendar year of $600 or more to a person for rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments, or other fixed or determinable gains, profits, and income, must file an information return with the IRS reporting the amount of such payments, as well as the name, address and taxpayer identification number of the person to whom such payments were made.[56] A similar statement must also be furnished to the person to whom such payments were made.[57]

The Code contains a separate provision (sec. 6041A) specifically dealing with payments of remuneration for services. Under this provision, a service recipient engaged in a trade or business who makes payments of remuneration in the course of that trade or business to any person for services performed must file with the Internal Revenue Service an information return (Form 1099) reporting such payments (and the name, address, and taxpayer identification number of the payee) if the remuneration paid to the person during the calendar year is $600 or more. Also, the service recipient must furnish to the person receiving such payments a statement setting forth the name, address, and taxpayer identification number of the service recipient, and the aggregate amount of payments made to the payee during the year.

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[55] Payments to independent contractors may be subject to backup withholding under certain circumstances (sec. 3406).

[56] Sec. 6041(a). A number of exceptions to this requirement are provided in Treasury regulations. In addition, to the extent the general information reporting requirements of this provision overlap specific information reporting requirements elsewhere in the Code, taxpayers are generally required to report only once, under the more specific information reporting provision.

[57] Sec. 6041(d).

2. Employment taxes

If an employer-employee relationship exists, the employer is subject to social security taxes under FICA and unemployment taxes under FUTA, and is required to withhold and pay over FICA and FUTA taxes imposed on the employee. On the other hand, if there is no employer-employee relationship, the service recipient is not subject to employment taxes; the worker pays self-employment tax under the Self-employment Contributions Act ("SECA") in lieu of FICA tax. Independent contractors are not subject to FUTA, but also generally are not entitled to related unemployment benefits.

Prior to 1990, the employment tax structure significantly favored independent contractors. Until 1983, the combined FICA tax rate on the employer and employee was significantly higher than the SECA tax rate. The Social Security Amendments Act of 1983 equalized the tax rates, but provided a credit for a portion of SECA taxes for years 1984 through 1989. For years after 1989, the tax rates are the same, and there is no SECA tax credit. An independent contractor is entitled to an income tax deduction for a portion of SECA taxes, just as an employer is entitled to deduct its share of FICA taxes.

Some differences still exist between FICA and SECA taxes, primarily because the base for calculating the taxes differs.

3. Pensions and employee benefits

If an individual is not an employee for Federal income tax purposes, the individual is entitled to establish his or her own retirement plan ("Keogh plan") to which the individual can make annual deductible contributions of $30,000 or more. If an individual is an employee for Federal income tax purposes, then employer contributions to a retirement plan are excludable from income. The limits on the benefits that can be provided under a plan maintained by a independent contractor are generally the same as those that apply to employees. However, individuals may have greater flexibility if they maintain their own qualified plan than if they were under an employer's plan, and may make greater contributions than an employer would make under an employer-sponsored plan. In some circumstances, an employer might wish to treat a worker as an independent contractor in order to avoid providing the worker with retirement and other employee benefits. On the other hand providing employee benefits can be an effective way to attract and retain workers.[58]

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[58] The IRS recently ruled that, where a worker was misclassified as an employee, the taxpayer may avoid retirement plan disqualification by retroactively canceling any accruals under the plan and by returning employee contributions and allocable earnings. PLR 9546018 (August 18, 1995). The IRS is reconsidering whether these corrective measures were appropriate.

Workers who are classified as employees are entitled to exclude from gross income certain employee benefits that cannot be excluded by workers classified as independent contractors. For example, benefits such as employer-provided health care, dependent care, and group-term life insurance are excluded from income (and wages for FICA tax purposes) of employees. Independent contractors are entitled to deduct 30 percent of the cost of their health insurance.

An employer's pension plans may be affected if a worker that was treated as an independent contractor is reclassified as an employee. For example, the service recipient may have improperly excluded the worker from the employer's tax-qualified pension plan. In some cases, this could technically cause the plan to fail to satisfy the applicable qualification rules. As a practical matter, the IRS is unlikely to disqualify a plan in such cases because it could create adverse consequences for plan participants. The IRS may, however, use the threat of disqualification to cause the taxpayer to take corrective action with respect to the excluded workers.

