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## WHY CONGRESS NEEDS TO FIX THE EMPLOYEE/ INDEPENDENT CONTRACTOR TAX RULES: PRINCIPLES, PERCEPTIONS, PROBLEMS, AND PROPOSALS

WALTER H. NUNNALLEE\*

### INTRODUCTION

America's ever changing economy and workforce have strained the classic employer/employee relationship. Businesses are having to adapt quickly to fluctuating work force needs, rapidly changing technologies, hiring freezes, and escalating administrative costs. Consequently, employers are increasingly hiring independent contractors for project and specialty work in lieu of the traditional long-term employee. Moreover, an expanding worker pool is seeking (or is willing to accept) independent contractor relationships that will provide part-time work to women with children, the elderly, moonlighters, and people on temporary layoff.<sup>1</sup>

Unfortunately, this trend toward using independent contractors (as opposed to employees) is escalating a tax problem which the income tax system is ill equipped to handle. Under the U.S. income tax system, anyone who provides services to another is classified as either an "employee" or "independent contractor."<sup>2</sup> There are no other classifications. The income tax consequences flowing from proper classification (to both the worker and the service recipient) are frequently substantial.<sup>3</sup> Likewise, the tax penalties for a misclassified worker can be devastating to all involved parties.<sup>4</sup>

The rules for determining proper worker classification date back to 1935 and represent a hodgepodge of requirements set forth by Congress, the Internal Revenue Service, and the courts.<sup>5</sup> The present worker classification rules are simply inadequate. Informed observers have de-

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1. For a thoughtful discussion of the increased use of independent contractors in the business community, see Dan R. Mastromarco, *The Rekindling Independent Contractor Debate*, 53 TAX NOTES 601 (1991).

2. See *infra* notes 110 - 124 and accompanying text.

3. See *infra* notes 12 - 70 and accompanying text.

4. See *infra* notes 81 - 109 and accompanying text.

5. See *infra* notes 110 - 144 and accompanying text.

scribed the rules as “radically confusing,”<sup>6</sup> as “placing in the hands of the [Internal Revenue Service] unacceptably wide discretion,”<sup>7</sup> and “as broken and cannot be fixed with only minor changes.”<sup>8</sup> Supreme Court Justice Scalia concluded that the rules have resulted in “venerable confusion.”<sup>9</sup>

Congress desperately needs to overhaul the current worker classification rules, but this is by no means an easy task. Because taxpayers, their advisors, and Government have competing interests, there is little consensus as to exactly how the rules “should” work. There is no shortage of proposals, however. Business groups, professional groups, and commentators have flooded Congress with recommendations.<sup>10</sup> It is, of course, ultimately up to Congress to fashion the most workable and equitable compromise of these various proposals.

This article does not attempt to offer a “best” set of rules — that has been attempted elsewhere.<sup>11</sup> Instead, this article: (i) strives to clarify the issues and problems by providing a rather detailed roadmap through the maze of current worker classification rules, (ii) categorizes and highlights key elements of recent proposals offered to Congress, and (iii) offers a set of general guidelines and principles Congress should consider in its effort to improve worker classification rules. Finally, this article joins a chorus of voices urging Congress to enact long overdue legislation that will address the problems created by the present worker classification rules.

Although worker classification rules may have a direct impact on state and local income tax withholding, state unemployment levies, worker’s compensation issues, Fair Labor Standards Act, Minimum Wage Act, etc., this article is limited to the “federal” income and employment tax rules.

### TAX CONSEQUENCES OF A PROPERLY CLASSIFIED WORKER

The Internal Revenue Service (IRS or Service) is convinced that an increasing number of employees are being misclassified as independent contractors. In 1984, the IRS estimated that the Government lost at least \$1.6 billion in tax revenues due to worker misclassification.<sup>12</sup> In 1987, the IRS began a pilot program entitled Employment Tax Examina-

6. From statements made by Representative Douglas Barnard, Democrat from Georgia, to the House Small Business Subcommittee on Exports, Tax Policy, and Special Problems on July 30, 1991. 10 Tax Mgmt. (BNA) at 915 (Aug. 5, 1991).

7. Mastromarco, *supra* note 1, at 606.

8. Robert K. Johnson and Stephen D. Rose, *Legislative Proposal On Classification of Workers As Employees Or Independent Contractors*, 55 TAX NOTES 821 (1992).

9. Ellin Rosenthal, *High Court Considers Independent Contractor Issue*, 54 TAX NOTES 415 (1992).

10. See *infra* notes 167 - 179 and accompanying text.

11. See, e.g., Mastromarco, *supra* note 1; Johnson and Rose, *supra* note 8.

12. See Mastromarco, *supra* note 1, at 607.

tion Program (ETEP) which dramatically increased the number of audits against employers (Employers) that use independent contractors.<sup>13</sup> According to the Commissioner's Annual Report, ETEP reclassified 77,000 workers in 1989 and imposed \$94 million in additional taxes and penalties.<sup>14</sup> Taxpayers and practitioners are both voicing loud objections to the increased audit pressure and are pleading for Congressional relief.<sup>15</sup>

Why are workers and the taxpayers to whom the workers are providing services (Service Recipients) so outraged by the worker classification rules? This can be answered only if one is first familiar with the tax consequences flowing from a properly classified employee (Employee) as contrasted with a properly classified independent contractor (IC).

### *Tax Consequences of Employee Status*

A properly classified Employee imposes upon the Service Recipient (in this case the Employer) a lengthy laundry list of tax responsibilities. For instance, the Employer must report each Employee's wages to the IRS on Form W-2 as well as other wage information on Form 941 (the quarterly payroll return).<sup>16</sup> More significantly, on behalf of each Employee, the Employer must withhold federal income taxes<sup>17</sup> and social security (FICA) taxes.<sup>18</sup> The Employer must also pay federal unemployment (FUTA) tax on behalf of the Employee.<sup>19</sup>

Furthermore, an Employer's obligation to its Employees many times runs well beyond the mere reporting of wages and withholding of taxes. For instance, the tax system allows an Employer to offer tax-favored fringe benefits to its Employees (but *only to its Employees*). For example, an Employer can provide its Employees with a tax-favored qualified retirement plan,<sup>20</sup> group-term life insurance,<sup>21</sup> an accident and health

13. *Id.* at 603.

14. *Id.*

15. See *infra* notes 167 - 179 and accompanying text.

16. See Daniel L. Morgan and Yale F. Goldberg, *Employees and Independent Contractors*, Tax Transactions Libr. (CCH), 73 (June, 1990).

17. I.R.C. § 3402 (1992).

18. See I.R.C. §§ 3101-3128 (1992). The Employer is required to withhold a stated percentage of the Employee's wages for Social Security Taxes. The current rate is 7.65% of the first \$57,600 of wages for 1993 (\$55,500 for 1992). The 7.65% tax rate is actually made up of two separate taxes: (i) the old age, survivors, and disability insurance tax (OASDI) is presently 6.2% (§ 3101 (a)); and (ii) the hospital insurance tax (HI) is currently 1.45% (§ 3101 (b)). The HI wage base is \$135,000 for 1993 (\$130,200 for 1992). These wage bases are adjusted annually for cost of living. Furthermore, the Employer is required to pay additional Social Security Taxes of 7.65% on the same wage base previously described. I.R.C. §§ 3101(a),(b) (1992). This creates an effective social security tax rate of 15.3% on the Employee's wage base.

19. See I.R.C. § 3301-3311 (1992).

20. See I.R.C. §§ 401 *et. seq.* (1992).

21. See I.R.C. § 79 (1992).

plan,<sup>22</sup> meals and lodging,<sup>23</sup> group legal services,<sup>24</sup> dependent child care,<sup>25</sup> educational assistance,<sup>26</sup> Employee discounts,<sup>27</sup> and various other Employee fringes.<sup>28</sup>

The above-listed Employee fringe benefits are tax-favored because the Employer is allowed to deduct the fringe benefit payment while the Employee can exclude the fringe benefit from taxable income. However, subject to limited exceptions,<sup>29</sup> an Employer must satisfy rigid nondiscrimination rules in order to qualify the fringe benefit for tax-favored treatment.<sup>30</sup> This generally means that the Employer must offer the fringe benefit to a broad range of Employees, and may not limit it primarily to highly-compensated Employees. Critically important, the fringe benefit nondiscrimination rules are applied to all actual and "deemed" Employees.<sup>31</sup> Consequently, a worker who is reclassified from IC status to Employee status will impose not only tax reporting and withholding obligations upon the Employer, but may violate the nondiscrimination requirements of the Employer's tax-favored fringe benefit plans.

### *Tax Consequences of Independent Contractor (IC) Status*

A Service Recipient who hires an IC has significantly less tax responsibilities than one hiring an Employee. A Service Recipient is not responsible for withholding any employment-related taxes for the IC. Nor is the Service Recipient required to include the IC in any of its Employee

22. See I.R.C. §§ 105 and 106 (1992).

23. See I.R.C. § 119 (1992).

24. See I.R.C. § 120 (1992). Pursuant to I.R.C. § 120(e), this provision terminated for taxable years beginning after June 30, 1992.

