DESCRIPTION AND ANALYSIS OF PROPOSALS RELATING TO THE DEDUCTION FOR HEALTH INSURANCE EXPENSES OF SELF-EMPLOYED INDIVIDUALS, WORKER CLASSIFICATION, TAXATION OF HOME OFFICE EXPENSES, AND ELECTRONIC FILING

Scheduled for a Public Hearing

Before the

SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT

of the

SENATE COMMITTEE ON FINANCE

on June 5, 1997

Prepared by the Staff

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JOINT COMMITTEE ON TAXATION

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INTRODUCTION

The Subcommittee on Taxation and IRS Oversight of the Senate Committee on Finance has scheduled a public hearing on June 5, 1997, on certain tax issues relating to small business. This document[1], prepared by the staff of the Joint Committee on Taxation, provides a description of present law and proposals and an analysis of issues relating to the following topics scheduled for the hearing: the deduction for health insurance expenses of self-employed individuals (Part I), worker classification (Part II), taxation of home office expenses (Part III), and electronic filing and automatic payment system (Part IV).

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[1] This document may be cited as follows: Joint Committee on Taxation, Description and Analysis of Tax Proposals Relating to the Deduction for Health Insurance Expenses of Self-Employed Individuals, Worker Classification, Home Office Deduction, and Electronic Filing (JCX-19-97) June 4, 1997.

I. DEDUCTION FOR HEALTH INSURANCE COSTS OF SELF-EMPLOYED INDIVIDUALS

A. Present Law

Under present law, the tax treatment of health insurance expenses depends on whether the taxpayer is an employee and whether the taxpayer is covered under a health plan paid for by the employee's employer. An employer's contribution to a plan providing accident or health coverage for the employee and the employee's spouse and dependents is excludable from an employee's income. In addition, businesses can generally deduct, as an employee compensation expense, the full cost of any health insurance coverage provided for their employees. The exclusion and deduction are generally available in the case of owners of the business who are also employees.

In the case of self-employed individuals (i.e., sole proprietors or partners in a partnership) no equivalent exclusion applies. However, under present law, self-employed individuals are entitled to deduct the amount paid for health insurance for the self-employed individual and the individual's spouse and dependents as follows: the deduction is 40 percent in 1997; 45 percent in 1998 through 2002; 50 percent in 2003; 60 percent in 2004; 70 percent in 2005; and 80 percent in 2006 and thereafter. The deduction is also available to more than 2-percent shareholders of S corporations. The deduction is not available for any month if the taxpayer is eligible to participate in a subsidized health plan maintained by the employer of the taxpayer or the taxpayer's spouse. In addition, no deduction is available to the extent that the deduction exceeds the taxpayer's earned income. The amount of expenses paid for health insurance in excess of the deductible amount could be taken into account in determining whether the individual was entitled to an itemized deduction for medical expenses.

Other individuals who purchase their own health insurance can deduct their insurance premiums only to the extent that the premiums, when combined with other unreimbursed medical expenses, exceed 7.5 percent of adjusted gross income.

B. Description of Proposal

S. 460 would increase the percentage deduction for health insurance of self-employed individuals to 100 percent. The other provisions relating to the deduction, e.g., the deduction would be limited to the amount of earned income from self-employment, would remain the same.

The proposal would be effective for taxable years beginning after December 31, 1996.

C. Analysis

Under present law, the Federal tax laws encourage the provision of health care in the employment context by providing the most favorable tax treatment for employer-provided health care. The next most favored group are the self-employed individuals. Taxpayers who do not

receive employer-provided health insurance and who are not self employed cannot deduct their health insurance expenses unless their medical expenses exceed 7.5 percent of their adjusted gross income ("AGI").

Under present law, self-employed individuals are disadvantaged when compared to individuals who organize their business in corporate form under subchapter C of the Code. In such a case, the individual could be the sole shareholder and employee of the company. Any employer contributions for health care would be fully excludable by the employee. Thus, some could argue that the tax treatment of self-employed individuals should be the same as that of employees. On the other hand, under present law, self-employed persons are treated more favorably than other individuals who do not receive employer-provided health care. Increasing the deduction for self-employed persons would merely exacerbate this inequity.