4. Miscellaneous business expenses

Independent contractors, like other businesses, are entitled to deduct their business expenses. For example, business expenses (such as meals and entertainment, a home office, and transportation) are deductible by independent contractors without regard to the amount of the expenses or whether they itemize deductions. On the other hand, an employee generally cannot deduct business expenses without itemizing deductions. For employees who itemize, miscellaneous business deductions for unreimbursed employee business expenses are generally subject to the 2-percent-of-adjusted gross income floor on itemized deductions.[59]

5. Nonfederal tax consequences

There may also be nonfederal tax consequences of worker classification. For example, State income tax laws may follow the Federal classification rules. Also, coverage under Federal and State workers' compensation plans, wage and hour laws, and similar worker-related programs may depend on the classification of a worker as an employee.

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[59] Business expenses that are reimbursed by the employer are generally excludable from an employee's gross income (and wages for employment tax purposes) if the expenses would be deductible (without regard to the 2-percent floor) if paid directly by the employee.

C. Statute of Limitations and Penalties

1. Statute of limitations

In general, the amount of any tax imposed by the Code must be assessed within 3 years after the return is filed (sec. 6501(a)). If no return is filed, the assessment may generally be made at any time (sec. 6501(c)(3)).

Several courts have held that where an employer has mischaracterized an employee as an independent contractor and has filed a Form 1099 (instead of a Form W-2 and a Form 941 with respect to that employee), "the 1099 information return was not 'the return' contemplated by the statute."[60] Consequently, the courts held that no statute of limitations applied, pursuant to section 6501(c)(3).

2. Penalties

__In general__

There are many penalty provisions in the Internal Revenue Code. The civil penalty provisions most generally applicable to disputes regarding classification of workers are described below. It is impossible to generalize about the imposition of civil penalties by the IRS in disputes regarding classification of workers because the specific facts, behavior, and intent in each dispute can vary considerably from case to case and because the IRS has significant discretion in most instances in determining whether a particular penalty should be imposed and whether reasonable cause for abating the penalty exists. Each individual penalty applies to an act (or omission) enumerated in the penalty. Because some disputes regarding classification of workers may involve multiple acts (or omissions) enumerated in different penalties, it is possible that multiple penalties may apply in some disputes.

__Information reporting penalties__

Failure to file correct information returns

Any person that fails to file a correct information return (such as Forms W-2 or 1099) with the Internal Revenue Service on or before the prescribed filing date is subject to a penalty that varies based on when, if at all, the correct information return is filed (sec. 6721). If a person files a correct information return after the prescribed filing date but on or before the date that is 30 days after the prescribed filing date, the amount of the penalty is $15 per return, with a maximum penalty of $75,000 per calendar year. If a person files a correct information return more than 30 days after the prescribed filing date but on or before August 1, the amount of the penalty is $30 per return, with a maximum penalty of $150,000 per calendar year. If a correct

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[60] Springfield v. U.S., 873 F.Supp. 1408 (DC CA, 1994); citing Ginter v. U.S., 815 F.Supp. 1289 (DC MO, 1993).

information return is not filed on or before August 1 of any year, the amount of the penalty is $50 per return, with a maximum penalty of $250,000 per calendar year.

There is a special rule for de minimis failures to include the required, correct information. This exception applies to incorrect information returns that are corrected on or before August 1. Under the exception, if an information return is originally filed without all the required information or with incorrect information and the return is corrected on or before August 1, then the original return is treated as having been filed with all of the correct required information. The number of information returns that may qualify for this exception for any calendar year is limited to the greater of (1) 10 returns or (2) one-half of one percent of the total number of information returns that are required to be filed by the person during the calendar year.

In addition, there are special, lower maximum levels for this penalty for small businesses. For this purpose, a small business is any person having average annual gross receipts for the most recent three taxable years ending before the calendar year that do not exceed $5 million. The maximum penalties for small businesses are: $25,000 (instead of $75,000) if the failures are corrected on or before 30 days after the prescribed filing date; $50,000 (instead of $150,000) if the failures are corrected on or before August 1; and $100,000 (instead of $250,000) if the failures are not corrected on or before August 1.

If a failure to file a correct information return with the IRS is due to intentional disregard of the filing requirement, the penalty for each such failure is generally increased to the greater of $100 or 10 percent[61] of the amount required to be reported correctly, with no limitation on the maximum penalty per calendar year (sec. 6721(e)). The increase in the penalty applies regardless of whether a corrected information return is filed, the failure is de minimis, or the person subject to the penalty is a small business.