25. See I.R.C. § 129 (1992).

26. See I.R.C. § 127 (1992). Pursuant to I.R.C. § 127(d), this provision terminated for taxable years beginning after June 30, 1992.

27. See I.R.C. § 132(c) (1992).

28. See, e.g., I.R.C. §§ 132(d) (granting tax-favored status to working condition fringe benefits), 132(b) (granting tax-favored status to no-additional-cost services), and 132(e) (granting tax-favored status to qualified transportation fringe benefits).

29. There are no discrimination rules applicable to accident and health plans providing benefits pursuant to a licensed insurance company. However, employer-provided self insured medical reimbursement plans are subject to employee nondiscrimination requirements. See I.R.C. § 105(h) (1992). Furthermore, there are no discrimination rules for working condition fringes or de minimis fringes under section 132. See I.R.C. § 132(h)(1) (1992).

30. For example, the following tax-favored fringe benefits carry nondiscrimination requirements: qualified retirement plan benefits (See I.R.C. §§ 401(a)(26), 410(b), and 414(q) (1992)); group term life insurance (See I.R.C. § 79(d) (1992)); self-insured medical reimbursement plans (See I.R.C. § 105(h) (1992)); group legal services (See I.R.C. § 120(c)(1) (1992)); dependent care (See I.R.C. § 129(d)(2) (1992)); educational assistance programs (See I.R.C. § 127(b)(2) (1992)); no-additional-cost services and qualified employee discounts (See I.R.C. § 132(h)(1) (1992); and cafeteria plans (See I.R.C. § 125(b)(2) (1992)).

31. *Id.* None of the nondiscrimination statutes contains a provision that would exclude reclassified workers.

fringe benefit plans. The Service Recipient can satisfy its only filing requirement by filing Form 1099 (an information return) with the IRS,<sup>32</sup> which merely reports the amount of compensation paid to the IC. Consequently, the IC status of a worker reduces substantially the administrative tax burden otherwise imposed upon an Employer. Instead, the tax reporting and payment burden is largely shifted to the IC.

Unlike an Employee, an IC has a litany of tax responsibilities and consequences. The IC is required to remit her own estimated income taxes to the IRS on a quarterly basis.<sup>33</sup> The IC is also responsible for paying her own Self-Employment Contribution Act (SECA) taxes on her net self-employment income.<sup>34</sup> The IC's SECA tax is the complement to (and is computed in a manner very similar to) an Employee's FICA taxes. The IC's SECA tax approximates the amount of the Employer's and Employee's share of an Employee's FICA tax.<sup>35</sup> Moreover, an IC can deduct one half of the SECA tax for purposes of computing her adjusted gross income.<sup>36</sup> This deduction is designed to complement the rule that allows an Employee to exclude the Employer's portion of FICA taxes from gross income. The IC pays no FUTA tax.<sup>37</sup>

Although an IC has more onerous tax reporting and payment obligations than an Employee, an IC is also entitled to certain substantive tax benefits not available to an Employee. For example, in 1986 Congress enacted Section 67 of the Internal Revenue Code of 1986 ("Code") which allows deductions for "miscellaneous itemized deductions" only to the extent such aggregate expenses exceed 2 percent of a taxpayer's adjusted gross income.<sup>38</sup> An Employee's unreimbursed business expense is a classic miscellaneous itemized deduction.<sup>39</sup> Consequently, most Employees' business deductions are significantly reduced or eliminated altogether under the 2 percent floor of Section 67. By contrast, an IC's business expense is not a miscellaneous itemized deduction and is therefore not limited by Section 67.<sup>40</sup> The IC also has a potential tax advantage over the Employee with regard to the so-called home office deduction. Taxpayers who maintain an office in the home may be enti-

32. See I.R.C. § 6041 (1992).

33. See I.R.C. § 6654(c) (1992).

34. See I.R.C. §§ 1401 *et. seq.* (1992).

35. As discussed in note 18, *supra*, Social Security taxes are generally paid at an effective rate of 15.3% on the Employee's wage base. Likewise, an IC is required to pay Self-Employment Contribution Act (SECA) Taxes on his net self-employment income at an effective rate of 15.3% on the same net self-employment income base as applied to an Employee. See I.R.C. § 1402 (1992).

36. I.R.C. §§ 164(f), 1402(a)(12) (1992).

37. I.R.C. §§ 3301, 3306(a) (1992) (which impose FUTA taxes only upon "Employers").

38. I.R.C. § 67(a) (1992).

39. See I.R.C. §§ 62(a)(1), 63(d), and 67(b) (1992).

40. I.R.C. § 62(a)(1) generally provides that trade or business expenses of a nonemployee (e.g., an IC) are deductions from gross income, and are therefore not itemized or miscellaneous itemized deductions.

tled to deduct depreciation, repair and maintenance, utilities, and insurance allocable to the home office.<sup>41</sup> Moreover, a valid home office may allow a taxpayer to deduct certain travel expenses that would otherwise be nondeductible commuting expenses,<sup>42</sup> and would also expand the deduction for home office computers.<sup>43</sup> However, since a home is an inherently personal (nondeductible) asset, Congress has placed severe statutory limitations on the availability of home office deductions. More specifically, in most situations, Section 280A allows home office deductions to an IC only if the home office is used regularly and on an exclusive basis as the IC's "principal place of business."<sup>44</sup>

The Supreme Court recently adopted a fairly restrictive interpretation of the phrase "principal place of business" which will, in all likelihood, significantly restrict the availability of the home office deduction for many taxpayers.<sup>45</sup> However, regardless of how principal place of business is defined, it is much easier for an IC to qualify for a home office deduction than an Employee. This is because Section 280A imposes additional requirements upon Employees. More specifically, an Employee can take home office deductions only if the home office is her principal place of business *and* is "for the convenience of her Employer."<sup>46</sup> For most Employees, it is very difficult to establish that a home office is for the convenience of their Employer.<sup>47</sup> By contrast, the IC is not saddled

41. Generally, a taxpayer must satisfy the rigid requirements of I.R.C. 280A in order to take home office deductions.

42. Treasury Regulations §§ 1.162-2(e) and 1.262-1(b)(5) expressly provide that commuting costs from a taxpayer's residence to his place of business are not deductible trade or business expenses. However, in Revenue Ruling 90-23, the IRS has ruled that travel costs from a taxpayer's residence to a "temporary work location" are deductible trade or business expenses. Rev. Rul. 90-23, 1990-1 C.B. 23. A "temporary work location" is any work location (other than the taxpayer's "regular place of business") where the taxpayer performs services on an irregular or short-term basis. Consequently, it would seem logical that a taxpayer who can establish a valid home office under I.R.C. § 280A would have a much stronger argument that his business travel away from the home office was not a nondeductible commute.

43. I.R.C. § 280F places severe limitations on the amount and timing of deductions for home computers used for business purposes. However, these restrictions do not apply to a home computer used in a taxpayer's home office that satisfies the requirements of section 280A(c)(1). I.R.C. § 280F(d)(4)(B) (1992).

44. I.R.C. § 280A(c)(1) (1992).

45. *Commissioner v. Soliman*, 113 S. Ct. 701 (1993). In this case, the Supreme Court reversed a Fourth Circuit decision whereby the court of appeals adopted a liberal facts and circumstances test for determining whether the home office was a taxpayer's "principal place of business." In reversing the appeals court decision, the Supreme Court suggested that the home office must be the most important and significant place of business, and that the time spent at each work location should be given primary consideration. *Id.*

46. I.R.C. § 280A(c) (1992).

47. The IRS generally takes the position that it is virtually impossible for an employee who is supplied an office at work to establish that her home office is "for the convenience of the employer." For example, in *Weissman v. Commissioner*, 751 F.2d 512 (2d Cir. 1984), the Government argued that the "convenience of employer" test was failed where a college professor was supplied only a shared office at the library of the college.

with this “convenience of employer” requirement.

Moreover, there are other deductions available to an IC that are unavailable to an Employee. For example, historically<sup>48</sup> an IC could deduct 25 percent of his health insurance premiums as an unrestricted “above-the-line” deduction<sup>49</sup> while the Employee must treat the entire payment as a potentially restricted “itemized deduction.”<sup>50</sup> Moreover, an IC can fully deduct interest incurred in her trade or business,<sup>51</sup> while an Employee’s trade or business interest is not deductible at all.<sup>52</sup> For example, if an IC borrows money to buy a truck to use exclusively in her business, the interest on the loan would be fully deductible. By contrast, interest on the same loan to buy the same truck for use in an Employee’s trade or business would not be deductible at all.

Finally, each expense allowed to an IC that is unavailable to an Employee serves to create other indirect tax savings to an IC. This indirect tax savings occurs because many deductions otherwise allowed to taxpayers are reduced as the taxpayer’s adjusted gross income exceeds certain levels. Consequently, each expense allowed to an IC (that is unavailable to an Employee) reduces the IC’s adjusted gross income which, in turn, may increase the amount of other deductible items. For example, a taxpayer’s personal exemptions and dependency deductions are scaled back as his adjusted gross income exceeds certain levels.<sup>53</sup> Thus, IC deductions that reduce the IC’s adjusted gross income may also serve to preserve the deductibility of his personal exemptions and dependency deductions.

