Employees vs. Independent Contractors

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I. INTRODUCTION

A. The classification of a worker as an employee or an independent contractor (sometimes referred to as "IC") for federal income and employment tax purposes is a critical issue for both the worker and the employer. For purposes of this outline, the term "employer" shall be used to include a party contracting with either an independent contractor or an employee.

1. Classification affects amounts subject to withholding and amounts taxed; employee benefits and qualified plans.

2. Misclassification can result in fines and penalties.

B. The Internal Revenue Service ("IRS") is aggressively examining employee/independent contractor issues after years of more moderate activity, causing the characterization issue to become more crucial than ever before. An IRS study revealed that over 90% of the 1,196 taxpayers studied owed additional employment taxes. As a response, the IRS has stepped up audit efforts in the employee/independent contractor area. Sumutka and Bonnier, "Independent Contractor or Employer?", 59 CPA Journal 54 (Nov. 1989). In 1988, the IRS announced that over 400 revenue officers in the collection division of the IRS have been trained in employment tax issues. As a result, as of March 1988, over 9,000 delinquent employment tax returns were filed and the IRS issued assessments against 92% of the selected employers. IR 88-45 (March 2, 1988). A number of recent private letter rulings demonstrate the increasingly vigorous attack of the IRS on independent contractor status. See, PLR 9012041 (December 22, 1989); PLR 9012040 (December 20, 1989); PLR 9010020 (December 7, 1989).

C. The classification of a worker as an employee or an IC can have state tax, as well as federal tax, implications. This outline does not address state tax issues.

II. IMPORTANCE OF CHARACTERIZATION

Characterizing a worker as an independent contractor rather than as an employee has a significant effect on both the worker and the employer.
A. Employment Taxes.

1. If an individual is an employee, the employer is responsible for contributions or withholding in three areas:

   (a) Federal income tax withholding - Every employer paying wages must deduct and withhold federal income taxes on such wages. § 3402. Unless otherwise indicated, all Section references in this outline are to the Internal Revenue Code of 1986, as amended ("Code").

   (b) Federal Insurance Contributions Act ("FICA") taxes - The employer is subject to an excise tax equal to 6.2% of the wages paid to each of its employees. § 3111. In addition, the employer is responsible for withholding the employees' share of FICA contributions from its employees' wages. An employee's share of FICA is also equal to 6.2% of his wages. § 3101, § 3102; and

   (c) Federal Unemployment Tax Act ("FUTA") taxes - An excise tax of 6.2% of the total wages paid by an employer is imposed on each employer with respect to the individuals in its employ. § 3301. Subject to certain limitations, the employer may, however, credit against up to 90% of this tax the amount of contributions paid by the employer into a state unemployment fund maintained under the state's unemployment compensation law. § 3302.

2. If an IC, the worker is responsible for his own taxes:

   (a) The worker's income will be subject to the tax imposed by the Self Employment Contributions Act ("SECA"), which is the equivalent of FICA for self-employed individuals. In 1990, taxes under SECA were 12.4%. § 1401.

   (b) The worker benefits from classification as an IC because his cash flow is increased when income and FICA taxes are not withheld.

   (c) Employers benefit by characterizing a worker as an IC because the characterization relieves their responsibility for FUTA taxes and matching FICA taxes and because it reduces the administrative burdens associated with
accounting for and withholding employment taxes.

(d) Self-employed individuals will be responsible for making estimated income tax payments on their income. § 6654.

(e) Employers must report payments to an independent contractor to the IRS on an information return if the aggregate payments to the independent contractor exceed $600 in one year. The employer must furnish a written statement to the IC setting forth the amount of reported payments if an information return is filed with the IRS. §§ 6041, 6041A; IRS Form 1099-MISC.

3. As FICA wage levels and rates rise, the incentive for workers and employers to recharacterize an employee as an independent contractor will increase. In 1990, the maximum amount of wages subject to FICA or self-employment taxes is $51,300, a $3,300 increase from 1989. §§ 1401, 1402, 3101, 3121.

B. Employee Business Expenses.

1. Under Section 162, employees may deduct certain work-related expenses that are not reimbursed by an employer. According to Temporary Treasury Regulation 1.67-1T, these expenses may include the cost of transportation, travel fares, meals and lodging while away from home, professional dues, continuing education courses and the cost of local transportation incurred in connection with the employee's performance of services. An employee's ability to deduct these expenses is, however, limited to the extent the aggregate of the expenses exceeds 2% of the employee's adjusted gross income. ("AGI"). § 67(a); see, Schedule A to IRS Form 1040.

2. An IC may deduct business expenses without regard to the 2% of AGI rule. Because an IC's business expenses are not treated as itemized deductions under Section 62(a)(2), the expenses are deducted directly from the IC's AGI. See, Schedule C to IRS Form 1040.
C. Employee Benefits.

1. Employees may exclude certain employer-provided benefits from income. These benefits include:
   
   (a) payments from accident and health plans maintained by an employer under Section 105;
   
   (b) the cost of the first $50,000 of group life insurance under Section 79;
   
   (c) tuition reduction provided to employees of educational institutions for undergraduate education under Section 117(d); and
   
   (d) nontaxable benefits elected under cafeteria plans pursuant to Section 125.

2. Because ICs are not employees, ICs must include in income the value of the benefits listed in C.1(a) - (d) above in income. Generally, employers prefer to characterize workers as ICs rather than employees to reduce the number of persons includable in qualified plans.