Failure to furnish correct payee statements

Any person that fails to furnish a correct payee statement[62] to a taxpayer (such as a copy of a W-2 or a 1099) on or before the prescribed due date is subject to a penalty of $50 per statement, with a maximum penalty of $100,000 per calendar year (sec. 6722). If the failure to furnish a correct payee statement to a taxpayer is due to intentional disregard of the requirement, the penalty is generally $100 per statement or, if greater, 10 percent[63] of the amount required to be shown on the statement, with no limitation on the maximum penalty per calendar year.

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[61] The penalty is 5 percent for several types of information returns.

[62] This term is defined in sec. 6724(d)(2), and refers to 22 information and reporting requirements in the Code, including secs. 6041(a) and 6041A(a).

[63] The penalty is 5 percent for several types of statements.

Failure to comply with other information reporting requirements

Any person that fails to comply with other specified information reporting requirements on or before the prescribed date is subject to a penalty of $50 for each failure, with a maximum penalty of $100,000 per calendar year (sec. 6723). The information reporting requirements specified for this purpose include any requirement to include a correct taxpayer identification number on a return or statement and any requirement to furnish a correct taxpayer identification number to another person.

Reasonable cause

The Code provides that any of the information reporting penalties may be waived if it is shown that the failure to comply is due to reasonable cause and not to willful neglect (sec. 6724). For this purpose, reasonable cause exists if significant mitigating factors are present, such as the fact that a person has an established history of complying with the information reporting requirements.

Accuracy penalties

Accuracy-related penalty

The accuracy-related penalty, which is imposed at a rate of 20 percent, applies to the portion of any underpayment that is attributable to negligence, any substantial understatement of income tax, or other enumerated situations (sec. 6662).

If an underpayment of tax is attributable to negligence, the negligence penalty is to apply only to the portion of the underpayment that is attributable to negligence rather than to the entire underpayment of tax.

Negligence includes any careless, reckless, or intentional disregard of rules or regulations, as well as any failure to make a reasonable attempt to comply with the provisions of the Code.

Fraud penalty

The fraud penalty, which is imposed at a rate of 75 percent, applies to the portion of any underpayment that is attributable to fraud (sec. 6663).

Reasonable cause

No accuracy-related or fraud penalty is to be imposed if it is shown that there was reasonable cause for an underpayment and the taxpayer acted in good faith (sec. 6664).

Penalty for aiding and abetting the understatement of tax liability

The penalty for aiding and abetting the understatement of tax liability applies in cases where the person aids, assists in, procures, or advises with respect to the preparation or presentation of any portion of a return or other document if (1) the person knows or has reason to believe that the return or other document will be used in connection with any material matter arising under the tax laws, and (2) the person knows that if the portion of the return or other document were so used, an understatement of the tax liability of another person would result (sec. 6701).

Penalty for failure to make timely deposits of tax

The penalty for failure to make timely deposits of tax is a four-tiered penalty. The amount of the penalty varies with the length of time within which the taxpayer corrects the failure (sec. 6656). A depositor is subject to a penalty equal to 2 percent of the amount of the underpayment if the failure is corrected within 5 days after the prescribed due date. A depositor is subject to a penalty equal to 5 percent of the amount of the underpayment if the failure is corrected after the date that is 5 days after the prescribed due date but on or before the date that is 15 days after the prescribed due date. A depositor is subject to a penalty equal to 10 percent of the amount of the underpayment if the failure is corrected after the date that is 15 days after the due date but on or before the date that is 10 days after the date of the first delinquency notice to the taxpayer (under sec. 6303). Finally, a depositor is subject to a penalty equal to 15 percent of the amount of the underpayment if the failure is not corrected on or before the date that is 10 days after the date of the first delinquency notice to the taxpayer (under sec. 6303).

Employer's liability for certain employment taxes as a result of misclassification of workers

If an employer treats services performed by an employee as if performed by a nonemployee and fails to withhold income or social security taxes as required by the wage withholding provisions of the income tax and social security tax laws, the employer's liability for those amounts is determined as a fraction of the employee's wages subject to income tax withholding or a fraction of the social security taxes required to be withheld (sec. 3509). The Code applies a lower fraction if the employer has complied with information reporting rules consistent with the treatment of the employee as a nonemployee.