### *Observation*

Based on the foregoing, it should be clear that in many respects the substantive tax rules that apply to ICs are far different from those applying to Employees. One might intuitively assume (as some have)<sup>54</sup> that the overall tax rules favor IC status over Employee status. Based on the Service’s massive attempt to reclassify ICs as Employees, it would appear that the Government believes this to be true. However, closer analysis reveals that the IC tax rules are probably not inherently more pro taxpayer than the Employee tax rules.

48. Under I.R.C. § 162(l)(6), this deduction expired for taxable years beginning after June 30, 1992.

49. I.R.C. § 162(l) (1992).

50. See I.R.C. §§ 162(l), 213(d)(1)(C) (1992).

51. I.R.C. §§ 163(a), (h)(2)(A) (1992).

52. I.R.C. § 163(h)(2)(A) (1992).

53. For example, on a joint return, each personal exemption is reduced by 2 percentage points for each \$2,500 (or fraction thereof) by which the taxpayer’s adjusted gross income exceeds \$162,700 for 1993 (\$157,900 for 1992). I.R.C. § 151(d)(3) (1992). The threshold is increased annually for inflation. I.R.C. § 151(d)(4) (1992).

54. See Subotnik, *infra* note 72.



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It is true that ICs are allowed many deductions unavailable to Employees.<sup>55</sup> However, Employees are granted a long list of tax-favored fringe benefits that are generally unavailable to ICs.<sup>56</sup> One commentator recently estimated that tax-free fringe benefits represent about 17 percent of the average Employee's compensation package.<sup>57</sup> Moreover, many of the deductions that are technically allowed to an IC (and not to an Employee) are more apparent than real. For example, an IC's business expenses are not subject to the 2 percent miscellaneous itemized deduction limitation. However, an Employee's business expense that is reimbursed under an Employer's "accountable plan" also avoids this 2 percent limitation.<sup>58</sup> In all likelihood, most legitimate Employee business expenses are reimbursed under an accountable plan.<sup>59</sup> Consequently, in actuality most Employee business expenses are probably not limited under the 2 percent rule.

With regard to the home office deduction, it is easier for an IC to qualify than an Employee. However, the rules that do apply to ICs are restrictive enough to deny home office deductions to many ICs.<sup>60</sup> Even if an IC does qualify, the home office expenses are frequently *de minimis* because they must be prorated based on square footage of the entire house.<sup>61</sup> For example, if a home office only represents 10 percent of the area of the entire home, the IC typically can depreciate only 10 percent of the house and deduct only 10 percent of the utilities and insurance.

Regarding health insurance, historically an IC could deduct 25 percent of the premiums as an above-the-line deduction<sup>62</sup> while an Employee must treat 100 percent of such premiums as below-the-line deductions.<sup>63</sup> However, most Employees are entitled to exclude the entire amount of Employer-provided health insurance premiums as a tax-favored fringe benefit.<sup>64</sup> Moreover, many observers believe that ICs are far less likely to maintain health insurance plans than Employers.<sup>65</sup>

Regarding the interest deduction, the IC can deduct business interest<sup>66</sup>

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55. See *supra* notes 38 - 53 and accompanying text.

56. See *supra* notes 20 - 31 and accompanying text.

57. Mastromarco, *supra* note 1, at 609.

58. I.R.C. §§ 62(a)(2)(A), (c) (1992).

59. I.R.C. § 62(c) generally describes an "accountable plan."

60. Even if an IC uses her home office as her "principal place of business," she must also use the office "regularly and on an exclusive" basis for business. Consequently, even a *de minimis* "personal" use of the home office will deny the deduction altogether. See I.R.C. § 280A(c)(1) (1992). Furthermore, virtually all observers believe that the new Supreme Court decision of *Commissioner v. Soliman*, see note 45, will substantially reduce the availability of the home office deduction for ICs.

61. Prop. Treas. Reg. § 1.280A-2(i)(3), 45 Fed. Reg. 52399 (1980).

62. I.R.C. § 162(l) (1992).

63. See I.R.C. §§ 162(l), 213(d)(1)(C) (1992).

64. See *supra* notes 20 - 31 and accompanying text.

65. E.g., Mastromarco, *supra* note 1, at 609.

66. I.R.C. §§ 163(a), (h)(2)(A) (1992).

while the Employee cannot.<sup>67</sup> However, most true Employees do not incur interest in their capacities as Employees. If a business expenditure must be financed, it would be much more cost effective for the Employer to finance the expenditure and provide the benefit to the Employee — frequently as a tax-free fringe benefit.<sup>68</sup>

Finally, with respect to employment-related taxes, since 1990 the combined FICA rate on Employees is the same as the SECA rate on ICs.<sup>69</sup> Indeed, in many instances the Employee's FICA wage base is lower than that of the IC after factoring in Employee's excluded fringe benefits.<sup>70</sup> Consequently, the social security tax system does not inherently favor ICs over Employees. Thus, it should appear fairly clear that the structural tax rules do not in operation inherently favor ICs over Employees. What then is driving the Service's aggressive effort to reclassify ICs as Employees?

#### WHY THE SERVICE ADAMANTLY PURSUES RECLASSIFICATION

The Service is probably well aware that the substantive tax rules do not inherently favor ICs over Employees. However, the Service is convinced that, as a group, ICs report less of their actual gross income and overstate more of their deductions than Employees.<sup>71</sup> Is the Service right? Of course it is. Virtually every practitioner knows intuitively (if not actually) that ICs are more likely to violate the income tax reporting rules than Employees.<sup>72</sup> As one informed commentator concluded: "Self-employed individuals are widely known for evasion of the income tax, and tax administrators throughout the world have searched for ways to induce the self-employed to comply with their tax obligations."<sup>73</sup> The reason is quite simple. An Employee's gross income and taxes are reported and withheld at the source. Accordingly, it is extremely difficult for an Employee to understate compensation and/or fail to pay her taxes. By contrast, an IC has no taxes withheld at the source. Also, an IC

67. I.R.C. § 163(h)(2)(A) (1992).

68. See *supra* notes 20 - 31 and accompanying text.

69. See *supra* note 35.

70. For example, certain contributions to pension and health insurance plans are generally excluded from the Employee's FICA wage base, but are not deductible from the IC's SECA wage base. Compare I.R.C. §§ 1402 with 3121(a)(5) (1992). See also, Mastromarco, *supra* note 1, at 609.

71. The IRS has reported that over 60 percent of all non-filing taxpayers were self-employed people who dealt in cash, or were wage earners who had little tax withheld from their wages. *IRS Aims Initiatives at Nonfilers*, TNT, Sept. 30, 1992, available in LEXIS, Fedtax Library, TNT File.

72. As one commentator concluded: "In recent years, compliance studies have confirmed what we have long inferred from the regular pleas of so many of our vendors for cash - that the self-employed are woefully deficient in reporting their income, that Horatio Alger has a foot of clay." Dan Subotnik, *Equity For The Compliers: On Eliminating - OR Extending - The Two-Percent Rule*, 56 TAX NOTES 809, 810 (1992).

73. Piroška Soos, *Self-Employed Evasion and Tax Withholding: A Comparative Study and Analysis of the Issues*, 24 U.C. DAVIS L. REV. 108 (1990).

typically has little incentive to notify the IRS if the Service Recipient fails to file its Form 1099.<sup>74</sup> By contrast, an Employee typically will notify either his Employer or the Service if he fails to get his Form W-2, otherwise the Employee might not get credit for his withheld taxes. Moreover, the 2 percent limitation under Section 67 substantially reduces the ability of most Employees to overstate questionable miscellaneous business deductions. Of course, the 2 percent rule does not apply to ICs. Based on a 1984 study, the Service estimates that at least \$1.6 billion in tax revenues are lost annually due to noncompliance by misclassified ICs.<sup>75</sup> Based on a 1989 General Accounting Office study, the Service estimates that 38 percent of Service Recipients have misclassified Employees as ICs.<sup>76</sup> Moreover, the Service estimates that there are now at least 3.4 million misclassified workers.<sup>77</sup> Consequently, the Service's position is quite simple — the more it encourages (or requires) Service Recipients to classify workers as Employees, the more likely the workers will pay their fair share of taxes. In the abstract this is not a bad policy. However, as discussed later, the rules for applying this policy are frequently unfair and often prove to be unworkable.

One should also note that some commentators believe that the Service pursues reclassification, in part, to generate penalty and interest revenues for the Government.<sup>78</sup> However, this author believes that a desire for penalty revenue does not drive the Service's efforts to reclassify.<sup>79</sup> This author also believes that if a worker classification system was implemented ensuring comparable tax reporting compliance between Employees and ICs, the Service would quickly retreat from its aggressive reclassification position.