3. Employees of certain qualified employers (primarily tax exempt organizations, public schools and certain state and municipal bodies) may exclude amounts contributed by their employer to a qualifying annuity contract purchased by the employer under a plan meeting the requirements of Section 404(a)(2). § 403(b). ICs hired by qualified employers would not be entitled to exclude such contributions from their gross income.

4. ICs hired by tax exempt organizations or state and local governments can be treated as employees for purposes of participating in a Section 457 qualifying deferred compensation plan of such employer. § 457(e)(2).

D. Nondiscrimination, Exclusive Benefit and Minimum Participation Requirements. Qualified pension and profit sharing plans and certain other employee benefit plans are required to meet extensive nondiscrimination, exclusive benefit and minimum participation requirements. See §§ 401, 410. The classification of a worker as an employee or an IC may affect whether a plan meets these requirements; therefore, the reclassification of an IC as an employee could cause an otherwise qualified plan to lose its qualified tax status.
E. **Tax Evasion.** Many workers prefer IC status because it is harder for the IRS to track their income. A 1981 study conducted by the IRS concluded that only 41% of self-employment income was voluntarily reported. U. S. Department of Treasury, Internal Revenue Service, "Income Tax Compliance Research: Estimates for 1973 - 1981" (July 1983), cited in Hulen, "Incorrect Determination of Worker Status can lead to Penalties, but Relief is Available," 37 Taxation for Accountants 108 (August 1986).

F. **KEOGH and IRA Plans.**

1. Classification as an IC affects a worker's ability to make deductible contributions to a qualified plan benefitting self-employed individuals ("KEOGH Plan"). Employees cannot deduct contributions to KEOGH Plans. *Herman v. Commissioner*, 52 TCM 1194 (1986).

2. ICs may set up and deduct contributions to individual retirement accounts ("IRAs"). § 219(a). Employees covered by a plan at work may not be able to deduct IRAs.

G. **Miscellaneous Benefits and Laws.** Certain benefits are available to, and certain laws apply to, employees but not to ICs. For example, employees, but not ICs, are:

1. protected from discrimination by their employers under the Civil Rights Act of 1964 and the Age Discrimination in Employment Act;

2. entitled to certain rights and benefits under the Occupational Safety and Health Act of 1970; and


The characterization of a worker as an employee or an IC is also relevant for purposes of the following laws: the Americans with Disabilities Act of 1990, the Copyright Act of 1976, the Fair Employment and Housing Act and the National Labor Relations Act.

H. **Penalties and Interest.** With the new focus on compliance with tax laws through penalties, the IRS and the courts are more likely than ever to punish misclassifications of workers. Until the recent changes
in the penalty rules, employers had every reason to take aggressive positions. Now that the risk of penalties and above market interest exists, employers must carefully review the classification of workers as employees and ICs.

III. DEFINITION OF EMPLOYEE

Any one of four relationships may exist between an employer and a worker. The worker may be a statutory employee, a statutory IC, a common law employee or a common law IC.

A. Statutory Determinations. Regardless of common law status, the Code specifies the employment status of certain categories of workers.

1. Statutory Independent Contractors: For employment tax purposes, Section 3508 treats "qualified real estate agents" and "direct sellers" as ICs. § 3508(a). However, these persons may still be considered employees for purposes of qualified pension, profit sharing and stock bonus plans. § 3508(b)(3); § 401(c).

(a) "Qualified Real Estate Agents." A real estate agent will be treated as an IC if three tests are satisfied:

(i) the person must be a licensed real estate agent;

(ii) substantially all the person's compensation (defined as at least 90% of total remuneration) for services as an agent must be related to sales or output rather than hours worked; and

(iii) the agent must have a written contract with the employer providing that the agent is not an employee for federal tax purposes. § 3508(b)(1).

(b) "Direct Sellers." Section 3508 defines a direct seller as a person engaged in selling (or soliciting the sale of) consumer products in the home or in a place other than a permanent retail establishment. Consumer products are any tangible personal property normally used for personal, family or household purposes. Prop. Treas. Reg. § 31.3508-1(g)(3). Direct sellers also include persons who sell (or solicit the sale
of) consumer products on a buy-sell basis, a
deposit commission basis or similar basis for
resale in the home or other than a permanent
establishment. § 3508(b)(2). To qualify as a
direct seller:

(i) substantially all the compensation
received by the direct seller must be
based on sales rather than hours worked,
and

(ii) a written contract between the seller and
employer must specify that the direct
seller is not an employee for federal tax
purposes. § 3508(b)(2).

(c) Under Treasury Regulation Section
31.3401(c)-1(c), doctors, lawyers, veteri-
narians, contractors and others who engage in
an independent trade, business or profession
in which they offer their services to the
public are not employees. A director of a
corporation is an independent contractor.

2. Statutory Employees. The term "employee" is
defined in three different Code provisions dealing
with employment taxes.

(a) Section 3401(c) (relating to income tax with-
holding) states that an employee includes an
officer, employee, or elected official of the
United States, a state, any political sub-
division thereof, or the District of Columbia,
or any agency or instrumentality of any one or
more of the foregoing. Section 3401(c) also
states that the term employee includes an
officer of a corporation. Because the term
employee is not comprehensively defined in
Section 3401(c), most authorities use the
definition contained in Section 3121(d)
(relating to FICA withholding) for types of
employees not specifically mentioned in Sec-
tion 3401(c).

(b) Section 3121(d) (relating to FICA withholding)
defines an employee as including the
following:

(i) an officer of a corporation;

(ii) an agent or commission driver who deli-
vers produce, baked goods, beverages,
meat or laundry for a principal;
(iii) a full time life insurance salesman;

(iv) a person working at home under the direction of the party that provides the materials and supplies the work;

(v) a traveling salesman; and

(vi) any individual who qualifies as an employee under common law rules (discussed at III.B. below).