From a policy perspective, it may be difficult to justify different Federal tax subsidies for health care expenses based upon whether or not someone is an employee or the form in which an entity does business. For example, if the objective is to provide a certain level of subsidy for all Americans who purchase health care, or for persons with certain income levels, the subsidy should be independent of employment status. Thus, many argue that subsidies should be provided to individuals regardless of employment status.

Under the bill, unless an employer voluntarily pays for 100 percent of an employee's coverage, self-employed individuals would receive a better tax subsidy for their health expenses than employees. Some would argue that the exclusion of employer-provided health coverage from the wages of employees for employment tax purposes reduces the disparity between the tax treatment of the health expenses of self-employed individuals and employees under the bill because self-employed individuals cannot deduct their health insurance expenses when calculating self-employment taxes.

II. WORKER CLASSIFICATION

A. Present Law and Background

1. Introduction

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.

2. Classification of workers

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."[2] 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.[3] 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.[4] The 20 factors were developed by the IRS based on an examination of cases and rulings considering whether a

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[2] Treas. Reg. sec. 31.3401(c)-(1)(b).

[3] Treas. Reg. sec. 31.3401(c)-(1)(b).

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

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 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,[5] 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

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[5] Employee or Independent Contractor?, Department of the Treasury, Internal Revenue Service, Training 3320-102 , (Rev. 10-96) TPDS 842381 (issued March 4, 1997) (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.

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.

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.

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.[6]

If certain requirements are satisfied, licensed real estate agents and "direct sellers" are treated as independent contractors for all Federal tax purposes.[7] 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

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[6] Sec. 3121(d).

[7] Sec. 3508.

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.

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").[8] 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.[9]

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 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."[10]

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

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[8] P.L. 95-600.

[9] P.L. 97-248.

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

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.

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.[11]

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. Taxpayers may not rely on an audit commencing after December 31, 1996, unless such audit included an examination for employment tax purposes of whether the worker involved (or any worker holding a position substantially similar to the position held by the worker involved) should be treated as an employee of the taxpayer. The rule does not affect the ability of taxpayers to rely on prior audits that commenced before January 1, 1997, even though the audit was not related to employment tax matters.

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.

Under the Small Business Job Protection Act of 1996 (the "Small Business Act"), a significant segment of the taxpayer's industry under the industry practice safe harbor does not

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

require a reasonable showing of the practice of more than 25 percent of an industry (determined without taking into account the taxpayer). This rule is intended to be a safe harbor; a lower percentage may constitute a significant segment of the taxpayer's industry based on the particular facts and circumstances.

The Small Business Act also provides that an industry practice need not have continued for more than 10 years in order for the industry practice to be considered long standing. As with the significant segment safe harbor, this provision is intended to be a safe harbor; an industry practice in existence for a shorter period of time may be considered long standing based on the particular facts and circumstances.

In addition, the Small Business Act clarifies that an industry practice will not fail to be treated as long standing merely because such practice began after 1978. Consequently, the provision clarifies that new industries can take advantage of section 530.

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.

Reliance on the common-law test can constitute a reasonable basis for purposes of applying section 530.

Burden of proof.--The Small Business Act provides that if a taxpayer establishes a prima facie case that it was reasonable not to treat a worker as an employee for purposes of section 530,[12] the burden of proof shifts to the IRS with respect to such treatment.[13] In order for the shift in burden of proof to occur, the taxpayer must fully cooperate with reasonable requests by the IRS for information relevant to the taxpayer's treatment of the worker as an independent contractor under section 530. It is intended that a request by the IRS will not be treated as reasonable if complying with the request would (1) be impracticable given the particular circumstances and the relative costs involved or (2) if the request does not relate to the particular basis on which the taxpayer relied in establishing its reasonable basis. The shift in the burden of proof does not apply for purposes of determining whether the taxpayer had any other reasonable basis for treating the worker as an independent contractor, but does apply to all other aspects of

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[12] For example, the taxpayer must establish a prima facie case that it reasonably satisfies the requirements of section 530 for not treating the worker as an employee, including the requirements relating to reporting consistency and consistency among workers with substantially similar positions, and the requirement that the taxpayer have a reasonable basis for not treating the worker as an employee.

