

WORKER CLASSIFICATION:
EMPLOYEE
VERSUS
INDEPENDENT CONTRACTOR

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INTRODUCTION

Among the more contentious areas of federal tax law is the classification of workers for federal tax purposes. Recent changes in the job market, in particular in the health care and high-tech industries, have emphasized the difficulties workers and employers frequently have with proper classification of workers and the consequences of misclassification.

The decision to classify a worker as an independent contractor can be a significant benefit to the business owner, since there is no obligation to withhold federal income and social security tax from compensation paid to an independent contractor, nor is there an obligation to pay the employer's share of social security and unemployment taxes. An erroneous decision to classify workers as independent contractors, however, can have devastating consequences for the business owner, who may face substantial liability for income, social security and unemployment tax, as well as liability for interest and penalties.

This outline addresses common worker classification issues under federal tax law. The outline discusses the provisions of federal law which obligate an employer to withhold taxes from the wages of employees and to pay the employer's share of social security and unemployment taxes. The outline then addresses the so-called "twenty common law factors," to which the Internal Revenue Service refers in classifying workers as employees or independent

contractors, the safe harbor provisions of § 530 of the Revenue Act of 1978, and the application of the mitigation provisions of § 3509 of the Internal Revenue Code. The outline also discusses recent worker classification initiatives at the Internal Revenue Service, including the worker Classification Settlement Program and the Internal Revenue Service's draft training guide for agents who conduct employment tax audits. Finally, and perhaps most importantly, the outline discusses the recent legislation under the Small Business Jobs Protection Act of 1996 and the Taxpayer Relief Act of 1997 which gave jurisdiction to the United States Tax Court to decide worker classification cases.

A. WORKER CLASSIFICATION. WHY IS IT IMPORTANT?

1. Requirements Imposed on Employers

Several provisions of the Internal Revenue Code require employers to collect and withhold taxes from the wages of employees. Section 3102(a) of the Internal Revenue Code of 1986 (26 U.S.C.)¹ requires an employer to deduct Federal Insurance Contributions Act ("FICA") taxes from the employee's wages. Code § 3402(a) requires the withholding of federal income tax. These taxes are commonly referred to as "trust fund taxes," and the employer's failure to pay such taxes over to the Internal Revenue Service can result in imposition of the

¹ Unless otherwise noted, all further references to the Internal Revenue Code (Title 26, U.S.C.) will be to "Code § ____."

Trust Fund Recovery Penalty under Code § 6672. See *Slodov v. United States*, 436 U.S. 238, 242-243 (1978).²

In addition to the requirement to deduct and withhold FICA and income taxes from an employees wages, the employer is obligated under Code §§ 3111(a) and 3301(a), respectively, to pay the employer's share of FICA and Federal Unemployment ("FUTA") taxes. Accompanying the obligation to withhold and pay over these various taxes is the obligation to file various tax forms, including Forms W-2, W-3, 940 (Employer's Federal Unemployment Tax Return) and 941 (Employer's Federal Employment Tax Return).

Businesses that classify their workers as independent contractors are freed from the burden of collecting and withholding taxes, paying the employer's share of FICA and FUTA taxes and filing various required returns. Frequently, the only employment-related tax form required of a business using independent contractor labor is the Form 1099-Misc., used to report miscellaneous income.

There are significant benefits to be gained by treating workers as independent contractors. There is also a significant risk to the employer who makes an erroneous decision to classify workers as an independent contractors. As many business owners have discovered, an erroneous classification decision

2 Section 6672 imposes personal liability on persons within the employer's organization for the willful failure to collect, truthfully account for or pay over trust fund taxes. In addition, Code §§ 3102(b) and 3403 provide personal liability for the employer, whether it is a corporation, partnership or individual, for taxes required to be withheld under §§ 3102 and 3402.

can lead to the imposition of significant liability for tax, penalties and interest following an audit or employment tax compliance check.