A person will not be considered an employee under Section 3121(d) if the individual has a substantial investment in facilities used in connection with the performance of his services (other than transportation facilities) or if the services are not part of a continuing relationship with the person for whom the services are performed.

(C) Section 3306(i) (relating to FUTA) uses the definition of employee contained in Section 3121(d) (discussed at III.A.2.(b) above), but exempts full-time life insurance salesmen and homeworkers from employee status.

B. Common Law Determination. Since most workers are not specifically covered by the statutory definitions of employee and ICs, the determination for federal tax purposes is usually made under common law rules. The common law rules focus on "control." Under these rules, a worker is an employee if the employer has the right to control and direct when, where and how the worker performs his tasks. The employer need not exercise this control; it is sufficient if the employer has the right to exercise control. Treas. Reg. § 31.3401(c)-1(b).

1. The IRS has developed a list of twenty common law factors to use in determining if a worker is an employee. Generally, these factors focus on the amount of control the employer has over worker, both with respect to the result to be accomplished and as to the details and means by which the result is accomplished. Where an employer controls or has the right to control a worker, the worker is an employee. Rev. Rul. 87-41, 1987-1 CB 296; see also Internal Revenue Manual Exhibit 5(10)00-4. These factors are as follows:

(a) Instructions: A worker who is required to comply with another person's instructions
about when, where and how he is to work is ordinarily an employee. It is not necessary that instructions be given; the employer simply must possess the right to give the instructions.

(b) Training: Training a worker indicates that the employer exercises control over the means by which the result is accomplished.

(c) Integration: When the success or continuation of a business depends to an appreciable degree on the performance of certain services, the workers performing those services are subject to a certain amount of control by the owner of the business.

(d) Services rendered personally: If services must be rendered personally, the employer is presumably interested in the methods used to accomplish the work as well as in the results of the work, indicating that the employer controls both the means and the results of the work.

(e) Hiring, supervising and paying assistants: If the employer hires, supervises and pays a worker's assistants, it has demonstrated control over the worker.

(f) Continuing relationship: A continuing relationship between the worker and the employer indicates that an employer-employee relationship exists. It does not matter if the work is provided on a part-time or on call basis or if it is performed irregularly.

(g) Set hours of work: The establishment of set hours of work by the employer is a factor indicating control. If set hours are not applicable to a particular occupation, a requirement that the worker perform services at certain times may demonstrate control.

(h) Full time required: If the worker must devote substantially full time to the employer's business, the employer has control over the worker. An independent contractor, on the other hand, is free to work when and for whom he chooses.

(i) Doing work on the employer's premises: if the work is performed on the employer's premises,
that factor indicates the employer has control over the worker. If work must be done away from the employer's premises (e.g., sales, construction), the right of an employer to designate a travel route, or to require work at a specific location or territory indicates control.

(j) Order or sequence set: Control is indicated if a worker is not free to choose his own pattern of work, but must perform services in the sequence set by the employer.

(k) Oral or written reports: A requirement that the worker must submit regular oral or written reports to the employer indicates control.

(l) Payment by hour, week or month: Payment by the hour, week or month points to an employer-employee relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed on as the cost of a job. Payment by the job or on a straight commission generally indicates the worker is an independent contractor.

(m) Payment of business and/or traveling expenses: Payment of the worker's business and/or traveling expenses indicates an employer-employee relationship.

(n) Furnishing tools and materials: If the employer furnishes significant tools, materials and other equipment, an employer-employee relationship usually exists.

(o) Significant investment: A worker is usually an IC if he invests in facilities that are not typically maintained by employees (such as the maintenance of an office rented at fair value from an unrelated party). A lack of such investment indicates an employer-employee relationship. Generally, facilities include equipment or premises necessary for work (e.g., office furniture), but do not include tools, instruments or clothing commonly provided by employees in their trade, nor does it include education, experience or training. The investment must be real—buying machinery on time from the employer may not count if the employer retains title and can elect to purchase it back from the worker. The invest-
ment must also be essential to perform the services in question. Furthermore, the investment must be adequate for the work in question and independent of the facilities of the employer.

(p) Realization of profit or loss: A worker who can realize a profit or a loss (in addition to the profit or loss ordinarily realized by employees) is an IC, but the worker who cannot is generally an employee. Profit or loss generally contemplates the use of capital in an independent business; commissions or piece work pay are not "profits" in this sense.

(q) Working for more than one firm at a time: If a worker performs more than de minimis services for a number of unrelated persons at the same time, he is usually an IC.

(r) Services available to the general public: A worker is usually an IC if he makes his services available to the general public on a regular and consistent basis. Advertising may be relevant.

(s) Right to discharge: The employer's right to discharge a worker is a factor indicating that the worker is an employee. An IC generally cannot be discharged unless his work does not meet contract specifications.

(t) Right to terminate: A worker is usually an employee if he has the right to end his relationship with his employer at any time without incurring liability. An IC is normally obligated to complete or make good the failure to complete a job.

2. Evaluation of the factors listed at B.1. above is very subjective. The presence of one factor or group of factors does not provide a presumption of the presence or absence of control. The degree of importance of each factor depends on the occupation and the factual context in which services are performed. Rev. Rul. 87-41, 1987-1 CB 296.