[13] The provision is generally intended to codify the holding in McClellan v. U.S., discussed above, with respect to the burden of proof in section 530 cases.

section 530. So, for example, provided the taxpayer establishes its prima facie case and fully cooperates with the IRS' reasonable requests, the burden of proof shifts to the IRS with respect to all other aspects of section 530, including whether the taxpayer had a reasonable basis for treating the worker as an independent contractor under the judicial or administrative precedent, prior audit, or long-standing industry practice safe harbors, whether the taxpayer filed all Federal tax returns on a basis consistent with treating the worker as an independent contractor, and whether the taxpayer treated any worker holding a substantially similar position as an employee. No inference is intended with respect to the application of the burden of proof in section 530 cases prior to the effective date of this provision.

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.[14] 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.[15] 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 independent contractor treatment.[16] 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."

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

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

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

There have been a few court decisions addressing this issue. For example, in REAG, Inc. v. U.S.,[17] 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.,[18] 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.

Recent IRS developments

Classification settlement program

On May 10, 1996, new procedures for the IRS classification settlement program ("CSP") were issued.[19] 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.

Under the CSP, the examining agent is to gather the facts necessary to determine whether section 530 is available and, if not, whether an improper classification has occurred, 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[20] 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

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[17] 801 F.Supp. 494 (W.D. Okla. 1992). The IRS has nonacquiesced.

[18] 785 F.Supp. 913 (D. Kan. 1992).

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

[20] 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.

assessment of 25 percent of the income tax withholding[21] 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 the jurisdiction of the District Director arising from an examination.[22] 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.[23] The procedure was subsequently extended for an additional one year period beginning May 27, 1997.[24]

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.

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[21] Id.

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

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

[24] Announcement 97-52, 1997-21 I.R.B. 22.

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.[25] 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.

3. Consequences of worker classification

Reporting and withholding requirements

Income tax withholding and reporting

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 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.[26] Independent contractors are required to make quarterly estimated tax payments.

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

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

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.[27] A similar statement must also be furnished to the person to whom such payments were made.[28]

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.

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

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[27] 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.

[28] Sec. 6041(d).

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.

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 up to $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.[29]

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.

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[29] 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.

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.[30]

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.

B. 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.[31] 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.[32] 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

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[30] 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.

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

[32] 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.

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.[33]

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

C. Description of Proposal

In general

S. 460 would: (1) provide a safe harbor for determining whether a service provider is not an employee for Federal tax purposes; (2) provide that, if certain requirements are satisfied, a determination by the Secretary that a service recipient or payor should have treated a service provider as an employee will not be effective before the 30th day after the earlier of the date on which is sent (a) the first notice of deficiency that allows for administrative review by the IRS Office of Appeals or (b) a notice of deficiency; (3) provide that compliance with statutory or regulatory standards are not treated as evidence of control for purposes of determining whether a service provider is an employer; and (4) repeal section 1706 of the 1986 Act.

Safe harbor for determination of employer status

Under the bill, if certain requirements are satisfied, then for all Federal tax purposes, the service provider will not be treated as an employee, the service recipient or, if different, the payor for the services, will not be treated as an employer, and compensation paid or received for

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[33] 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 services will not be treated as paid or received with respect to employment. If the safe harbor is not satisfied, whether the service provider is an employee would be determined under other Code provisions, section 530 of the 1978 Act, and the common law, as applicable. The safe harbor does not apply if the service recipient or payor fails to comply with reporting requirements with respect to a service provider, unless such failure is due to reasonable causes and not willful neglect.

The safe harbor could be satisfied in one of two ways. The safe harbor would be satisfied if the services are provided pursuant to a written contract providing that the service provider will not be treated as an employer for Federal tax purposes, and either the service provider meets certain requirements with respect to (1) the service recipient and others, or (2) business structure and employer benefits.