The applicable amounts are 1.5 percent of wages (3 percent where no information returns are filed) where the employer erroneously treated the worker as a nonemployee for income tax purposes. The applicable amount where the employer erroneously treated the worker as a nonemployee for social security purposes is 20 percent of the social security taxes required to be withheld (40 percent where no information returns are filed). Even where this procedure applies, however, the employer is still liable for the employer's share of FICA and FUTA taxes.

These provisions do not apply if the employer treats the employee as a nonemployee with intentional disregard of the law. In this case, the employer is responsible for 100 percent of the income and FICA tax required to be withheld.

D. Data Regarding Worker Classification and Compliance

IRS audits of employment tax returns declined from over 100,000 in 1979 to about 62,000 in 1994.[64] This represented a decrease in audit coverage from approximately one-half of one percent to approximately two-tenths of one percent of employment tax returns filed.

The IRS has prepared several surveys from audits of employment tax returns. Two of the most widely utilized in the analysis of employment tax issues are the Strategic Initiative to Establish a Research Project on Withholding Noncompliance (known as "SVC-1") and the Employment Tax Examination Program ("ETEP").

The SVC-1 examined 3,331 employers for tax year 1984 and found that nearly 15 percent of employers misclassified employees as independent contractors.[65] According to the IRS, the section 530 safe harbor protected 2 percent of misclassified employees from being reclassified as employees. Of those returns using the section 530 safe harbor protections, nearly half relied on the prior audit provision. The SVC-1 survey also found that when employers classified workers as employees, more than 99 percent of wage and salary income was reported. However, when workers were classified as independent contractors, 77 percent of gross income was reported when a Form 1099 was filed, and only 29 percent of gross income was reported when no Form 1099 was filed.

The IRS performed 11,380 audits in the ETEP from fiscal years 1988 through 1994. Employers were audited to determine employment status of personnel who often were not classified as employees for employment tax purposes. The General Accounting Office ("GAO") has conducted a study of audits from the ETEP. GAO has reported that these audits resulted in proposed tax assessments of $751 million and reclassification of 483,000 workers as employees.[66]

In addition to these data sources, the Taxpayer Compliance Measurement Program ("TCMP") provides information on the overall level of tax compliance of sole proprietorships.

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[64] Internal Revenue Service, "1993-1994 Data Book."

[65] Internal Revenue Service, "Strategic Initiative on Withholding Noncompliance (SVC-1) Employer Survey Report of Findings," June 1989. This represents the IRS initial determination of worker status, and is not necessarily the final outcome.

[66] General Accounting Office, "Tax Administration Issues Involving Worker Classification," Statement of Natwar M. Gandhi, Associate Director, Tax Policy and Administration Issues, General Government Division, August 2, 1995 (GAO/T-GGD-95-224).

The TCMP consists of approximately 54,000 individual income tax returns that are extensively audited. The most recent year of the TCMP is for tax year 1988. The 1988 TCMP indicated that gross income reporting for Schedule C filers improved when a Form 1099 was issued. TCMP data indicated that overall compliance for gross income reporting averaged 94 percent, while net income reporting averaged only 75 percent for Schedule C (Profit or Loss from Sole Proprietorship) filers. (The voluntary compliance percentage varies by employment sector and with income.)

III. DESCRIPTION OF PROPOSALS

A. Independent Contractor Tax Simplification Act of 1995 (H.R. 1972)

In general

The Independent Contractor Simplification Act of 1995 (H.R. 1972)[67] would provide a statutory safe harbor for determining worker classification for employment tax purposes. If the standards set forth in the bill are met, the worker would not be treated as an employee and the service recipient (or payor) would not be treated as an employer.

Standards for determining whether individuals are not employees

Under the bill, the following three sets of requirements would have to be satisfied in order for a worker not to be treated as an employee: (1) worker requirements regarding the service recipient; (2) worker requirements regarding others; and (3) documentation requirements. The requirements regarding the worker would be satisfied if, in connection with performing the services, the worker: (1) has a significant investment in assets and/or training; (2) incurs significant unreimbursed expenses; (3) agrees to perform the services for a particular amount of time or to complete a specific result and is liable for damages for early termination without cause; (4) is paid primarily on a commissioned basis; or (5) purchases products for resale.