(a) The Internal Revenue Manual states that "[t]he weight to be given each factor is not always constant. The degree of importance of each factor may vary depending on the occupation and reason for existence. Therefore, in each
case, the agent will have two things to consider: First, does the factor exist; and second, what is the reason for or importance of its existence or nonexistence." Internal Revenue Manual Exhibit 5(10)00-4.

(b) The courts, however, have focused on a few factors as most important. Herman, 52 TCM 1194, 1196 (1986); see also U.S. v. Silk, 331 U.S. 704, 716 (1947). These factors are:

(i) the degree of control exercised by the employer over the details of the work;

(ii) the existence of a continuing relationship between the worker and the employer;

(iii) the right to discharge the worker;

(iv) the worker's opportunity for profit or loss;

(v) the relationship the parties believe they are creating;

(vi) the party investing in the facilities used in the work; and

(vii) whether the work is part of the principal's regular business.

Most courts have considered the right to control factor to be the single most important test. Quigley, "Cost Increases for Misclassifying a Worker as an Independent Contractor," 39 Taxation for Accountants 116 (Aug. 1987).

3. The following factors can also be used to support the characterization of a worker as an IC:

(a) The worker has an occupation or business distinct from the employer's business.

(b) The worker has incorporated, with the corporation having its own employee identification number.

(c) The worker operates under a fictitious or assumed name.

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(d) The worker advertises his services to others (e.g., yellow pages).

(e) The worker is not entitled to bonuses.

(f) The worker has not signed an anti-competition or secrecy agreement.

(g) The worker sets his own prices and supplies his own tools.

(h) Customers pay the worker, and the worker does not remit 100% of the payments to the employer.

(i) The worker possesses a trade, construction or professional license necessary for the work performed.

(j) The employer reports the worker's pay on a Form 1099.

(k) The employer did not have the worker complete INS Form I-9, Employment Eligibility Verification.

4. For the application of the common law rules to various professions, see 391 Tax Management Portfolio (BNA), "Employee Defined," which has collected and digested opinions on over 370 different professions.

C. Leased Employees. In certain cases, an employer may be required to treat a worker otherwise properly characterized as an IC as an employee for purposes of applying the qualified employee benefit plan rules. § 414(n).

1. If an IC is a leased employee under Section 414(n), the worker is counted as an employee in determining if the employer's qualified plans meet coverage and nondiscrimination requirements. See, § 414(n)(3); see also §§ 79, 106, 117(d), 120, 125, 127, 129, 132, 274(j), 505, and 4980B. A leased employee may participate in an employer's plans without violating the exclusive benefit requirements applicable to such plans. Usually, the inclusion of a non-employee in these plans would violate the exclusive benefit rules. Prop. Treas. Reg. § 1.414(n)-3(a); see also Prop. Treas. Reg. § 1.414(n)-2.

2. A worker is a leased employee if:
(a) the worker provides services to the employer in a capacity other than as an employee;

(b) the worker provides his services pursuant to an agreement between the employer and a leasing organization (i.e. any person or entity other than the worker);

(c) the worker has provided the services to the employer on a substantially full-time basis for at least one year (at least 1500 hours or 75% of the average number of hours customary for an employee in the position in question); and

(d) the services are of a type historically performed by employees in the industry of the employer. § 414(n)(2); Prop. Treas. Reg. § 1.414(n)-1; Notice 84-11, 1984-2 CB 469.

D. State Law Determinations of Employment Status. The classification of workers as employees or independent contractors for federal tax purposes may not be the same as the classification for state law purposes. Many state agencies use statutory tests other than the common law test used by the IRS to determine whether a person is an employee. For example, in Virginia, the Virginia Unemployment Compensation Act provides that an individual who receives remuneration for services is an employee unless:

1. The individual has been and will continue to be free from control or direction over the performance of such services, both under his contract of service and in fact; and

2. The service is either outside the usual course of the business for which such service is performed, or such service is performed outside of all the places of business of the enterprise for which such service is performed; or such individual, in the performance of such service, is engaged in an independently established trade, occupation, profession or business. Va. Code § 60.2-212. This statutory definition is intended to be broader and more inclusive than the common law concept of employee. VEC v. A.I.M. Corp., 225 Va. 338, 302 SE2d 534 (1983); Life & Casualty Insurance Company of Tennessee v. Unemployment Compensation Commission, 178 Va. 46, 16 SE2d 357 (1941).
IV. RECHARACTERIZATION OF INDEPENDENT CONTRACTOR AS EMPLOYEE

A. Employer Liability on Reclassification. If the IRS reclassifies a worker's status from IC to employee, the employer will become liable for (i) some or all (depending on whether Section 3509 applies) of the federal income and FICA taxes which should have been withheld from the worker's pay, (ii) the employer's share of the FICA taxes and (iii) FUTA taxes. The IRS may also assess penalties and interest. The recharacterization may result in the loss of qualified status for employee benefit and pension plans, causing the employer to lose the deductions associated with such plans. Generally, the IRS must assess the taxes and penalties related to a reclassification within the three year statute of limitations. § 6501(a). If an employer failed to file employment tax returns, filed fraudulent returns or filed returns in a willful attempt to defeat or evade taxes, there is no statute of limitations. § 6501(c). If an employer has misclassified workers as ICs, there is a distinct possibility that the employer will have failed to file employment tax returns.

B. Section 3509. Section 3509 specifies an employer's tax liability for employment taxes if the IRS recharacterizes an IC as an employee and the employer did not intentionally disregard the requirements to withhold and pay employment taxes. § 3509(c). If applicable, the provisions of Section 3509 are mandatory to a situation.