### *Observation*

In order to curb perceived rampant noncompliance, the Service is creating a tax environment that makes Service Recipients afraid to classify workers as ICs. The Service creates this fear by threatening to reclassify workers from IC status to Employee status on a large scale basis. A successful reclassification can create a significant (and possibly over-

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74. It is commonly perceived that many (if not most) ICs report their gross income based on the amounts reported on their Forms 1099. If an IC fails to receive a Form 1099 for moneys received, there is little immediate economic incentive to report the earnings since no taxes were withheld.

75. See Mastromarco, *supra* note 1, at 607.

76. *Id.*

77. *Id.*

78. *Id.* at 610 (where the author states: "Penalties by their nature, should not be a separate means to raise revenue, but rather a method by which the underlying, substantive tax laws to raise revenue are enforced.").

79. My conclusion is based primarily on private conversations with various officials with the Internal Revenue Service.

whelming) obligation for the parties involved.<sup>80</sup> The reclassification generates not only direct taxes, penalties, and interest, but also ripple effect costs. For example, the reclassification may cause the Service Recipient to violate an array of nondiscrimination rules that permeate the tax system.

### TAX CONSEQUENCES OF WORKER RECLASSIFICATION

When an IC is reclassified as an Employee, the Employer becomes liable for all or a portion of the income and FICA taxes that should have been withheld. In addition, the Employer is then liable for the Employer's portion of the FICA and FUTA taxes.<sup>81</sup> Moreover, a long laundry list of tax penalties (and interest) may be imposed.

For example, an Employer hit with a reclassified Employee may be subject to the following retroactive penalties: failure to file Forms 940 and 941,<sup>82</sup> failure to timely pay withheld income or employment taxes,<sup>83</sup> failure to timely deposit certain taxes,<sup>84</sup> and failure to file necessary information returns with the IRS on the worker-payee.<sup>85</sup> Additionally, when a Service Recipient is determined to have willfully neglected to file a return, or fraudulently failed to file a return, penalties may be substantially increased.<sup>86</sup>

Moreover, the obligations for certain back taxes can reach beyond the actual Employer and create personal liability for certain individuals known as "responsible persons."<sup>87</sup> This obligation is commonly referred to as the "100-percent penalty."<sup>88</sup> The penalty arises because the Employer is required to withhold an Employee's income taxes and the Employee's portion of FICA taxes. These withheld taxes are subject to a trust in favor of the Government and are aptly referred to as "trust fund" taxes.<sup>89</sup>

The 100-percent penalty is based *only* on the trust fund portion of employment taxes (i.e., income tax withholding and Employee's portion of FICA taxes). FUTA taxes and Employer's portion of FICA taxes *cannot* be collected through this penalty. Moreover, the 100-percent penalty is separate and distinct from the liability imposed upon the Employer for the trust fund taxes. Consequently, a responsible person cannot require

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80. See *infra* notes 81 - 109 and accompanying text.

81. See *supra* notes 18 - 19 and accompanying text.

82. I.R.C. § 6651(a) (1992).

83. I.R.C. § 6651(b) (1992).

84. I.R.C. § 6656(a) (1992).

85. I.R.C. §§ 6721 and 6722 (1992).

86. See I.R.C. §§ 6651(f)(1) and 6721(e) (1992).

87. I.R.C. § 6672 (1992).

88. *Id.*

89. I.R.C. § 7501 (1992).

the Service to pursue collection from the Employer first.<sup>90</sup>

A responsible person is personally liable for the 100-percent penalty and the penalty is not dischargeable in bankruptcy.<sup>91</sup> A responsible person is generally any person who "willfully" fails to collect or pay over the trust fund taxes, or who "willfully" attempts to defeat the payment of such taxes.<sup>92</sup> The Code defines a "person" (who may be "responsible") as including an officer or Employee of a corporation,<sup>93</sup> or a member or Employee of a partnership.<sup>94</sup> A person is liable for the 100-percent penalty if he has the "responsibility and duty" to pay over the trust fund taxes.<sup>95</sup> Whether a person is "responsible" is generally based on a facts and circumstance test. However, an individual will generally be considered a responsible person if she was in a position to direct which of the Employer's expenses will be paid.<sup>96</sup>

In addition to employment tax penalties, worker reclassification can unexpectedly (and retroactively) eliminate tax benefits previously granted to the Service Recipient and to the worker. As noted earlier,<sup>97</sup> an IC reclassified as an Employee can cause the Employer to have retroactively violated a legion of fringe benefit nondiscrimination rules applying to: qualified retirement plans, group term life insurance, self-insured medical reimbursement plans, COBRA requirements, group legal services, dependent care programs, educational assistance programs, no additional cost fringe benefits, qualified employee discount fringe benefits, and cafeteria plans. Furthermore, the courts have held that an IC who is reclassified as an Employee may bring suit to recover damages for not receiving benefits under the Employer's retirement plan.<sup>98</sup>

Employee reclassification can also create additional taxes, interest, and penalties for S Corporations that use stockholders as workers. As most students of the tax system know, an S Corporation's taxable income generally bypasses corporate taxation,<sup>99</sup> passes directly through to the stock-

90. See *Peterson v. United States*, 728 F. Supp. 624 (D. Idaho 1989); *Turchon v. United States*, 77 B.R. 398 (E.D.N.Y. 1987), *aff'd*, *In re Turchon*, 841 F.2d 1116 (2d Cir. 1988).

91. See 11 U.S.C. 523(a)(1); 11 U.S.C. 507(a)(7)(C) (1992).

92. I.R.C. § 6672 (1992); Rev. Rul. 54-158, 1954-1 C.B. 247.

93. I.R.C. § 6671(b) (1992).

94. *Id.*

95. In *Anderson v. United States*, 561 F.2d 162 (8th Cir. 1977), an accounting firm that oversaw the finances of an employer was deemed a responsible person for purposes of the 100-percent penalty.

96. *Id.*

97. *Supra* note 31 and accompanying text.

98. *Holt v. Winpisinger*, 811 F.2d 1532 (D.C. Cir. 1987); *Short v. Central States Pension Fund*, 729 F.2d 567 (8th Cir. 1984). The Supreme Court has recently held that the "common law" test for determining employee status applies for purposes of determining a worker's rights to retirement benefits under ERISA. This decision reversed a Fourth Circuit decision that would have defined Employee much more liberally for ERISA purposes. *Nationwide Mut. Ins. Co. v. Darden*, 112 S.Ct. 294 (1992).

99. See I.R.C. § 1363(a) (1992).

holder(s),<sup>100</sup> and is taxed exclusively on the stockholder's individual tax return.<sup>101</sup> Corporate dividends to an S Corporation's stockholders are generally income tax free<sup>102</sup> and *are not* subject to withholding, FICA, or FUTA taxes.<sup>103</sup> Consequently, closely-held S Corporations tend to pay a stockholder/worker dividends instead of compensation to avoid the employment-related taxes. However, an S Corporation that primarily or exclusively distributes dividends to a stockholder who is reclassified as an Employee will be subject to withholding, FICA, and FUTA taxes as well as penalties and interest.<sup>104</sup>

Finally, an IC who is reclassified as an Employee could theoretically lose (or have reduced) the following deductions: contributions to the reclassified IC's own retirement plan, businesses expenses unreimbursed under an "accountable plan," certain home office deductions (and related travel expenses), 25 percent of the cost of health insurance premiums, and trade or business interest with respect to the worker's "employment" status.<sup>105</sup> In addition, the loss or reduction of these deductions may serve to further scale back the worker's itemized deductions and personal exemptions.<sup>106</sup>

### Observation

Based on the foregoing, it should be clear to any reasonably informed taxpayer that the costs (in taxes, penalties, and interest) of a reclassified worker(s) can be devastating and far reaching. Indeed, some suggest that such penalties could push a cash-strapped business into bankruptcy.<sup>107</sup> Consequently, the mere existence of such substantial reclassification penalties places enormous power in the hands of the Service. The Service's power is magnified by the fact that there are few if any definitive standards for determining proper worker classification. The worker classification rules are a maze of complex and occasionally inconsistent rules found in a patchwork of Internal Revenue Code provisions, Tax Acts (not found in the Code), Treasury Regulations, cases, rulings, and administrative pronouncements.<sup>108</sup> Ultimately, the rules rely heavily on

100. I.R.C. § 1366(a) (1992).

101. I.R.C. §§ 1363(a), 1366(a) (1992).

102. Under I.R.C. § 1368(b), distributions by an S Corporation to its stockholders are generally tax free to the extent of the stockholder's basis in his stock.

103. For SECA tax purposes, dividends are expressly excluded from the definition of "net self-employment income." I.R.C. § 1402(a),(b) (1992).

104. *E.g.*, *Radtke v. United States*, 895 F.2d 1196 (7th Cir. 1990); *Spicer Accounting, Inc. v. United States*, 918 F.2d 90 (9th Cir. 1990); Rev. Rul. 74-44, 1974-1 C.B. 287.

105. *See supra* notes 33 - 52 and accompanying text.

106. *See supra* note 53 and accompanying text.