The requirements regarding others would be satisfied if one of the following two requirements is met: (1) a place of business requirement; or (2) a services available to the public requirement. The place of business requirement would be satisfied if the worker: (1) has a principal place of business; (2) does not primarily perform services in the service recipient's place of business; or (3) pays a fair market rent for use of the service recipient's place of business. The services available to the public requirement would be satisfied if the worker is not required to perform services exclusively for the service recipient, and during the year (or the preceding or subsequent year) the worker (1) has performed a significant amount of services for other persons; (2) has offered to perform services for other persons through advertising, individual written or oral solicitations, listings with agencies, brokers, or other organizations that provide referrals, or other similar activities; or (3) provides service under a business name that is registered with (or licensed by) a State or a political subdivision (or an agency or instrumentality of a State or political subdivision).

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[67] H.R. 1972 was introduced on June 30, 1995, by Messrs. Christensen, Armey, DeLay, Bliley, Hyde, Kasich, Livingston, Crane, Thomas, Bunning, McCrery, Hancock, Camp, Ramstad, Zimmer, Sam Johnson (Texas), Ms. Dunn, Messrs. Portman, English, Ensign, and others.

The documentation requirements would be satisfied if the services performed by the worker are performed pursuant to a written contract between the worker and the service recipient (or payor) and the contract provides that the worker will not be treated as an employee.

If the service recipient (or payor) fails to file the appropriate Federal tax returns (including information returns) with respect to a worker for a taxable year, treatment of the worker as an independent contractor under the new standards would not be available for such year. Thus, the classification of the worker for the year would be determined under the present-law rules.

If the worker performs services through an entity owned in whole or in part by the worker, then the standards under the bill could be applied to include the entity as the worker. The term service recipient (and payor) would not include any entity which is owned in whole or in part by the worker. Thus, the new standards would not apply if the worker has any ownership interest in the service recipient (or payor) (e.g., the worker provides services through a personal service corporation).

<u>Effective date</u>

The bill would be effective with respect to services performed after December 31, 1995.

B. Independent Contractor Tax Fairness Act of 1995 (H.R. 582)

<u>In general</u>

The Independent Contractor Tax Fairness Act of 1995 (H.R. 582)[68] would establish a statutory safe harbor for determining worker classification. If these standards are met, the worker would not be treated as an employee and the service recipient would not be treated as an employer. The bill would also codify and modify section 530 of the Revenue Act of 1978. Worker classification under the bill would apply for all Federal tax purposes, not just for employment tax purposes. The bill would also increase the penalties assessed against service recipients for failures to furnish required information returns to independent contractors (Form 1099). The bill would require the Secretary to propose legislation providing objective criteria for determining whether a worker is an employee, and would require the Secretary to issue a report to Congress detailing the efforts being made in giving taxpayers maximum latitude in determining worker classification under the bill.

<u>Standards for determining whether individuals are not employees</u>

Under the bill, a worker would not be treated as an employee if the worker performs services pursuant to a qualified agreement and the worker satisfies one of the following four

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[68] H.R. 582 was introduced on January 19, 1995, by Mr. Kim.

requirements relating to: (1) potential for realization of profit or loss; (2) maintenance of separate principal place of business; (3) making services available to the general public; or (4) receiving payment on a commission basis. The realization of profit or loss requirement would be satisfied if the worker can realize a profit or loss as a result of the worker's services (in addition to the profit or loss ordinarily realized by employees). The separate principal place of business requirement would be satisfied if the worker's principal place of business is not located at a place of business of the service recipient and the worker has a significant investment in facilities or tools which are used by the worker to perform services of the type performed for the service recipient and which are not typically maintained by employees. The making services available to the general public requirement would be satisfied if the services performed by the worker are made available to the general public on a regular and consistent basis, and the worker has performed such services other than as an employee for at least one other service recipient during the year (or the preceding year). The last requirement would be satisfied if the worker is paid exclusively on a commission basis, and either the worker's principal place of business is not located at a place of business of the service recipient or, if so located, the worker pays fair market rental value for the place of business.

An agreement between the worker and the service recipient would be qualified if it is in writing and it specifies the following: (1) the services to be provided, the duration of the services, and the remuneration to be paid for the services; (2) that the worker reasonably believes that the worker satisfies the new standards for being treated not as an employee, the service recipient will not treat the worker as an employee for Federal tax purposes, and the worker is aware of the Federal tax obligations resulting from such treatment; and (3) that the service recipient will maintain a separate accounting of the income and expenses relating to the agreement.