1. Section 3509 does not apply when the employer withheld income taxes but not FICA taxes. § 3509(d)(2).

2. Section 3509 limits an employer's liability for FICA and income taxes resulting from a reclassification.

   (a) The employer is liable for 20% of a nonstatutory employee's share of FICA (i.e., 1.24% of the employee's wages in 1990) and for 1.5% of the wages paid to the employee, in addition to the employer's share of FICA. § 3509(a).

   (b) If the employer treated the employee as an IC but did not comply with the reporting requirements of Sections 6041(a) or 6041A for payments to ICs by filing Form 1099, its liability is increased to 40% of the employee's share of FICA (i.e., 2.48% of the employee's wages in 1990) and 3% of wages. § 3509(b). This increased liability will not
be imposed if the employer can show (i) a reasonable basis for the inconsistent treatment and (ii) that the inconsistent treatment was not due to willful neglect. \textit{Id.}

(c) Section 3509 does not reduce the employer's liability for FUTA and for the employer's share of FICA taxes.

(d) The employer cannot recover any of the tax due under Section 3509 from the employee. The employer may not use income taxes paid by the employee and self-employment taxes paid by the employee which the employee cannot recover to offset the employer's liability under Section 3509. § 3509(d); see also §§ 3402(d), 6521. Section 3509 does not reduce the amount of tax for which the employee is liable; however, if the employee paid income and SECA taxes consistent with IC treatment, the employee may claim a refund for the portion of SECA taxes paid by the employee which should have been paid by the employer as FICA taxes. § 3509(d)(1).

3. Section 3509 does not relieve an employer from liability for penalties and interest because of failure to withhold, deduct and pay taxes; however, for purposes of applying any penalty or addition to tax, the employer's tax liability is limited to the amount the employer is liable for under Section 3509 instead of the original amount the employer should have withheld, deducted and paid over. Prop. Treas. Reg. § 31.3509-1(d)(6).

C. \textbf{If Section 3509 does not apply.}

1. If the employer intentionally disregards its duties to withhold and pay employment taxes, Section 3509 does not apply and Sections 3402, 3403 and 6521 control. §§ 3402, 3403, 3509(c) and 6521.

(a) When a worker is reclassified from an IC to an employee and Section 3509 does not apply, the IRS can retroactively impose the following tax liability on the employer:

(i) The employer is liable for all income withholding tax whether or not actually withheld. (The IRS need not first proceed against the employee.) Treas. Reg. § 31.3403-1.
(ii) The employer is responsible for both its share and the employee's share of FICA taxes. In 1990, the employer's share and the employee's share of FICA taxes are each equal to 6.2% of wages. §§ 3101, 3111.

(iii) The employer is liable for payment of FUTA taxes. In 1990, FUTA taxes are equal to 6.2% of wages. § 3301.

(b) Intentional disregard is determined by reviewing all the facts and circumstances. In most cases, reasonable reliance on an accountant's or attorney's advice should prevent a finding of intentional disregard. See L.D. Caulk Co. v. U.S., 53-2 USTC ¶9643 (D.C. Del. 1953); Chared Corp. v. U.S., 69-2 USTC ¶9535 (D.C. Tex. 1969), aff'd, 71-2 USTC ¶9537 (5th Cir. 1971).

2. When Section 3509 does not apply, an employer may offset its liability with income taxes paid by workers and with SECA taxes paid by workers the refund of which is barred by the statute of limitations or any other law (other than Section 7122, relating to compromises). §§ 3402(d), 6521(a). The employer must provide the employee's name and social security number to use these credits. Employees who erroneously pay SECA taxes are not allowed refunds if the employer has used the offsets provided in Sections 3402(d) and 6521.

These credits are often not available to employers because employers in many cases cannot prove that employees have paid the taxes. The employer cannot require the IRS to review the worker's return in an attempt to show that the taxes have been paid. Moreover, workers either may not have paid taxes or may not have given their correct names or social security numbers to the employer. Furthermore, the worker may no longer be providing services to the employer at the time of an audit, resulting in the employer's inability to locate the worker.

The employer may be able to convince the worker to become involved. First, the employer can point out that the IRS is already aware that the worker provided services and received remuneration. Second, under Internal Revenue Manual 5(10)52.1(2), an employer cannot cause an IRS agent to require workers to provide copies of the workers' tax

3. In general, when a worker has underreported income and the worker is later classified as an employee by the IRS, Section 3509 will reduce the employer's liability. On the other hand, when the worker has fully paid self-employment and income taxes, the employer may be better off using the offsets provided by Sections 3402(d) and 6521. In some situations, then, employers may have an incentive to claim intentional disregard of the requirements to withhold and pay taxes to avoid the application of Section 3509. Employers should, however, remember that while this action may allow them to avoid Section 3509, it may imply an absence of good faith on their part.

D. Other Penalties. The Code contains a number of civil and criminal penalties which could apply to employers. See, for example, §§ 6651, 6656, 6662, 6663, 6672, 6601, 6674, 6682, 6694, 6701, 6721, 6722, 6723, 7201, 7203, 7204, 7206 and 7207. This outline does not discuss the specifics of these penalties or the effects on the application of these penalties. Listed below, however, are a few penalties of which employers should be made aware.

1. Section 6651. If an employer fails to file required returns regarding withholding or group term life insurance, fails to file information returns regarding payments to independent contractors or to pay any tax shown on or assessed with respect to the foregoing returns, the employer will be subject to a penalty of up to 25% of the tax required to be paid. The penalty increases to up to 75% if fraud is involved.