In addition, there may be significant collateral consequences involved in reclassifying a worker as an employee, including possible liability for medical and health benefits, annual and sick leave, retirement plan benefits and stock options, and the recharacterization of expenses as unreimbursed employee business expenses for tax purposes.

2. Why Worker Classification is Important to the IRS

The question of worker classification is important to the Internal Revenue Service for an obvious reason: taxpayer compliance. The IRS estimates there is an annual "tax gap" of \$150 billion. The IRS believes the gap between the amount taxpayers pay and what the IRS believes is truly owed can be reduced significantly by shifting to employers the obligation to withhold tax and report amounts earned by workers.

Worker classification for federal tax purposes has been a minefield for some time, both for workers and employers. Adding to the confusion surrounding the issue was a directive from Congress in 1978 which prohibited the IRS from issuing any regulations or revenue rulings to clarify the worker classification issue. See § 530, Revenue Act of 1978, (P.L. 95-600), as amended by P.L. 96-167, P.L. 96-541, P.L. 97-248 and P.L. 99-514. At present, the IRS resolves worker classification issues by reference to:

1. Certain statutory rules classifying workers as independent contractors or employees;
2. The twenty common law factors;
3. The safe harbor provisions of § 530 of the Revenue Act of 1978;
4. Mitigation provisions under IRC § 3509;
5. Relief from payment of income tax pursuant to IRC § 3402(d);
6. Classification Settlement Program.

B. STATUTORY EMPLOYEES

At the outset, the question of worker classification may be governed by statute. The Internal Revenue Code specifies certain categories of workers who are deemed either to be statutory employees or, in some cases, who are treated as independent contractors for purposes of federal tax law. Among the types of statutory employees are corporate officers³ and certain drivers and traveling salesmen.⁴ Certain home workers and life insurance salesmen are treated as statutory employees for purposes of FICA taxes.⁵ On the other hand, certain real estate agents and direct sellers are deemed *not* to be employees for employment tax purposes.⁶

3 Internal Revenue Code §§ 3121(d)(1), 3306(i) and 3401(c).

4 Internal Revenue Code §§ 3121(d)(3)(A), 3121(d)(3)(D), 3306(i).

5 Internal Revenue Code §§ 3121(d)(3)(B) and 3121(d)(3)(C).

6 Internal Revenue Code § 3508(a).

C. WORKER CLASSIFICATION UNDER THE TWENTY COMMON LAW FACTORS

The primary test for determining whether a worker is an independent contractor or an employee is through application of the so-called twenty common law factors. In general, the common law test focuses on the degree of control exercised by the employer over the manner and means by which the job is completed. The employer need not actually direct and control performance of the job as long as it retains the right to do so.

In applying the common law test, the IRS has developed from the case law twenty factors to assess whether there is sufficient control present to establish an employer/employee relationship. Rev. Rul. 87-41, 1987-1 C.B. 296. These factors also form the basis for the questions on Form SS-8 which is used by the Internal Revenue Service to determine whether a worker is an employee or independent contractor. See Exhibit 1. The twenty factors include whether the worker:

1. Is required to comply with the employer's instructions;
2. Receives training from or at the direction of the employer;
3. Provides services which are integrated into the employer's business;
4. Is required to render the services personally;
5. Hires, supervises or pays others on behalf of the employer;
6. Maintains a continuing working relationship with the employer;

7. Is required to follow set working hours;
8. Works full time for the employer;
9. Performs the work on the employer's premises;
10. Performs the work in a sequence which the employer establishes;
11. Is required to submit regular oral or written reports to the employer;
12. Is paid periodically at set intervals, such as by the hour, week or month;
13. Receives payment for business or travel expenses;
14. Furnishes his or her own tools and materials;
15. Lacks a significant investment in the business or facilities used;
16. Cannot realize a profit or loss from his or her services;
17. Works for more than one employer at a time;
18. Makes his or her services available to the general public;
19. Can be fired by the employer; and/or
20. May quit work at any time without incurring liability to the employer.