Under the bill, a failure to satisfy the new standards could not be construed as indicating that a worker is an employee of the service recipient under other provisions, e.g., the common-law rules.

Codification of and modification to section 530

Under the bill, section 530 of the Revenue Act of 1978 would be repealed and would be codified in a modified form.[69] The reporting consistency requirement and the reasonable basis requirement (including the judicial or administrative precedent, prior audit, and industry practice safe harbors) would generally be retained. However, the requirement that the taxpayer must not

[69] By repealing present-law section 530, the bill would repeal section 1706 of the Tax Reform Act of 1986; thus, the newly codified provisions of section 530 would apply to technical services workers. The bill contains a special rule that would excuse the reporting consistency requirements with respect to technical services workers to the extent the requirements are not met since such workers were previously treated as employees by reason of section 1706.

have treated any worker holding a substantially similar position as an employee for any period after 1977 would no longer apply.

The bill would also add some new rules to the codified section 530 provisions. The prior audit safe harbor would be modified so that it may cease to be available if the taxpayer is not relying on an employment tax audit and an employment tax audit is made. Under this provision, if, after an employment tax audit (and after providing the taxpayer an opportunity for an appeal), the IRS notifies the taxpayer in writing that a worker (or workers holding substantially similar positions) should be treated as employees for employment tax purposes, the prior audit safe harbor would no longer apply with respect to such workers for any calendar month beginning more than 180 days after the date such notice is sent. For purposes of this rule, an employment tax audit would mean an audit by the IRS conducted solely for employment tax purposes and which includes an examination of workers holding positions substantially similar to the position held by the individual involved.

The bill would also provide that a significant segment of the taxpayer's industry under the industry practice safe harbor does not require a showing of the practice of more than 25 percent of an industry (i.e., a lower percentage could constitute a significant segment of the taxpayer's industry). In applying this rule, the Secretary would have to give taxpayers maximum latitude in determining which industry is the appropriate industry.

Under the bill, if a taxpayer chooses to treat a worker as an employee for any subsequent period, such treatment would not affect the taxpayer's ability to rely on the codified section 530 provisions for any prior period.

Penalties for failure to furnish information returns

The bill would increase the penalties assessed against service recipients for failures to furnish required information returns (Forms 1099) to independent contractors. In the case of such a failure, the general penalty would be increased from $50 to $75 per information return, and the penalty for intentional disregard of the requirement would be increased from $100 to $125 per information return. The bill would also require the Secretary to modify Federal income tax return forms (e.g., Form 1040) so that a taxpayer is required to report each amount for which the taxpayer received an information return separately. In addition, the Secretary would be directed to take appropriate steps to inform service recipients of: (1) their obligations with respect to independent contractors; (2) the changes in the bill to the rules for determining worker classification; and (3) the increases in the penalties under the bill for failures to furnish required information returns.

Treasury report

Under the bill, the Secretary would be required to propose, no more than 180 days after the date of enactment, legislation which specifies objectively measurable criteria for determining whether a worker is an employee or independent contractor for Federal tax purposes. Such legislation would not modify the present-law statutory provisions treating certain workers as independent contractors. It would be intended that the criteria in such proposed legislation allow taxpayers maximum latitude in determining worker classification.

The Secretary would also be required, within one year after the date of enactment, to submit a report to Congress detailing efforts being made in giving taxpayers maximum latitude in determining worker classification under the provisions in the bill.

Effective dates

The provisions under the bill relating to worker classification would be effective beginning on the first day of the first calendar year beginning after the date of enactment, except that the repeal of section 530 of the Revenue Act of 1978 would apply to periods in calendar years beginning after the date of enactment. The increases in the penalties for failures to furnish required information returns would apply to information returns the due date for which (without regard to extensions) is after December 31, 1996. The provisions directing the Treasury to take certain actions would be effective on the date of enactment.

IV. ISSUES

In general

Under a perfectly efficient tax system, the classification of an individual as an employee or independent contractor would have no substantive effect on the individual's Federal income tax liability nor would it have an effect on the level of compliance with the Federal tax laws. Under such a system, the choice of whether to be classified as an employee or independent contractor would be a neutral one made on the basis of sound business considerations. Similarly, under such a system, the Federal government should be indifferent as to whether an individual is classified as an employee or an independent contractor.