2. Section 6656. Failure of an employer to make a required timely tax deposit with the government can result in a penalty of up to 15% of the underpayment. This penalty applies to deposits of tax relating to the following forms:

(a) Form 941 - Employer's Quarterly Federal Tax Return;

(b) Form 943 - Employer's Annual Tax Return for Agricultural Employees; and
3. **Section 6672.** If an employer willfully fails to withhold, collect or account for employment taxes, then the individual responsible for such withholding, collection or accounting becomes personally liable for 100% of the tax. A Section 6672 penalty should not apply in a case where Section 3509 relief is granted since Section 6672 requires willfulness and Section 3509 requires good faith.

4. **Section 6674.** If an employer willfully furnishes a false or fraudulent statement or willfully fails to furnish a statement required by Sections 6051 (receipts for employees regarding withholding taxes) or 6053(b) (relating to tips), the employer will be subject to a penalty equal to $50 for each failure.

E. **Criminal Sanctions.**

1. Where an employer willfully attempts to avoid collecting, paying, accounting for or withholding taxes or willfully misclassifies an employee as an IC, the IRS may impose criminal sanctions. These sanctions are generally in addition to other applicable penalties. See, §§ 7201, 7202, 7203, 7204, 7206 and 7207.

2. Very few criminal misclassification cases reach the courts since most are settled in a plea agreement. For examples and discussion of these cases, see Sbarbaro, Reese and Miller, "The Employee/Independent Contractor Dilemma: When Misclassification Becomes a Crime," 2 Corporate Taxation 5 (November/December 1989).

F. **Requalification of Benefit Plans.**

The reclassification of ICs as employees may cause the IRS to find a violation of the exclusive benefit rule or coverage and participation requirements applicable to pension, profit-sharing, and stock bonus plans. The IRS may revoke a previously issued favorable determination letter for such a plan. In this case, the employer's only remedy is to ask the IRS National Office to exercise its discretion under Section 7805(b) to limit the retroactive effect of the revocation. Falk and Gegelman, "Defending Employee vs. Independent Contractor Issues," 71 Journal of Taxation 380, 383-4 (December 1989).
1. The request is made through the key district director and must meet the requirements set forth in Revenue Procedure 90-4, 1990-2 IRB 10.

2. If relief is denied, a final revocation letter will be issued and a notice of deficiency may be issued to the employer, the trust, and some or all plan participants. Under Section 7476, within 90 days after the final determination, the employer may seek a declaratory judgment from the Tax Court that the plan satisfies the qualification requirements.

3. No formal guidance has been issued as to the required proper corrective actions if a violation of the exclusive benefit rule or coverage and participation requirements is discovered. But see Treas. Reg. § 1.401(k)-1(f)(3)(ii) and Prop. Treas. Reg. § 1.401(m)-1(e)(5)(ii). The employer should work with the IRS to determine proper corrective actions.


A. History. Section 530 of the Revenue Act of 1978 (hereinafter cited as RA Section 530), although not part of the Code, provides some relief to employers from retroactive reclassifications of ICs to employees by the IRS. RA Section 530 "grandfathered" the treatment of workers as ICs if certain conditions are satisfied. Section 269 of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") indefinitely extended the protection of RA Section 530. TEFRA, § 269(c).

B. Purpose. When the requirements of RA Section 530 are met, RA Section 530 prevents the assessment of tax, interest and penalties that would otherwise apply for failure to treat a worker as an employee. The relief provided by RA Section 530 is limited to employment tax issues and applies to the employer's share of FICA, FUTA, responsibility to withhold income taxes and to withhold the employee's share of FICA. See §§ 3101, 3102, 3111, 3301, 3402, 3403.

1. RA Section 530 has no effect on other issues which may result from a reclassification. Proposed Treasury Regulation Section 1.414(n)-1(d)(2) provides that the determination of employer for FICA, FUTA and income tax withholding purposes does not affect the determination of who the employer is for purposes of the qualified plan provisions of the Code. Moreover, RA Section 530 will not help an
employer with respect to recharacterizations by state agencies or federal agencies other than the IRS.

2. RA Section 530 does not change a worker's employment status. If the worker is properly classified as an employee, the employer will be liable for future employment taxes even though RA Section 530 prevented the assessment of such taxes for past periods.

C. Qualifying for RA Section 530 Protection. An employer must pass certain tests to receive RA Section 530 protection.

1. Reporting Test. An employer must show it filed all required returns, including information returns, related to the worker in question.

2. Reasonable Basis Test. The employer must have a "reasonable basis" for not treating the worker as an employee.

(a) RA Section 530(a)(2) provides that a reasonable basis exists if the employer shows reasonable reliance on one of three standards:

(i) Judicial or administrative precedent (e.g., published rulings, technical advice from the IRS, or a letter ruling to the employer). A letter from an IRS Revenue Officer Examiner does not constitute administrative precedent. TAM 9033003 (May 2, 1990).

(ii) Past IRS audit. A reasonable basis exists if a past tax audit of the employer did not result in an assessment attributable to the employment tax treatment of an individual in a position similar to the worker in question. The audit need not be an employment tax audit to count as support. Rev. Proc. 85-18, 1985-1 CB 518. A compliance interview does not constitute an audit for purposes of the safe haven. TAM 9033003 (May 2, 1990).

(A) If an employer fails to pass the consistency test (discussed at IV.C.2. below), the employer will not be able to rely on a later audit
which does not consider employment tax issues as support. Rev. Rul. 84-161, 1984-2 CB 202.