107. *E.g.*, Charles Davenport, *ABA Tax Section Meeting: Employment Tax Panel Reviews Relief Measures*, 56 TAX NOTES 841, 842 (1992); Rita L. Zeidner, *Industries Testify For and Against Tighter Employment Status Controls*, 56 TAX NOTES 405 (1992).

108. *See infra* notes 110 - 144 and accompanying text.

"facts and circumstances"<sup>109</sup> — an inherently messy standard. Such a standard (combined with enormous penalties) allows the Service to strike fear in the hearts of most Service Recipients. The Service's aggressive audit policy has indeed created an environment of fear for most informed Service Recipients. The only way to eliminate this fear is for taxpayers to simply treat all workers as Employees from the outset, which is precisely what the Service wants.

### SUMMARY OF WORKER CLASSIFICATION RULES

To the weak-hearted, the worker classification rules may appear overwhelming. Borrowing a quote from a well-known tax commentator, the worker classification rules could be aptly described as "a creation of prodigious complexity . . . essentially impenetrable to all but those with the time, talent, and determination to become a thoroughly prepared expert on the subject."<sup>110</sup>

When evaluating the classification rules, one should keep one overriding concept in mind: the rules are based primarily on employer-employee common law rules.<sup>111</sup> Consequently, the common law rules constitute the "general rules," and any other rules (statutory or otherwise) represent exceptions or modifications to the general rules. To be sure, Congress has infiltrated the common law general rules with a series of statutory special rules, safe harbors, and presumptions.

#### *General Rule (The Common Law "Control" Test)*

The Treasury Regulations generally provide that a worker is deemed an Employee for tax purposes if the Service Recipient "has the right to control" and direct the worker, not only as to result but also as to the details and means by which the result is accomplished.<sup>112</sup> This so-called control test is essentially a codification of the common law doctrine of *respondeat superior* applicable to tort actions.<sup>113</sup> In applying the control test, courts typically look to the "substance" of the relationship rather than the "form."<sup>114</sup> Furthermore, the control test focuses primarily on

109. See *infra* notes 111 - 124 and accompanying text.

110. Lawrence Lokken, *Partnership Allocations*, 41 TAX L. REV. 547 (1986). Professor Lokken used this statement to describe the horribly complex regulations under I.R.C. § 704(b). However, this quote is equally applicable to the worker classification rules.

111. See I.R.C. § 3121(d)(2) (1992) (making common law rules determining worker status applicable for FICA tax purpose). See also I.R.C. § 3306(i) (1992) (making common law rules applicable for FUTA tax purposes). Although I.R.C. § 3401 does not expressly apply the common law rules for income tax withholding purposes, courts typically do apply the rules for withholding purposes. *E.g.*, *Lanigan Storage & Van Co. v. United States*, 389 F.2d 337 (6th Cir. 1968).

112. See *Treas. Reg.* §§ 31.3121(d)-1 (1986) (FICA), 31.3306(i)-1 (1986) (FUTA), and 31.3401(c)-1 (1986) (income tax withholding).

113. *Lifetime Siding, Inc. v. United States*, 359 F.2d 657 (2d Cir. 1966).

114. See, *e.g.*, *Illinois Tri-Seal Prods., Inc. v. United States*, 353 F.2d 216 (1965).

the Service Recipient's control over the details and means by which work is performed, not control over the end results.<sup>115</sup> Moreover, the Treasury Regulations make it clear that Employee status is not based on the actual exercise of control. Instead, it is sufficient that the alleged Employer has the "right to control," whether or not the right is actually exercised.<sup>116</sup>

In determining whether a Service Recipient has the requisite control over a worker, the courts have relied on a large (and cumbersome) laundry list of factors. Some commentators have observed that courts may, in the aggregate, consider up to fifty factors.<sup>117</sup> However, the Service has ruled that it will focus primarily on twenty factors.<sup>118</sup> Today, many practitioners use these twenty factors as a checklist for avoiding Employee status.

It is beyond the scope of this article to review each of the twenty factors in detail. However, the following is a brief survey of these factors:<sup>119</sup>

- (1) *Instructions.* The Service Recipient's right to instruct the worker on "how" the work is to be performed supports Employee status.
- (2) *Training.* Ongoing and organized training programs for workers imply Employee status.
- (3) *Integration.* A Service Recipient should make sure that the Worker does not integrate his operations with that of the Service Recipient in order to support IC status.
- (4) *Services Rendered Personally.* IC status is further supported if the worker is not required to render the services personally.
- (5) *Hiring and Supervision.* ICs should control their own helpers and such helpers should be Employees of the IC.
- (6) *Continuing Relationship.* Even the appearance of a permanent working relationship between the Worker and Service Recipient suggests Employee status.
- (7) *Set Hours of Work.* ICs should have the authority to set their own work schedules and that of their assistants and helpers.
- (8) *Full Time Required.* If the Service Recipient requires the worker to work fulltime (or a minimum number of hours or days), Employee status is implied.
- (9) *Work On Employer's Premises.* To help avoid Employee status, ICs should not be given office space or work stations on the Service Recipient's premises.
- (10) *Sequence of Work.* ICs should establish their own timetables and priorities, and should not be required to perform services in a particular sequence.

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115. See, e.g., *United States v. Polk*, 550 F.2d 566 (9th Cir. 1977).

116. Treas. Reg. § 31.3401(c)-1(b) (1986).

117. See Daniel L. Morgan and Yale F. Goldberg, *Employees and Independent Contractors*, Tax Transactions Libr. (CCH), 221 (Apr. 1991).

118. Rev. Rul. 87-41, 1987 C.B. 296.

119. *Id.*



- (11) *Reports*. The IC should be responsible only to the ultimate customer. The IC should never be required or encouraged to make progress or final reports to the alleged Employer.
- (12) *Payment Terms*. If possible, the IC should be paid by job, not by the hour, week, or month.
- (13) *Business/Travel Expenses*. If the Service Recipient pays for the Worker's licenses, meals, or transportation expenses, Employee status is implied. Such expenses should be covered in the IC's overall contract price.
- (14) *Tools and Materials*. The IC should be responsible for furnishing his own tools and equipment (and for determining which tools he needs).
- (15) *Significant Investment*. The larger the IC's financial investment in her own business enterprise (e.g., premises, inventories, supplies, vehicles, and equipment), the more she looks like an independent business person and less like an Employee.
- (16) *Realization of Profit Or Loss*. The IC should operate in a fashion so that he bears the ultimate risks for profit or loss from his business enterprise. The ultimate customer should pay the IC directly and the IC should carry his own liability insurance coverage.
- (17) *Multiple Customers*. The IC should avoid working exclusively for the alleged Employer. The IC should clearly establish that he offers his services to outsiders.
- (18) *Offering Service to the Public*. The IC should document that she offers her services to the public generally by advertising, placing her business name in the telephone directory, and using business cards.
- (19) *Right to Discharge*. The alleged Employer should avoid retaining the right to fire the IC at will (this indicates Employee status). Instead, the alleged Employer should merely avoid giving the IC further work if the alleged Employer is dissatisfied.
- (20) *Right to Terminate*. Employees generally have the right to quit anytime without incurring liability. By contrast, an IC contracts to perform an agreed upon "result." The agreement should quantify the measure of damages if the IC does not complete satisfactorily the bargained for result.

The Service indicates that the above-listed factors should serve only as guides, and not as rules of law.<sup>120</sup> The degree of importance of each factor depends on the worker's occupation and the context in which the services are performed. In other words, the Service will weigh the twenty factors on a case-by-case basis. According to some commentators, courts tend to place greater emphasis on certain factors.<sup>121</sup> Furthermore, courts frequently consider control factors in addition to the Service's twenty factors.<sup>122</sup> Finally, the Treasury Regulations generally provide that cer-

120. *Id.* at 298.

121. See Morgan and Goldberg, *supra* note 117, at 211.01.

122. *Id.* at 211.

tain trades or professions are inherently independent such as: physicians, lawyers, dentists, veterinarians, construction contractors, public stenographers, and auctioneers (provided they offer services to the public).<sup>123</sup>

### *Observation*

Congress long ago recognized that the common law control test (based on facts and circumstances) is fraught with uncertainty. Such a test could unfairly cause reclassification to an unsuspecting or ill-advised taxpayer. Consequently, Congress enacted Section 530 of the Revenue Act of 1978<sup>124</sup> (Section 530) creating a safe harbor from the harsh retroactive recharacterization penalties under the common law test.

### *The Section 530 Safe Harbor*

Initially, Congress intended Section 530 to be temporary until Congress could agree upon a set of rules more workable than the common law test.<sup>125</sup> However, Congress has yet to fashion an alternative test and Section 530 remains in effect today,<sup>126</sup> even though it was never made part of the Internal Revenue Code.

Section 530 generally provides that a taxpayer who demonstrates a "reasonable basis" for not treating a worker as an Employee is protected against retroactive assessment of employment taxes.<sup>127</sup> However, the Service generally presumes that a taxpayer who seeks Section 530 relief for a worker automatically concedes that the Worker is otherwise an Employee.<sup>128</sup> As discussed later, this presumption can create traps for unsuspecting taxpayers.