However, under present law, the calculation of an individual's Federal tax liability will be determined, in part, by the individual's status as an employee or independent contractor. For example, an employer is entitled to a deduction for 100 percent of the costs of providing health insurance to an employee and the employee is not required to include such amounts in income. If an employer does not provide health insurance to its employees, the employees are entitled to deduct their health insurance expenses only to the extent such expenses (plus all other medical expenses of the employee) exceed 7.5 percent of the employee's adjusted gross income. On the other hand, a self-employed individual (e.g., an independent contractor) is entitled to deduct no more than 30 percent of the costs of health insurance. Thus, an individual may prefer to be classified as either an employee or as an independent contractor depending upon whether the employer provides excludable health insurance to its employees.

In addition, tax return data shows that there is a lower level of compliance with Federal tax laws by independent contractors as opposed to employees. Although there may be a variety of reasons for this lower level of compliance, the effect of it is that the Federal government is not indifferent as to whether an individual is classified as an employee or as an independent contractor.

The present-law rules relating to the classification of individuals as employees or independent contractors impose a set of subjective standards that do not result in clearly applicable rules. These standards result in the following adverse consequences: (1) there is confusion among taxpayers about whether or not they may legally be classified as independent contractors, (2) taxpayers and the Federal government engage in excessive litigation over whether individuals are appropriately classified as independent contractors, (3) the uncertainty over the standards contributes to lack of faith in the present-law tax system, (4) certain types of taxpayers (i.e., technical services personnel) are not entitled to the use of certain safe harbors available to other taxpayers, and (5) the Federal government may lose revenue because of the misclassification of workers.

Reasons for misclassification of workers

In general

Misclassification of workers can be either inadvertent or deliberate. At the extremes, it will be clear whether a worker is properly characterized as an employee or independent contractor. However, many work situations will involve the grey area in between. Under the common-law test, some of the 20 factors may support employee status, while some may indicate independent contractor status. Because the determination of proper classification is factual, reasonable people may differ as to the correct result given a certain set of facts. Thus, even though a taxpayer in good faith determines that a worker is an independent contractor, an IRS agent may reach a different conclusion by, for example, weighing some of the 20 factors differently than the taxpayer. Taxpayers wishing certainty can obtain private letter rulings regarding the status of workers. However, not all taxpayers may wish to undertake the expense of obtaining a ruling or may not be able to wait for a ruling from the IRS or may be concerned that the IRS will take a conservative approach that favors employee status, even though a court might find otherwise. The prohibition on issuance of general guidance by the IRS may make the likelihood of such errors greater; the IRS is not permitted to publish guidance stating which factors are more relevant than others. In the absence of such guidance, not only may taxpayers and the IRS differ, but different IRS agents may also reach different conclusions, resulting in inconsistent enforcement. The publication of the IRS Training Guide may aid consistent enforcement by different agents; however, the guidelines leave substantial discretion to individual agents and do not resolve all issues.

Misclassification of workers as independent contractors may also be deliberate. In some cases, workers and service recipients may prefer to classify workers as independent contractors, both for tax and nontax reasons. For example, the worker may wish to take advantage of the ability to contribute on a deductible basis to a pension plan or to deduct significant work-related expenses. A service recipient may wish to avoid administrative problems associated with withholding income and employment taxes. The service recipient also may wish to avoid coverage and nondiscrimination requirements applicable to qualified retirement plans by classifying lower-paid workers as independent contractors. The IRS may have an interest in classifying workers as employees, in order to obtain the benefits of withholding.

Workers sometimes argue that they prefer independent contractor status because it gives them more control over their own lives. To the extent such reasons exist in particular cases, service recipients may feel compelled to classify workers as independent contractors rather than employees. In many instances, it may be very difficult to distinguish whether a misclassification was deliberate or inadvertent.

Section 530 of the Revenue Act of 1978

While section 530 of the Revenue Act of 1978 was designed to reduce disputes between taxpayers and the IRS regarding classification of workers, it also has been a source of misclassification and disputes between taxpayers and the IRS. There are several possible reasons for this. Like the common-law test, some aspects of section 530 depend on the facts and circumstances, and reasonable people may differ as to the correct result given a certain set of facts. For example, under the industry standard safe harbor, there is no statutory standard for determining what portion of the industry constitutes a significant segment. In the absence of a statutory rule, the IRS and taxpayers may reach different conclusions based on available case law. Similarly, different conclusions may be reached as to the proper industry in which the taxpayer is engaged in business.