In addition to the foregoing factors, there are other factors which may be considered, including the skill level required, whether benefits are provided, and the intent of the parties.

1. Regulations

Although the IRS has been precluded since 1978 from issuing regulations and revenue rulings dealing with the question of worker classification, Treasury Regulation § 31.3401(c)-1, originally issued in 1957 and amended in 1970, provides some minimal, additional guidance. The regulation describes an employer-employee relationship as follows:

(b) Generally the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is an employer. Other factors characteristic of an employer, but not necessarily present in every case, are the furnishing of tools and the furnishing of a place to work to the individual who performs the services. In general, if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods of accomplishing the result, he is not an employee.

Although the twenty common law factors serve as a guideline for determining worker classification issues, application of the factors requires subjective judgment on the part of the person reviewing a specific factual situation. Accordingly, inconsistent application of the factors by the IRS has

made it difficult for business owners to predict how the IRS will classify individuals who perform services for a particular business.

D. THE SECTION 530 "SAFE HARBOR"

IRS recharacterization of workers as employees for federal tax purposes has frequently had harsh consequences for businesses who erroneously classified workers as independent contractors. Employers who acted in good faith in classifying workers as independent contractors frequently have faced tax assessments for multiple years⁷ for amounts the IRS determined should have been withheld from the wages of workers. Together with interest and penalties, assertion of these liabilities have been fatal to the viability of a number of businesses.

Congress recognized the harsh consequences of worker reclassification when it enacted § 530 of the Revenue Act of 1978. Section 530 established safe harbor provisions under which taxpayers could avoid the harsh retroactive recharacterization of workers as employees. See H. Rep. 95-1748, 1978-3 (Vol. 1) C.B. 629. To take advantage of the § 530 safe harbor provisions, the employer must establish that:

⁷ In general, in the absence of the taxpayer's agreement, the IRS has three years from the date a return is filed to conduct an audit and assess additional tax. Code § 6501(a). In worker reclassification, cases, since no employment taxes would have been filed, there technically is no statute of limitations for assessment, and the IRS would not be precluded from asserting liabilities for multiple years. See Code §6501(c)(3) (tax may be assessed at any time when no return has been filed).

1. It did not treat the worker in question as an employee for any period;
2. It filed all required federal tax returns or forms, including information returns such as Forms 1099, with respect to the worker for all periods since 1978 on a basis consistent with its treatment of the worker as an independent contractor;
3. It did not treat as an employee any individual holding a substantially similar position to the employee; and
4. It had a reasonable basis in law for classifying the worker as an independent contractor.

Items 1 through 3 all relate to consistency of treatment, and are fairly straightforward. Essentially, to claim the benefit of the § 530 safe harbor, the employer must have treated the worker consistently as an independent contractor and must have issued any required Forms 1099 rather than Forms W-

2. A history of treating the worker in question, or a worker in a substantially similar position, as an employee during any period is fatal to a claim for relief under § 530.

The "reasonable basis" requirement is more problematic, and has been the most-frequent source of disputes with the IRS over the applicability of § 530. In general the "reasonable basis" part of the test is satisfied if the taxpayer acted in reasonable reliance on any one of the following:

- a. A past IRS audit of the taxpayer in which there was no assessment attributable to the treatment (for employment tax purposes) of the individuals holding positions substantially similar to the position in question;

b. It was a long-standing recognized practice of a significant segment of the industry in which such individual was engaged (the practice need not be uniform throughout an entire industry); or

c. Judicial precedent, published rulings or technical advice, a letter ruling, or a determination letter pertaining to the taxpayer.