Section 530 relief is available only if the Service Recipient has a "reasonable basis" for treating a worker as an IC. A taxpayer can satisfy this reasonable basis test only if he meets any one of three alternative tests. The first test requires the taxpayer to demonstrate that he reasonably relied on judicial precedent, a published IRS ruling, a technical advice memorandum, or a private letter ruling pertaining to the taxpayer.<sup>129</sup> The second test requires the taxpayer to show that she has been subject to a past IRS audit (whether or not an employment tax audit) which did

123. Treas. Reg. §§ 31.3121(d)-1, 31.3306(i)-1, and 31.3401(c)-1(c) (1986).

124. Revenue Act of 1978, Pub. L. No. 95-600, 92 Stat. 2763, as amended by Act of Dec. 29, 1979, Pub. L. 96-167, 93 Stat. 1275, Tax Treatment Extension Act of 1980, Pub. L. 96-541, *reprinted in*, 1980-2 C.B. 596, The Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248, 96 Stat. 325, and Pub. L. 99-514, *reprinted in*, 1986-3 (Vol. 1) C.B. 1.

125. See Revenue Act of 1978, 95th Cong., 2d Sess. (1978), 1978-3 C.B. 315, 507-08.

126. See The Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, § 269(c), 96 Stat. 325.

127. See Revenue Act of 1978, Pub. L. No. 95-600, § 530(a)(1)(B), 92 Stat. 2763.

128. See Rev. Proc. 85-18, 1985-1 C.B. 518, at § 3.08. See also General Explanation of the Tax Reform Act of 1986, P.L. 99-514, H.R. 3838, 99th Cong.

129. Revenue Act of 1978, Pub. L. No. 95-600, § 530(a)(2)(A), 92 Stat. 2763.

not result in the assessment of employment taxes based on misclassification of workers holding substantially similar positions.<sup>130</sup> Finally, the third test requires the taxpayer to establish that a significant segment of his industry has a long-standing practice of treating that type of worker as an IC.<sup>131</sup>

Both the Service and Congress recognize that Section 530 is a very powerful safe harbor, and many taxpayers could (and probably would) abuse its use if it had no limitations. Consequently, the Service and Congress have adopted positions that attempt to curb widespread abuse of Section 530.

For example, the Service takes the position that the "industry practice" under the third test is determined on a nationwide basis.<sup>132</sup> The Ninth Circuit Court of Appeals, however, has disagreed by concluding that industry practice allows a taxpayer to look to the employment tax practices of the taxpayer's industry in the taxpayer's immediate vicinity.<sup>133</sup>

Congress feared that taxpayers might attempt to switch existing Employees to ICs and later claim relief under Section 530. Consequently, Section 530 provides that its relief is not available with respect to any worker (or any other worker holding a "substantially similar position") who was treated by the Service Recipient as an Employee for any tax period.<sup>134</sup> As expected, the IRS rigidly applies this so-called consistency rule against taxpayers.<sup>135</sup>

In the early 1980s Congress became convinced that too many taxpayers in the technical service industries were becoming overly aggressive in using Section 530, creating unfair competition with respect to the more responsible taxpayers. Consequently, as part of the Tax Reform Act of 1986,<sup>136</sup> Congress passed Section 1706<sup>137</sup> adding new subsection (d) to Act Section 530. Section 1706 now denies Section 530 relief to certain technical service workers including engineers, designers, draftsmen, computer programmers, systems analysts, or other similarly situated workers. In other words, the above-listed technical service workers are classified using *only* the common law control test — Section 530 relief is wholly unavailable.

130. *Id.* at § 530(a)(2)(B). The Service has also held that the audit need not be an employment tax audit. Rev. Proc. 85-18, 1985-1 C.B. 518.

131. Revenue Act of 1978, Pub. L. No. 95-600, § 530(a)(2)(C), 92 Stat. 2763.

132. See Priv. Ltr. Rul. 8733004 (Apr. 23, 1987), Priv. Ltr. Rul. 8749001 (Feb. 10, 1987).

133. *General Inv. Corp. v. United States*, 823 F.2d 337 (9th Cir. 1987).

134. Revenue Act of 1978, Pub. L. No. 95-600, 530(a)(3), 92 Stat. 2763.

135. The IRS has taken the position that Section 530 relief is unavailable if a Form 1099 was not timely filed for the worker. Rev. Rul. 81-224, 1981-2 C.B. 197.

136. Tax Reform Act of 1986, Pub. L. 99-313, 99th Cong., 2nd Sess. (1986).

137. *Id.* at § 1706.

In 1987, the Service issued Revenue Ruling 87-41<sup>138</sup> providing further guidance on the application of Section 1706. For instance, the ruling makes it clear that Section 1706 applies only to three-party "broker" arrangements involving technical service workers. For example, Section 1706 would apply to a situation whereby a third-party broker arranged to supply a computer programmer to a Service Recipient. However, Section 1706 would apply *only* to the broker (i.e., the Service Recipient could still assert a Section 530 defense). Moreover, if the Service Recipient contracted directly with the computer programmer (and no broker was involved), Section 1706 would have no application and Section 530 relief would be available to the Service Recipient.

### *Observation*

Section 530 (as amended by Section 1706) is fraught with uncertainties and many of its undefined terms and phrases have created excessive litigation.<sup>139</sup> Furthermore, Section 530 only applies relief from assessment of employment taxes.<sup>140</sup> Consequently, Section 530 can operate as an insidious trap for unwary taxpayers who use it to avoid employment tax assessments, and thus unexpectedly violate the fringe benefit non-discrimination rules. This trap is exacerbated by the Service's position that anyone seeking Section 530 relief is automatically conceding that the worker is otherwise an Employee.<sup>141</sup>

### *"Statutory" Employees and ICs*

Congress has decided (or been persuaded by special interest groups) that certain types of workers should automatically be treated as Employees or as ICs. Consequently, Congress has enacted statutes that, for employment tax purposes only, statutorily classify workers as either Employees or ICs. For example, in 1982 Congress enacted section 3508 which treats the following workers as ICs: "qualified real estate agents" (certain commissioned licensed real estate agents), and "direct sellers" (certain commissioned workers who sell consumer products in their homes).<sup>142</sup>

By contrast, for certain employment tax purposes and if specified conditions are met, the following workers are statutorily treated as Employees: corporate officers, certain commissioned truck drivers, certain full-time life insurance salesmen, certain home workers, and certain traveling

138. 1987-1 C.B. 296.

139. See *infra* note 163.

140. Revenue Act of 1978, Pub. L. No. 95-600, § 530(a)(1)(A), 92 Stat. 2763.

141. See *supra* note 128.

142. I.R.C. § 3508 (1992). This statute contains many special rules and technical prerequisites that are beyond the scope of this article.

salesmen.<sup>143</sup> However, some of these so-called statutory employees can still qualify as ICs for purposes of section 62 (above the line deductions) and section 67 (miscellaneous itemized deductions).<sup>144</sup>

### *Observation*

It is apparent that Congress sometimes feels that the worker classification rules are too onerous, and at other times that they are too lenient. For instance, the Section 530 safe harbor was enacted because the rules were deemed too harsh, but Section 1706 was passed because the rules were believed to be too lenient. Likewise, Congress has also wrestled with whether the penalties that result from a reclassified worker are too harsh or too lenient. To date, it appears that Congress believes that worker reclassification penalties are generally too burdensome. Consequently, Congress has enacted several statutes granting worker reclassification "penalty" relief.

### WORKER RECLASSIFICATION PENALTY RELIEF

In 1982, Congress enacted Section 3509 which does not affect whether a worker is reclassified, but instead reduces the amount that would otherwise be assessed against the Employer of a reclassified worker.<sup>145</sup> Section 3509 relief applies only to income tax withholding and the Employee's share of FICA taxes.<sup>146</sup> It *does not* apply to FUTA taxes, the Employer's portion of FICA taxes, or interest and penalties. Moreover, Section 3509 is not available at all to certain statutory Employees if the Service Recipient intentionally disregarded the worker reclassification rules, or if the Employer deducted income withholding tax but did not deduct FICA taxes.<sup>147</sup>

Section 3509 is mandatory when it applies.<sup>148</sup> If the Employer properly and timely filed Form 1099 for the reclassified worker, the Section 3509 assessment is: 20 percent of the reclassified Employee's share of FICA tax that should have been withheld, and 1.5 percent of the Employee's wages paid for income tax withholding liability.<sup>149</sup> Furthermore, if the Employer did not properly and timely file the Form 1099, the Section 3509 assessments listed above are doubled.<sup>150</sup>

Like most rules in the worker reclassification area, section 3509 has

143. See I.R.C. §§ 3401(c), 3121(d)(1),(3) (1992). These statutes contain many special rules and technical prerequisites that are beyond the scope of this article.