Under the first method of satisfying the safe harbor, the requirements with respect to the service recipient would be met if, in connection with performing the service the service provider (1) has the ability to realize a profit or loss, (2) incurs unreimbursed expenses which are ordinary and necessary to the service provider's business and which are at least equal to 2 percent of the service provider's adjusted gross income provided pursuant to contracts specifying that the service provider is not an employee and (3) agrees to perform services for a particular amount of time or to complete a specific result or task. The requirements with respect to others would be satisfied if the service provider (1) has a principal place of business (including a home office), (2) does not primarily provide the services at a single service recipient's facilities, (3) pays a fair market value for the use of the service recipient's facilities, or (4) operates primarily with equipment not supplied by the service recipient.

Under the second method of satisfying the safe harbor, the business structure and employee benefits requirement would be met if the service provider (1) conducts business as a properly constituted corporation or limited liability company under applicable state laws and (2) does not receive from the service recipient or the payor benefits that are provided to employees of the service recipient.

The burden of proof with respect to treatment of a service provider as not an employee under the safe harbor is on the Secretary if (1) the services are provided pursuant to a contract specifying that the service provider will not be treated as an employee, (2) applicable reporting requirements are satisfied (or the failure to satisfy the requirements is due to reasonable cause and not willful neglect), and (3) the service provider, service recipient, or payor (as the case may be) (a) establishes a prima facie case that it was reasonable to treat the service provider as not an employee under the safe harbor and (b) has fully cooperated with reasonable requests from the Secretary.

Reclassification of workers by the Secretary

A determination by the Secretary that a service recipient or payor should have treated a service provider as an employee or that the service provider should have treated himself or

herself as an employee would not be effective before the notice date if the service provider, payor, or service recipient (as the case may be) demonstrates a reasonable basis for determining that the service provider is not an employee and that such determination was made in good faith. The notice date would be defined as the 30th day after the earlier of the date on which is sent the first notice of deficiency that allows for administrative review by the IRS Appeals Office or a notice of deficiency.

Effective dates

In general, the provisions of the bill would be effective with respect to services performed after the date of enactment. The provisions relating to reclassifications by the Secretary would be effective with respect to determinations by the Secretary after the date of enactment. The repeal of section 1706 of the 1986 Act would apply to periods ending after the date of enactment.

D. Analysis

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.

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. The Small Business Act made a number of clarifying changes under section 530 which should help reduce such disputes. However, further changes may be appropriate.

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.

The consequences of misclassification can be severe, particularly if the misclassification was inadvertent. One way to address any possible 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.

III. TAX TREATMENT OF HOME OFFICE EXPENSES

A. Present Law

A taxpayer's business use of his or her home may give rise to a deduction for the business portion of expenses related to operating the home (e.g., a portion of rent or depreciation and repairs). Code section 280A(c)(1) provides, however, that business deductions generally are 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 unit. In the case of an employee, the Code further requires that the business use of the home must be for the convenience of the employer (sec. 280A(c)(1)).[34] These rules apply to houses, apartments, condominiums, mobile homes, boats, and other similar property used as the taxpayer's home (sec. 280A(f)(1)). Under Internal Revenue Service (IRS) rulings, the deductibility of expenses incurred for local transportation between a taxpayer's home and a work location sometimes depends on whether the taxpayer's home office qualifies under section 280A(c)(1) as a principal place of business (see Rev. Rul. 94-47, 1994-29 I.R.B. 6).

Prior to 1976, expenses attributable to the business use of a residence were deductible whenever they were "appropriate and helpful" to the taxpayer's business. In 1976, Congress adopted section 280A, in order to provide a narrower scope for the home office deduction, but did not define the term "principal place of business." In Commissioner v. Soliman, 113 S.Ct. 701 (1993), the Supreme Court reversed lower court rulings and upheld an IRS interpretation of section 280A that disallowed a home office deduction for a self-employed anesthesiologist who practiced at several hospitals but was not provided office space at the hospitals. Although the anesthesiologist used a room in his home exclusively to perform administrative and management activities for his profession (i.e., he spent two or three hours a day in his home office on bookkeeping, correspondence, reading medical journals, and communicating with surgeons, patients, and insurance companies), the Supreme Court upheld the IRS position that the "principal place of business" for the taxpayer was not the home office, because the taxpayer performed the "essence of the professional service" at the hospitals.[35] Because the taxpayer did

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[34] If an employer provides access to suitable space on the employer's premises for the conduct by an employee of particular duties, then, if the employee opts to conduct such duties at home as a matter of personal preference, the employee's use of the home office is not "for the convenience of the employer." See, e.g., W. Michael Mathes, (1990) T.C. Memo 1990-483.