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

Congress has directed that the "reasonable basis" test is to be liberally construed and applied. H.R. Rep. No. 95-1748, 95th Congress 2d Sess. 5 (1978), 1978-3 (Vol. 1) C.B. 629, 633. Similarly, in General Investment Corp. v. United States, 823 F.2d 337 (9th Cir. 1987), the Ninth Circuit held that the determination of what constitutes the relevant "industry" should be liberally construed in favor of the taxpayer in light of the remedial character of § 530.

A taxpayer who fails to meet any of the three § 530 "safe havens" may nevertheless be entitled to relief if it can demonstrate in some other manner, a reasonable basis for not treating the individual as an employee. Rev. Proc. 85-18, 1985-1 C.B. 518.

Thus, a reasonable basis was determined to exist where a taxpayer relies on the previous audit of another taxpayer. Rev. Rul. 83-152, 1983-2 C.B. 172. A reasonable basis also existed where the IRS audited an unincorporated trucking business without challenging the tax treatment of drivers, where the business was transferred to a corporation, where the nature of the trucking business remained unchanged after incorporation, and where the required information

returns were filed. T.A.M. 8320005. A "reasonable basis" was also established through an analysis of the degree of control exerted over workers based upon the language of Reg. § 31.3401(c)-1. American Institute of Family Relations v. United States, 79-1 U.S.T.C. ¶ 9364 (C.D.Cal. 1979). The court found that the workers (counselors) were under the taxpayer's control merely as to the result to be accomplished and not as to the means and methods for accomplishing the result.

In *Critical Care Register Nursing, Inc. v. United States*, 776 F. Supp. 1025 (E.D.Pa. 1991), the district court concluded that a business that provided registered nurses to hospitals had reasonably relied on a reading of the twenty common law factors in reaching the conclusion that its workers could properly be treated as independent contractors. The court noted that "[t]his conclusion is based on the fact that relief under § 530, according to the House Report, was deemed necessary when strict enforcement of the common law rules resulted in the reclassification of workers and the liability of taxpayers for employment taxes that had not been previously withheld and paid to the Treasury." *Id.* at 1028.

In *Queensgate Dental Family Practice, Inc. v. United States*, 91-2 U.S.T.C. ¶ 50,536 (D.Pa. 1991), the Court found a reasonable basis for classification of dentists working for a nonprofessional business corporation as independent contractors. In *Queensgate*, the president of the corporation telephoned counsel for the Pennsylvania Dental Board to find out how the

dentists should be classified. He was advised that it would be illegal for a nonprofessional business corporation to enter into an employer/employee relationship with a licensed dentist and that the dentists must be treated as independent contractors. The court concluded that the telephone inquiry constituted a good faith inquiry into the question of how the business should treat the dentists. Therefore, the business had a reasonable basis for treating the dentists as independent contractors and qualified for relief under § 530.

E. APPLICATION OF INTERNAL REVENUE CODE SECTION 3509

If a taxpayer facing reclassification of its workers is unable to take advantage of the safe harbor provisions of § 530, either because of inconsistent treatment of the workers in question or because of a lack of a reasonable basis for the classification decision, it may nevertheless take advantage of the mitigation provisions of § 3509 of the Internal Revenue Code. Under § 3509, if an employer subject to a reclassification decision did not intentionally disregard the withholding requirement and properly filed all information returns (Forms 1099), its liability for employment taxes is limited to:

1. The employer's portion of FICA;
2. 1.5% of the amount of wages paid the employee(s);
3. 20% of the amount of FICA that otherwise would be imposed;
4. Interest on the unpaid amounts; and
5. The amount of FUTA tax due.

If the employer has failed to file Forms 1099, but did not intentionally disregard the withholding requirement, the amounts due under 2 and 3, above, are increased to 3% and 40%, respectively. If the IRS believes there has been intentional disregard of the withholding requirements, the employer is liable for the full amount of FICA (both employer and employee portion), 20% of the amount of wages paid, interest, and applicable penalties, possibly including the civil fraud penalty.