(B) The audit can be used only if it is an audit of the employer in question. For example, the audit of the sole shareholder of an S corporation cannot be used as a reasonable basis by the S corporation. C. D. Ulrich, Ltd. v. U.S., 88-1 USTC ¶9318 (DC Minn 1988). On the other hand, if a sole proprietorship is incorporated, the corporation can rely on rulings issued to the proprietorship. See, Lambert's Nursery and Landscaping, Inc. v. U.S., 65 AFTR 2d 90-573 (5th Cir. 1990); Ridgewell's, Inc. v. U.S., 81-2 USTC ¶9583 (Ct. Cl. 1981).

(C) In a recent case, the Fifth Circuit held that an employer can treat workers as ICs under the prior audit safe haven even if the workers are employed in a different industry than the industry subject to the prior audit. Lambert's Nursery and Landscaping, Inc. v. U.S., 65 AFTR 2d 90-573 (5th Cir. 1990).

(1) The court noted that the two sets of employees were "substantially similar" in their relationship to the employer in terms of control, supervision, pay and demands.

(2) The IRS failed to provide authority for its assertion that the type of work done rather than the structure of the relationship between the taxpayer and his workers should be the preeminent interpretative factor for the prior audit safe haven. The Fifth Circuit decided that the relationship of the workers to the employer is the "most important element of the § 530(a)(2)(B) [prior audit safe haven] analysis."
(D) Taxpayers are most likely to rely on past audits as support for reasonable basis since prior IRS examinations infrequently raised worker classification issues.

(iii) Industry Practice. An employer has authority for treating an individual as an IC if such treatment reflects a long standing practice of a significant segment of the industry in which the worker is engaged.

(A) No fixed amount of time makes a practice long standing. PLR 8749001 (Feb. 10, 1987).

(B) The geographical region of an industry may be less than nationwide. General Investment Corp. v. U.S., 823 F.2d 337 (9th Cir. 1987). In a private letter ruling, the IRS has held that small geographic regions generally provide the most appropriate basis for evaluating the practices of a particular industry. PLR 8749001 (Feb. 10, 1987).

(C) In one recent case, a court held that an employer could rely on his fourteen years in the industry in question as evidence that his practice of treating workers as ICs was consistent with industry practice. In re Edward W. McAtee, 89-2 USTC ¶9625 (Bktcy Ct. ND Iowa 1989). Generally, however, the employer must be able to document industry practice to use it as a "reasonable basis."

(D) It may be difficult for an employer to use the industry practice safe haven because other industry employers may be reluctant to divulge their worker classifications for fear of IRS audit. Sumutka and Bonnier, "Independent Contractor or Employee?", 59 CPA Journal 54, 60 (Nov. 1989). If an employer decides to use the industry practice safe haven, it should be prepared to
supply the IRS with the following information:

(1) the specific industry involved;

(2) the number of entities working in the industry in a specified locality;

(3) names of currently in business entities within the employer's advertising circle which treat the same class of workers as ICs and the length of time of such treatment;

(4) the date the employer began treating the workers as ICs; and

(5) photocopies of information provided by the industry or trade association if the employer relied on the association's direction to treat the workers as ICs. Internal Revenue Manual 5(10)47.5.

(b) Outside of its three safe havens, RA Section 530 does not define reasonable basis. The legislative history to RA Section 530 does, however, specify that the term should be interpreted broadly in favor of the taxpayer and that the three safe havens are not the exclusive methods for fulfilling the reasonable basis test. H. Rep. No. 95-1748, 95th Cong., 2d Sess. 5 (1978); In re McAtee.

(c) The treatment of workers in similar positions as employees can prevent a finding that a reasonable basis exists. RA 530(a)(3); see also PLR 8925001 (Nov. 21, 1988); PLR 8616002 (July 17, 1985).

3. Consistency Test. An employer must show it has consistently treated the worker as an IC rather than as an employee for all periods after December 31, 1977.

(a) The test has several requirements:
(i) The employer may not have treated the worker as an employee for any period ending before January 1, 1980.

(ii) For periods after December 31, 1978, all federal tax returns, including information returns, must be filed on a basis consistent with characterizing the worker as an IC. This includes the filing of Form 1099 which must be filed by all persons engaged in a trade or business who pay compensation of $600 or more per year to any individual. See Rev. Rul. 81-224, 1981-2 CB 197. (Form 1099-NEC, referred to in Revenue Ruling 81-224, has been replaced with Form 1099-MISC.)

(iii) For all periods beginning after 1977, the employer must not have treated as an employee any individual holding a job substantially similar to the worker in question.

(b) Revenue Procedure 85-18, 1985-1 CB 518 outlines the methods of determining whether an employer has treated an individual as an employee:

(i) the employer withheld income tax or FICA from wages (regardless of whether paid to the government), or

(ii) the employer filed an employment tax return with respect to the individual, regardless of whether tax was actually withheld. (Amended and delinquent returns do not constitute evidence of treatment as an employee.) The filing of Forms 940, 941, 943 or W-2 by an employer is treatment of the worker as an employee by the employer. See, PLR 8302001 (Sept. 17, 1981).

(c) Once an employer treats a worker as an employee, no relief is available under RA Section 530, even if the requirements of RA Section 530 are met in a later year. Rev. Rul. 84-161, 1984-2 CB 202. However, relief will not be denied under the consistency test for any periods prior to the period in which a worker was treated as an employee. For example, if a worker was treated as an IC in

D. Exception for Technical Workers. Section 1706 of the Tax Reform Act of 1986 amended RA Section 530 to add Section RA 530(d), which excludes from the safe harbors certain technical service workers, effective for compensation paid and services performed after December 31, 1986.