[35] In response to the Supreme Court's decision in Soliman, the IRS revised its Publication 587, Business Use of Your Home, to more closely follow the comparative analysis used in Soliman by focusing on the following two primary factors in determining whether a home office is a taxpayer's principal place of business: (1) the relative importance of the activities performed

not meet with patients at his home office and the room was not a separate structure, a deduction was not available under the second or third exception under section 280A(c)(1) (described above).

Section 280A(c)(2) contains a special rule that allows a home office deduction for business expenses related to a space within a home that is used on a regular (even if not exclusive) basis as a storage unit for the inventory or product samples of the taxpayer's trade or business of selling products at retail or wholesale, but only if the home is the sole fixed location of such trade or business.

Home office deductions may not be claimed if they create (or increase) a net loss from a business activity, although such deductions may be carried over to subsequent taxable years (sec. 280A(c)(5)).

B. Description of Proposals

S. 460 and S. 406

S. 460 (introduced on March 18, 1997, by Senator Bond) and S. 406 (introduced on March 5, 1997, by Senator Hatch) contain the identical proposal to amend the rules governing the deductibility for Federal income tax purposes of home office expenses. Both bills would amend present-law section 280A to specifically provide that a home office qualifies as the "principal place of business" if (1) the office is the location where the taxpayer's essential administrative or management activities are conducted on a regular and systematic (and not incidental) basis by the taxpayer, and (2) the office is necessary because the taxpayer has no other location for the performance of the essential administrative or management activities of the business. As under present-law, deductions would be allowed for a home office meeting the above two-part test only if the office is exclusively used on a regular basis as a place or business by the taxpayer, and, in the case of an employee, only if such exclusive use is for the convenience of the employer.

Effective date.--S. 460 and S. 406 would be effective for taxable years beginning after December 31, 1996.

House-passed version of Balanced Budget Act of 1995 (H.R. 2491, 104th Cong.)

Under the House-passed version of the Balanced Budget Act of 1995 (H.R. 2491, 104th Cong.), section 280A would be amended to specifically provide that a home office qualifies as the "principal place of business" if (1) the office is used by the taxpayer to conduct administrative or management activities of a trade or business and (2) there is no other fixed location of the trade or business where the taxpayer conducts substantial administrative or

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at each business location; and (2) the amount of time spent at each location.

management activities of the trade or business. As under present law, deductions would be allowed for a home office meeting the above two-part test only if the office is exclusively used on a regular basis as a place of business by the taxpayer, and in the case of an employee, only if such exclusive use is for the convenience of the employer.

Thus, under the proposal, a home office deduction would be allowed (subject to the present-law "convenience of the employer" rule governing employees) if a portion of a taxpayer's home is exclusively and regularly used to conduct administrative or management activities for a trade or business of the taxpayer, who does not conduct substantial administrative or management activities at any other fixed location of the trade or business, regardless of whether administrative or management activities connected with his trade or business (e.g., billing activities) are performed by others at other locations. The fact that a taxpayer also carries out administrative or management activities at sites that are not fixed locations of the business, such as a car or hotel room, would not affect the taxpayer's ability to claim a home office deduction under the proposal. Moreover, if a taxpayer conducts some administrative or management activities at a fixed location of the business outside the home, the taxpayer still would be eligible to claim a deduction so long as the administrative or management activities conducted at any fixed location of the business outside the home are not substantial (e.g., the taxpayer occasionally does minimal paperwork at another fixed location of the business). In addition, a taxpayer's eligibility to claim a home office deduction under the proposal would not be affected by the fact that the taxpayer conducts substantial non-administrative or non-management business activities at a fixed location of the business outside the home (e.g., meeting with, or providing services to, customers, clients, or patients at a fixed location of the business away from home).