Another possible source of misclassification is the scope of section 530. By its terms, section 530 applies only to the service recipient's employment tax treatment of the worker--it does not apply to the worker or for income tax purposes. However, many workers may believe that the service provider's classification of the worker as not an employee automatically applies for income tax purposes and may, for example, file their income taxes on the basis that they are an independent contractor, when under the common-law test, they are an employee.

Differences between the interpretation of section 530 by the courts, the IRS, and taxpayers may also result in misclassifications and disputes. For example, section 530 does not by its terms apply only in situations in which the worker has been determined to be a common-law employee and courts have not necessarily required such a showing. However, the IRS position is that section 530 applies only after there has been a determination (which the taxpayer does not have to agree with) that the worker in question is an employee. Another example is the application of the "other reasonable basis" safe harbor. The IRS position is that the common law cannot be a basis for satisfying this part of the section 530 safe harbor. However, some courts have accepted it as a basis. The burden of proof under section 530 has also generated some confusion because courts have reached different results as to what the taxpayer is required to demonstrate.

The issues that arise under section 530 itself indicate that statutory clarifying changes would help reduce misclassification and disputes between taxpayers and the IRS.

Consequences of misclassification

One issue that arises with respect to misclassification of workers is the effect on Federal budget receipts. Revenue loss can occur when workers are misclassified as self employed if such workers are treated more favorably for tax purposes than are employees. Another possible source of revenue loss is if there are lower compliance rates with respect to self-employed individuals and their service recipients compared to the compliance rates of employees and their employers.

To the extent that there are more favorable tax rules with respect to self-employed individuals than there are with respect to employees, there will be an incentive for workers to be classified as self employed rather than employees. This incentive exists to some extent under present law because, in some cases, self-employed individuals receive more favorable tax treatment than employees. However, under present law, in some cases (e.g., the ability to exclude certain types of employee benefits from gross income), employees are treated more favorably than self-employed individuals. Thus, any revenue loss resulting from the more favorable treatment for self-employed individuals may be at least partially offset by other factors associated with self-employed status.

It is clear that under present law there is revenue loss associated with lower compliance rates of independent contractors and service recipients compared to the compliance rates of employees and their employers. Tax data indicate that service recipients often fail to file requisite Forms 1099 for payments made to independent contractors, and that independent contractors often fail to report the unreported payments as income. In addition, employers must file information reports on all wages paid to employees; the requirement with respect to service recipients are not as comprehensive. Even when Forms 1099 are issued, compliance is somewhat less than when workers are classified as employees and withholding is required.

Another issue that arises with respect to misclassification of workers is the consequences to the worker and the service recipient when a worker is reclassified as an employee. As discussed above, the employer is liable for a portion of employment taxes, and also may be subject to penalties. As discussed above, there may also be consequences beyond employment taxes; for example, the employer's pension plan may be affected.

The worker may also face a variety of consequences. In some cases, the worker may view these as positive. For example, the worker may benefit from being included in a pension or health plan sponsored by the employer. On the other hand, the worker may face higher tax liability as an employee, for example, because independent contractors may take certain deductions that are not available to employees.

Many businesses and workers feel that the consequences of misclassification are severe, particularly if the misclassification was inadvertent. One way to address any perceived unfairness under present law would be to modify the rules relating to the definition of employee to provide more clarity for employers so that there would be less opportunity for inadvertent misclassifications and disagreements with the IRS over the correct interpretation of the law.

Special issues related to section 530 of the Revenue Act of 1978

Special issues can arise under section 530 because it applies only to the service recipient and only for employment tax purposes. One of these issues, mentioned above, is that the taxpayer may erroneously believe that the service recipient's treatment of the worker is correct, and file his or her own tax return as an independent contractor, rather than as an employee. In such cases, the individual may have unexpected tax liability stemming from the inadvertent misclassification.

Anther issue relates to social security. If a service recipient is relying on section 530, it is not required to pay employment taxes, even if the worker is in fact an employee. In such a case, the employee is liable for his or her share of social security taxes, and will earn credit for social security benefits with respect the services performed. Although only one-half the regularly applicable social security tax would be paid, the employee would receive full social security benefits with respect to that service. On the other hand, if the worker files as an independent contractor, he or she would be liable for the full amount of self-employment taxes.

One way to address these and similar problems that arise would be to provide that section 530 applies generally for purposes of the Code. In many cases, such a change would codify existing taxpayer practice.