F. RELIEF/ABATEMENT OF INCOME TAX UNDER IRC SECTION 3402(d)

In the event a worker is reclassified as an employee, IRC § 3402(d) provides that an employer will be able to avoid liability for income taxes that should have been withheld. In order to seek relief pursuant to this section, the taxpayer must submit Forms 4670 and 4669 reflecting that the employee(s) in question satisfied their income tax liability. See Exhibit 2.

Regardless, the employer may still remain liable for any penalties or additions to tax that apply as a result of the failure to withhold. Also, § 3402(d) relief is not available if § 3509 applies. IRC § 3509(d)(1)(C).

G. CLASSIFICATION SETTLEMENT PROGRAM

The IRS released the Classification Settlement Program (“CSP”) on March 5, 1996. This program represented a recognition by the IRS that absent a legislative solution, the problem of classifying a worker as an employee or independent contractor would continue. Accordingly, the CSP Program was an

attempt by the IRS to improve its procedures for resolving cases in which it believed a misclassification of workers had occurred. The CSP Program was an attempt to achieve the same settlement results when cases were appealed, however, accomplishes that result at the agent level.

If the taxpayer decides to accept a CSP offer, in essence, the taxpayer is admitting that it improperly treated workers as independent contractors for the year involved and will start treating those workers as employees in the future. If the taxpayer is unwilling to concede this issue and believes that the workers are independent contractors, the taxpayer should request a hearing before the IRS Appeals Office.

If the taxpayer decides to participate in the CSP, the taxpayer should first make a determination as to its level of compliance with the § 530 safe harbor. Based on this assessment, the CSP agreement will require either that the taxpayer pay 100 percent of one year's liability if not in compliance with § 530, or 25 percent of one year's liability if in compliance with § 530. It should be noted that the one-year liability is computed under § 3509, if applicable. A third option under CSP applies to a taxpayer entitled to § 530 safe harbor treatment who elects to prospectively treat workers as employees with assurance from the IRS that the § 530 safe harbor for earlier years will not be lost. The Small Business Job Protection Act of 1996 provides this assurance to taxpayers by statute.

It should be noted that the authority to execute CSP agreements is delegated only to supervisors, not revenue agents or revenue officers. In addition, the CSP is only a test program and the IRS will review the results at the end of two years (March 5, 1998) to decide whether to continue the program.

H. EARLY REFERRAL TO APPEALS

In Announcement 96-13, 1996-12 IRB 33, the IRS outlined on a one-year test basis (subsequently extended), a program for the early referral of employment tax cases to the Appeals Division. This is similar to the procedure that has been in place for coordinated exam cases. The one-year test period for the early referral procedure for employment taxes began March 18, 1996. The early referral procedure can be used where the employment tax portion of an IRS audit has been completed and the taxpayer disagrees with the agent's proposal, but the income tax audit is not complete.

The early referral program is optional for the taxpayer. Rev. Proc. 96-9 1996-2 IRB 15, outlines the procedure for a taxpayer wishing to take advantage of this program. The taxpayer may request that an employment tax issue be referred to Appeals by making a written request to the agent's manager. Assuming that the manager agrees that the facts have been adequately developed and that the issue involves employment taxes, the manager will instruct the agent to prepare an employment tax report and issue a 30-day letter.

The taxpayer then has 30 days to respond in writing and request the opportunity to conference the case at the Appeals level.

I. TRAINING MANUAL

The IRS recently undertook a major initiative to streamline its approach to worker classification tax audits. In 1996, the IRS issued a training guide to be used by IRS agents in conducting employment tax audits. In a memorandum accompanying the guide, IRS Commissioner Margaret Milner Richardson commented:

The issue of worker classification [has been] often mentioned as one of small business' greatest concerns. Responding to this concern, I pledged that the Service would emphasize in its worker classification training the principle that I have stated many times — that the interest of the Service is to assure that both the business and the worker, whether under the withholding rules or under the rules governing the self-employed, pay the proper amount of taxes.