144. See Rev. Rul. 90-23, 1990-1 C.B. 28.

145. I.R.C. § 3509 (1992).

146. I.R.C. § 3509(a) (1992).

147. I.R.C. §§ 3509(c), (d)(2) (1992).

148. I.R.C. § 3509(a) (1992); Treas. Reg. § 31.3509-1(c)(ii) (1986).

149. I.R.C. § 3509(a) (1992).

150. I.R.C. § 3509(b) (1992).

traps for the unsuspecting taxpayer. For example, an Employee gets no reduction in his liability for income taxes and FICA taxes assessed against the Employer under Section 3509.<sup>151</sup> Furthermore, the Employer cannot reduce his Section 3509 assessment by any income tax or FICA tax actually paid by the Employee.<sup>152</sup>

If section 3509 does not apply (e.g., the Worker is a statutory Employee; the Employer intentionally disregarded the applicable rules; or the Employer deducted income tax withholding but did not deduct FICA taxes), then the Employer may be allowed a tax reduction if the reclassified workers paid their own taxes. For instance, Section 3402(d) authorizes an Employer to credit against her proposed assessment any income taxes paid by the worker.<sup>153</sup> Likewise, section 6521(a) authorizes a similar credit for FICA taxes previously paid by the reclassified worker.<sup>154</sup> However, there are several limitations and restrictions to these so-called "abatement" provisions which may limit their availability to the Employer.<sup>155</sup>

#### WHY THE EXISTING RULES DON'T WORK

The worker classification rules fail at many levels. Ultimately, however, the rules fail because they are premised upon an unworkable and impractical "facts and circumstances" test. This does not suggest that facts and circumstances determinations are never appropriate in our tax system. Indeed, it would be unreasonable to expect our tax system to establish definitive and objective rules for all potential tax matters. As expected, the tax system frequently and appropriately embraces a facts and circumstances approach to matters that are inherently fuzzy. For example, the Supreme Court has long held that the deductibility of an "ordinary and necessary" business expense will be determined on a case-by-case basis.<sup>156</sup> This makes sense because the term "ordinary and necessary" (i) is not self defining, (ii) requires flexibility, and (iii) in the vast majority of cases, expenses incurred by an operating trade or business will be presumed ordinary and necessary. Therefore, such a test is needed to accommodate rapidly changing business practices and would only in fact be applied to a small minority of business expenditures.

By contrast, the worker classification issue potentially applies to every

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151. See Rev. Rul. 86-111, 1986-1 C.B. 176.

152. I.R.C. § 3509 (d)(1)(B) (1992).

153. I.R.C. § 3402(d) (1992).

154. I.R.C. § 6521(a) (1992).

155. I.R.C. § 3402(d) generally provides that an employer's income tax withholding liability can be abated only if it can adequately demonstrate that the worker reported and paid tax on the income. The abatement does not eliminate employer liability for penalties or additions to tax. See Treas. Reg. § 31.3402(d)-1 (1986).

156. *Welch v. Helvering*, 290 U.S. 111 (1933).

worker in the United States. A tax system should not (and perhaps cannot) tolerate a facts and circumstances determination on such a large scale basis. This would be analogous to adopting a case-by-case determination of how business entities are to be taxed. Imagine a tax system that would require owners of business entities to apply a facts and circumstances test in determining whether their entity would be taxed as a partnership,<sup>157</sup> a C Corporation,<sup>158</sup> or an S Corporation.<sup>159</sup> The business community would not and should not tolerate such a system. It seems clear that such a system is equally inappropriate with regard to worker classification.

Furthermore, the facts and circumstances test that is presently being applied to worker classification issues is particularly weak. For example, the courts frequently state that they will look at the "substance" of a worker relationship rather than the "form."<sup>160</sup> Thus, a Service Recipient cannot rely on a written contract with a worker to ensure IC status if the parties fail (intentionally or unintentionally) to follow its terms. By contrast, the Treasury Regulations make it clear that Employee status exists if the Service Recipient merely has the "right to control" the worker, whether or not the right is actually exercised.<sup>161</sup>

These rules effectively place the Service Recipient in a no win situation. If the Service Recipient has no contractual right to control the worker but does so anyway, Employee status is found. If the Service Recipient has a contractual right to control the worker but never does so, Employee status is still found.

As stated previously,<sup>162</sup> Congress presumably recognizes that the common law control test is unwieldy, unpredictable, and frequently inequitable. Consequently, it adopted the safe harbor provisions of Section 530 to provide a safe haven for unsuspecting taxpayers. However, Section 530 is at best a band-aid remedy to the problems surrounding the common law test. Section 530 creates its own uncertainty by adopting ill-defined terms that have spawned litigation.<sup>163</sup> Moreover, Section 530 is at the same time too broad and too narrow. For instance, it is too narrow because it applies only to employment taxes and certain segments of

157. Subchapter K of the Internal Revenue Code of 1986, sections 701 through 761, establishes comprehensive rules for taxing partnerships.

158. Subchapter C of the Internal Revenue Code of 1986, sections 301 through 385, establishes comprehensive rules for taxing corporations that fail to be taxed under Subchapter S.

159. Subchapter S of the Internal Revenue Code of 1986, sections 1361 through 1378, establishes comprehensive rules for taxing S corporations that qualify and elect to do so.

160. *E.g.*, *Illinois Tri-Seal Prods., Inc. v. United States*, 353 F.2d 216 (1965).

161. *Treas. Reg. § 31.3401(c)-1(b)* (1986).

162. *See supra* note 124 and accompanying text.

163. *See e.g.*, *General Inv. Corp. v. United States*, 823 F.2d 337 (9th Cir. 1987) (the court was asked to determine whether "industry practice" meant "nationwide" or in the taxpayer's immediate vicinity); *American Institute of Family Relations v. United States*, No. CV 72-1402 WMB, 1979 WL 1347 (C.D. Cal. Feb. 22, 1979) (dealing with definition of "reasonable basis").

business.<sup>164</sup> This creates unnecessary tax traps relating to Employee nondiscrimination rules, and horizontal tax inequity among similarly situated businesses. In contrast, Section 530 is too broad because of the prior audit rule. The prior audit rule allows a Service Recipient to avoid reclassification simply because an IRS agent failed to raise the issue on audit.<sup>165</sup> A similarly situated business that is audited by a more thorough agent cannot use Section 530. Again, this creates unjustifiable horizontal inequities between comparable businesses.

Finally, for many offending taxpayers, the penalties for reclassification far outweigh the crime. It is inherently unfair to have a penalty structure that can literally bankrupt a business when the penalty relates to a facts and circumstances test. Penalties should be designed to encourage a taxpayer's behavior that will improve compliance. However, as one commentator states: "The problem with conforming taxpayer behavior [under the current worker classification rules] is that, in many cases, the taxpayer does not know what the proper behavior is."<sup>166</sup> In other words, the harsh penalties for worker reclassification are frequently unfair when applied to a taxpayer who reasonably believed that he satisfied the common law control test. Moreover, certain reclassification penalties are unknown even to reasonably informed taxpayers and, therefore, cannot encourage tax compliance. For example, in all likelihood, the fact that a reclassified worker could violate various fringe benefit nondiscrimination rules is frequently overlooked by taxpayers.

### OVERVIEW OF CURRENT PROPOSALS

In response to the Service's intensified audit efforts, there has been a recent flurry of proposals for improving the worker classification rules. The proposals have come from Congressmen, bar associations, the American Institute of Certified Public Accountants, Congressional subcommittees, and various business groups. Although there seems to be a consensus that the worker classification rules desperately need improvement, there is little consensus as to exactly how the rules should work. The proposals do, however, fall into four major categories: (i) a revision of Section 530 to curb perceived abuses and inequities, (ii) tax amnesty plans allowing Service Recipients to voluntarily reclassify workers without penalty, (iii) more objective worker classification safe harbor rules, and (iv) measures to improve reporting compliance by Service Recipients and ICs. A more detailed review of each of these categories is helpful.

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164. See *supra* notes 127 - 141 and accompanying text.

165. See *supra* note 130 and accompanying text.

166. Mastromarco, *supra* note 1, at 610.



*Proposed Section 530 Revisions*

Section 530 allows a taxpayer to avoid worker reclassification if he can demonstrate a "reasonable basis for not treating a worker as an Employee." As discussed previously,<sup>167</sup> a Service Recipient can satisfy the reasonable basis test only if he can demonstrate that: he reasonably relied on certain authoritative precedents, a significant segment of his industry has historically treated that type of worker as an IC, or he has been subject to a past IRS audit which did not result in the assessment of employment taxes (prior audit rule).

Many believe that the prior audit rule should be eliminated because it creates inequities between comparable taxpayers. It is commonly assumed that our tax system should strive to promote and preserve horizontal tax equity. That is, similarly situated taxpayers should be taxed under the same rules unless persuasive reasons suggest otherwise. The prior audit rule dilutes horizontal tax equity because it grants a taxpayer more favorable tax treatment (in perpetuity) simply because an examining agent failed to recognize that the taxpayer was misclassifying its workers. Such a broad safe harbor based on fortuitous circumstances erodes taxpayer confidence in the tax system, and can create unfair competitive advantages in the business world. Consequently, the American Institute of Certified Public Accountants recommends that the prior audit rules apply *only if* the prior audit raised the worker status issue on substantially similar facts.<sup>168</sup> Furthermore, several Congressmen<sup>169</sup> have proposed that the prior audit rule be repealed altogether.