The legislative history indicated that, if a taxpayer in fact does not perform substantial administrative or management activities at any fixed location of the business away from home, then the second prong of the proposal would be satisfied, regardless of whether or not the taxpayer opted not to use an office away from home that was available for the conduct of such activities. However, in the case of an employee, the question whether an employee opted not to use suitable space made available by the employer for administrative activities is relevant to determining whether the present-law "convenience of the employer" test is satisfied. In cases where a taxpayer's use of a home office did not satisfy the proposal's two-part test, the taxpayer nonetheless might be able to claim a home office deduction under the present-law "principal place of business" exception or any other provision of section 280A.

IV. ELECTRONIC FUND TRANSFER SYSTEM FOR COLLECTION OF CERTAIN TAXES

A. Present Law

Employers are required to withhold income taxes and social security payroll ("FICA") taxes from wages paid to their employees. Employers also are liable for their portion of FICA taxes, excise taxes, and estimated payments of their corporate income tax liability.

The Code requires the development and implementation of an electronic fund transfer system to remit these taxes and convey deposit information directly to the Treasury (Code sec. 6302(h)[36]). The Electronic Federal Tax Payment System ("EFTPS") was developed by Treasury in response to this requirement.[37] Employers must enroll with one of two private contractors hired by the Treasury. After enrollment, employers generally initiate deposits either by telephone or by computer.

The new system is phased in over a period of years by increasing each year the percentage of total taxes subject to the new EFTPS system. For fiscal year 1994, 3 percent of the total taxes are required to be made by electronic fund transfer. These percentages increased gradually for fiscal years 1995 and 1996. For fiscal year 1996, the percentage was 20.1 percent (30 percent for excise taxes and corporate estimated tax payments). For fiscal year 1997, these percentages increased significantly, to 58.3 percent (60 percent for excise taxes and corporate estimated tax payments). The specific implementation method required to achieve the target percentages is set forth in Treasury regulations. Implementation began with the largest depositors.

Treasury had originally implemented the 1997 percentages by requiring that all employers who deposit more than $50,000 in 1995 must begin using EFTPS by January 1, 1997. The Small Business Job Protection Act of 1996 provided that the increase in the required percentages for fiscal year 1997 (which, pursuant to Treasury regulations, was to take effect on January 1, 1997) will not take effect until July 1, 1997.[38] This was done to provide additional time prior to implementation of the 1997 requirements so that employers could be better informed about their responsibilities.

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[36] This requirement was enacted in 1993 (sec. 523 of P.L. 103-182).

[37] Treasury had earlier developed TAXLINK as the prototype for EFTPS. TAXLINK has been operational for several years; EFTPS is currently operational. Employers currently using TAXLINK will ultimately be required to participate in EFTPS.

[38] Sec. 1809 of P.L. 104-188.

On June 2, 1997, the IRS announced[39] that it will not impose penalties through December 31, 1997, on businesses that make timely deposits using paper Federal tax deposit coupons while converting to the EFTPS system.

B. Description of Proposals

S. 570

S.570 (introduced on April 14, 1997, by Senators Nickles, Breaux, Mack, Baucus, D'Amato and others) would modify the implementation of the EFTPS system. Under the bill, taxpayers would only be required to participate in EFTPS for a calendar year if, for the second preceding calendar year, the amount of depository taxes exceeded a specified amount, as follows:

If the second preceding calendar year is:	The specified dollar amount is:
1995	$47,000,000
1996	$30,000,000
1997	$20,000,000
1998	$10,000,000
1999 or later	$ 5,000,000

The bill also would require the Secretary to encourage taxpayers to participate in the EFTPS system on a voluntary basis.

Effective date.--The bill would be effective with respect to deposits required to be made on or after the date of enactment.

S. 740

S.740 (introduced on May 14, 1997, by Senator Daschle) would provide that no penalty shall be imposed for a one-year period beginning July 1, 1997, solely by reason of a failure to use EFTPS if the taxpayer was first required to use the EFTPS system on or after July 1, 1997.

C. Analysis

Some taxpayers are concerned about being required to participate in EFTPS without being given sufficient time or information to make adequate preparations.

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[39] IR-97-32.

S. 570 would significantly slow down the phasing-in of participation in EFTPS as compared with present law (as specified in Treasury regulations). The one-year moratorium on penalties on new participants in EFTPS provided by S. 740 could be accomplished by administrative action by the Treasury Department, instead of requiring legislative action.