The Commissioner went on to note that the training manual attempts to "identify, simplify, and clarify the factors that should be applied in order to accurately determine worker classification under the common law. . . . Finally, these training materials address the application of § 530 of the Revenue Act of 1978 to reinforce that § 530 should be actively considered during an examination."

The Internal Revenue Service released its new training materials on worker classification on August 2, 1996. The training materials demonstrate that the Internal Revenue Service is providing revenue agents and revenue officers with better guidance to insure that they treat the worker classification

issue in a fair and consistent manner, including the application of § 530, of the Revenue Act of 1978 (safe harbor provisions). The most significant development in the IRS's new approach, however, is the underlying premise of the new training materials which provide that either worker classification - independent contractor or employee - can be a valid and appropriate business choice. See Training, 3320-102(7-96), p.1-1. In addition, the training materials de-emphasize the twenty (20) common law factors for determining whether a worker is an employee or independent contractor.

J. SMALL BUSINESS JOB PROTECTION ACT

On August 20, 1996, the Small Business Job Protection Act (PL.104-188) was signed by the President which made limited but significant changes in the worker classification area. Although Congress introduced several other bills in an attempt to resolve the problem on a more comprehensive basis by adding additional safe harbors under which a taxpayer could treat a worker as an independent contractor, none of these bills would have totally eliminated the twenty common law factor standard. The following changes were made in the worker classification area:

1. Modification of § 3508 to treat newspaper carriers as direct sellers;
2. Requiring the IRS when it begins an employment tax audit to give the taxpayer written notice of the provisions of § 530;
3. Providing that § 530 is available without a prior determination by the IRS that the workers are employees;

4. Limiting the prior audit safe harbor to prior employment tax audits;
5. For purposes of the reasonable basis test under the § 530 safe harbor, clarifying that a “significant segment” of an industry is twenty-five percent and that “long-standing” does not need to be a practice which has been in existence for a minimum of ten years;
6. Shifting the burden of proof to the IRS if the taxpayer establishes *prima facie* a reasonable basis for having not treated workers as employees;
7. Providing that if a taxpayer starts to treat workers as employees, the § 530 protection for earlier years will not be lost; and
8. Requiring consideration of the relationship of the parties in determining whether workers have been consistently treated.

K. TAX COURT JURISDICTION

The Taxpayer Relief Act of 1997 (P.L. 105-34) expanded the Tax Court jurisdiction to include a *de nova* review of the IRS’s determination that a worker should be reclassified as an employee, or that the employer is not entitled to relief under § 530 of the Revenue Act of 1978 (Internal Revenue Code § 7436, Proceedings for Determination of Employment Status) (effective date August 5, 1997). In the past, it was necessary for the taxpayer to pay the withholding for one employee for one quarter in order to file a claim for refund and pursue litigation in either the Federal district court or the U.S. Court of Federal Claims. The new provision granting the Tax Court jurisdiction of employment tax disputes

allows the taxpayer to pursue litigation without first paying the tax. In addition, assessment and collection of the tax is suspended while the matter is pending in the Tax Court, the taxpayer is entitled to seek awards of costs and fees under § 7430, and interest will be tolled.

There are several open questions with respect to how broad the Tax Court's jurisdiction will be and whether the Tax Court will decide other related matters in the worker classification cases such as qualified plan and fringe benefit issues.

L. CONCLUSION

The issue of worker classification has been one of concern to the Internal Revenue Service for a number of years. With the "tax gap" estimated at \$150 billion per year, we can expect the IRS to continue to focus on worker classification issues. By placing the burden of withholding and the obligation of reporting on the employer, the IRS ensures that income that otherwise might escape taxation will be reported and tax on that income will be paid. The IRS's CSP program can be expected to do little to relieve the consequences to taxpayers faced with an adverse classification determination. Only when Congress steps in and provides clear guidelines can we expect some resolution in this area of the law.