*Tax Amnesty Plans*

Few would disagree that the penalties for worker reclassification can be (and many times are) extremely harsh. Excessive penalties can occur even where the taxpayer honestly believed that she satisfied the common law control test. Such a harsh penalty structure inhibits a taxpayer from voluntarily reclassifying an IC as an Employee even though the taxpayer knows that the worker is misclassified. Consequently, several proposals recommend a tax amnesty plan allowing taxpayers to voluntarily reclassify ICs as Employees without penalty. One proposal would allow for only a two-year amnesty,<sup>170</sup> while another proposes an indefinite am-

167. See *supra* notes 124 - 141 and accompanying text.

168. Hearing on Independent Contractors Before the Committee on Small Business of the United States House of Representatives, 102d Cong., 1st Sess., (July 30, 1991) (Statement of the Tax Division of the American Institute of Certified Public Accountants) (July 30, 1991) [hereinafter AICPA Statement]. This statement was reprinted as part of seminar materials presented at the May 1992 American Bar Association Section of Taxation meeting entitled "Resurgence of the Employee-Independent Contractor Controversy."

169. See H.R. 3813, 102d Cong., 1st Sess. (1991) (introduced by Rep. T. Lantos, D-CA).

170. See H.R. 3109, 102d Cong., 1st Sess. (1991).

nesty.<sup>171</sup> One proposal operates as a tax amnesty by recommending that all worker reclassifications be prospective only.<sup>172</sup> Some of the amnesty proposals require a taxpayer to demonstrate that either it misclassified workers based on a good faith misunderstanding of the rules, or it properly filed all tax forms regarding the misclassified worker.<sup>173</sup> A primary objective of these amnesty proposals is to encourage more misclassified ICs to come back into the tax system which, in turn, will improve tax compliance for large numbers of taxpayers.

### *Worker Classification Safe Harbors*

Many believe that the current worker classification rules need to be more objective and predictable. To this end, several groups and commentators have proposed new safe harbor classification rules which, if satisfied, would *guarantee* that a worker would not be re-classified. For example, instead of using the current 20-factor test, one proposal would look *only* at the following six factors to determine Employee status:<sup>174</sup>

- (1) The Service Recipient and worker mutually agree that the worker is not an Employee.
- (2) The businesses of the Service Recipient and the worker are managed independently.
- (3) The worker's principal place of business is not located at the Service Recipient's facilities.
- (4) The worker offers similar services to the general public or employs other workers.
- (5) The worker risks significant fluctuations in income.
- (6) The worker provides services under a written agreement containing specified provisions that support IC status.

If the Service Recipient satisfies each of these factors, IC status would be guaranteed. Otherwise, she would have to rely on the common law control test.

One enterprising proposal suggests that all workers should be classified as Employees for withholding tax purposes unless the worker meets either of two ironclad safe harbors. The first safe harbor would allow nonemployee status if the worker certified that his service trade or business expenses exceed 20 percent of the worker's net income from such

171. See H.R. 5011, 102d Cong., 2d Sess. (1992) (introduced by Reps. D. Barnard, D-GA, E. Jenkins, D-GA, and M. Siskey, D-VA [hereinafter H.R. 5011]; H.R. 3813, 102d Cong., 1st Sess. (1991).

172. Mastromarco, *supra* note 1, at 610; AICPA Statement, *supra* note 168, at 125 (proposing prospective reclassification only if Forms 1099 were properly filed and there was no evidence of fraud).

173. E.g., Johnson and Rose, *supra* note 8, at 827 (this proposal recommends a retroactive amnesty provided certain conditions were met); H.R. 4216, 102d Cong., 2d Sess. (1992) (introduced by Rep. T. Lantos, D-CA).

174. AICPA Statement, *supra* note 168, at 124.

services.<sup>175</sup> The theory here is that forcing withholding on a worker with high business expenses would cause undue cash flow problems to the worker because of over-withholding of taxes. The second safe harbor would ensure IC status if the worker failed to work for the Service Recipient a minimum number of days in the previous quarter.<sup>176</sup> These two objective tests would replace the common law factors presently used to classify workers.

### *Improve Reporting Compliance*

Many believe that the primary problem with the current worker classification rules is that too many ICs are under-reporting gross income. Reasons for this noncompliance include: taxpayer ignorance of complex rules, too many Service Recipients failing to file Forms 1099 for their workers, and the Service's failure to aggressively match the filed Forms 1099 with the IC's tax return. Consequently, groups and commentators have proposed that the Service and tax practitioners strive to educate the business community regarding worker classification rules and responsibilities through seminars, newsletters, etc.<sup>177</sup> Others have recommended that more Service Recipients be required to file Forms 1099, and the failure to file penalties be increased (particularly if the worker is shown to have underpaid his taxes).<sup>178</sup> Finally, several commentators have urged the Service to implement a program that will aggressively match the Form 1099 information with the information filed on the IC's tax return.<sup>179</sup>

### FINAL OBSERVATION AND SUGGESTIONS

It is relatively clear that there is no single best solution to the worker classification dilemma. Whatever solution Congress adopts will inevitably be a compromise. The number of different proposals illustrates that there are at least three competing interests. The Service is primarily interested in taxpayer reporting compliance and raising tax revenue. Taxpayers yearn for horizontal equity and reduced administrative costs. Tax advisors seek more predictability and consistency in the worker classification rules. Consequently, there is no real consensus as to how the rules should work. Indeed, there is little consensus even within the business community on what the definition of an IC should be. As one commentator put it: "The business community has historically failed to reach

175. Johnson and Rose, *supra* note 8, at 822.

176. *Id.*

177. AICPA Statement, *supra* note 168, at 126-127.

178. See Mastromarco, *supra* note 1; AICPA Statement, *supra* note 168, at 127; H.R. 5011 (which would lower the threshold for reporting payments to ICs from \$600 to \$100, and would dramatically increase the penalties for failing to file Forms 1099).

179. Mastromarco, *supra* note 1, at 609-10.

agreement among its members as to an appropriate definition for independent contractor status.”<sup>180</sup>

Consequently, it would be presumptuous for this article or any article to propose a “best” set of rules that should be applied to worker classifications. Instead, Congress is urged to develop its own compromise pulling from the many proposals that have been offered. However, in establishing its new worker classification rules, there are certain guidelines and principles that Congress should address.

There is little disagreement that Congress should reject the current common law facts and circumstances test as its primary test. Instead, worker classification should rely on the fewest and the most objective standards possible. A more objective approach not only improves compliance but fosters the perception that similarly situated taxpayers are being taxed comparably.

Congress should also reduce the tax incentives that appear to favor ICs over Employees. So long as the substantive tax rules appear to favor ICs, workers will strive to manipulate whatever rules exist to achieve IC status. Consequently, Congress should seriously consider whether the differing treatment of miscellaneous itemized deductions, trade or business interest, and home office deductions are justified. At least one commentator has suggested that the differing tax treatment should be eliminated in order to promote horizontal tax equity.<sup>181</sup>

The rules should not be so onerous and rigid as to discourage temporary employment. An overly broad definition of Employee stifles business opportunities for true entrepreneurs, discourages hiring of new workers, and encourages Employers to squeeze more work out of its existing Employees. Congress should recognize that ICs are a vital part of the U.S. economy and the worker classification rules should not be skewed in a manner that will unduly hamper opportunities for ICs.

However the term Employee is ultimately defined, the same definition should be used for all tax purposes. It would be unworkable to have one definition of Employee for tax withholding purposes and another definition for retirement, accident, and health and other fringe benefit plans. Congress should not attempt to define Employee only for tax withholding purposes as some proposals seem to do.

The rules should promote horizontal tax equity. To this end, there should be no safe harbor provisions that benefit only certain segments of business as is currently the case under Section 530. A tax environment where taxpayers believe that they are being treated equitably with other comparable taxpayers will encourage taxpayer compliance. Safe harbors

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180. *Id.* at 602.

181. Subotnik, *supra* note 72.

that are established should be based on objective standards and should not create competitive advantages between comparable industries.

Congress should not base its rules on the erroneous assumption that the “substantive” tax rules inherently favor ICs over Employees. Instead, Congress should recognize that the present “reporting” rules inherently favor ICs over Employees. Consequently, the focus should not be on how to force a large number of ICs into Employee status. Instead, the focus should be how to improve the present reporting rules to ensure that ICs have comparable compliance rates with Employees.

Finally, Congress needs to encourage businesses with misclassified workers to voluntarily reclassify the workers as Employees. An easy and direct way to accomplish this is to provide taxpayers with a tax amnesty for voluntary conversion.

In conclusion, revision of the worker classification rules is long overdue. Congress has ample proposals from which to choose. It is time for Congress to agree upon a workable and informed compromise and go with it.