1. Reasons for RA Section 530(d): Many firms working in the technical services field took aggressive positions in claiming their workers constituted ICs even though the workers would qualify as employees under the common law rules. Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 1343-1344. These firms were able to use the relief provided under RA Section 530 because of their consistent, though aggressive, treatment of workers as ICs. Because these employers were not subject to employer FICA taxes and FUTA taxes, they could broker their workers at a lower cost than other employers. Employers in the technical services field who were not taking aggressive positions asked Congress to adopt rules to prohibit the resulting competitive inequities. Id.

2. Workers Affected: RA Section 530(d) provides that the general rules of RA Section 530 do not apply to individuals, such as engineers, designers, drafters, computer programmers, systems analysts or others in a similar line of work, who provide technical services pursuant to an arrangement between a taxpayer and another person (a three-party arrangement).

(a) Therefore, for income and employment tax purposes, the common law rules will be used to determine whether a person is an employee or an IC. Notice 87-19, 1987-1 CB 455 as modified by Notice 87-38, 1987-1 CB 500.

(b) Section 530(d) does not automatically convert technical specialists from ICs to employees. Id.

(c) Section 530(d) applies only to three party situations (i.e., the worker, the firm's client using the worker and the brokering
Two party situations involving technical workers are still governed by the general rules of RA Section 530.

(d) Problems with RA Section 530(d):

(i) While RA Section 530(d) eliminates inequities among technical service specialists, it creates inequities between technical specialists and workers in other industries.

(ii) RA Section 530(d) creates the problem RA Section 530 was supposed to prevent - it forces the IRS to make a separate retroactive determination in each employee versus IC case.

(iii) Although the provisions of RA Section 530(d) cannot be avoided by forming a personal service corporation ("PSC") controlled by the specialists themselves, the law is unclear on what happens if the PSC was in existence prior to the enactment of RA Section 530(d). See H. Rep. No: 99-841, 99th Cong., 2d Sess. II-834 - II-835 (1986).

(iv) A conflict exists between situation 2 in Revenue Ruling 87-41 and Section 3401 where a client engages a technical specialist through a broker, but pays the specialist directly. In Revenue Ruling 87-41, the broker is the potential employer, while Section 3401 treats the client as the employer for purposes of income tax withholding, FICA taxes and FUTA taxes.

E. Time for Requesting Relief Under RA Section 530. RA Section 530 relief is available to employers under audit by the IRS or who are involved in administrative (including Appellate) or judicial processes with respect to assessments based on employment status reclassifications. Employers who have entered into final closing agreements under Section 7121 or compromises under Section 7122 regarding employment status controversies are ineligible for RA Section 530 relief unless they have not completely paid their liability, in which case the employer can seek relief for the outstanding liability. Employers who settled employment status matters administratively other than under Section 7121 or 7122 or who
unsuccessfully litigated such cases are also eligible for relief, provided (i) their claims are not barred by the statute of limitations, or (ii) with respect to judgments already paid, the doctrine of res judicata. Rev. Proc. 85-18, 1985-1 CB 518.

F. Proposed Repeal. In late 1989, the IRS and General Accounting Office ("GAO") recommended that Congress repeal RA Section 530. The GAO demonstrated their belief that the safe haven was only temporary; however, Congress has not yet decided to repeal RA Section 530.

VI. CONTESTING RECHARACTERIZATION

A. The majority of contested recharacterizations occur during examination of employment tax returns.

1. While the employer may negotiate with the examining agent after the examination is over, such negotiations are not usually successful. The examining agents generally have limited settlement authority.

2. If the employer cannot reach an agreement with the agent, it may lodge a protest with the Appeals Office or pay the tax and claim a refund. Failure to reach an agreement with the Appeals Office will result in a tax assessment. Kenny and Hulen, "Determining Employee or Independent Contractor Status," 20 Tax Adviser 661, 668 (October 1989).

B. An employer may file a claim for refund for amounts paid as a result of a reclassification of a worker as an employee.

1. The claim must be filed within 2 years of payment of tax or 3 years of filing the return. Section 6511(a).

(a) Employment taxes are "divisible," i.e., an employer has a separate tax obligation for each employee. Steele v. U.S., 280 F.2d 89 (8th Cir. 1960); see also Spivack v. U.S., 370 F.2d 612 (2d Cir. 1967), cert. denied, 387 U.S. 908 (1967). Therefore, an employer need pay the assessed tax with respect to only one worker in each group of functionally indistinguishable workers to obtain judicial review.

(b) Employment taxes are subject to a 3 year statute of limitations which begins to run on the later of April 15 of the succeeding
calendar year or the date the applicable return is filed. § 6513(c).

2. If a claim for refund is denied, the employer must file suit within 2 years of the notification of disallowance. § 6532(a).

C. Interest-Free Tax Adjustment of Section 6205. Under Section 6205 and Treasury Regulation Section 31.6205-1(c)(2), where underpayments of FICA and income tax withholding liabilities inadvertently arise, the IRS may assess additional income tax withholding, FICA and railroad retirement tax liabilities without interest if the liability is determined to exist after the return for the period giving rise to the liability is filed. Generally, the underpaid tax must be paid at the time the error is ascertained. The employer, however, must report the underpayment on a return or supplemental return filed on or before the last day on which the return is required to be filed for period in which the error was ascertained. Treas. Reg. § 31.6205-1(c)(2).

1. The IRS does not "ascertain" an error within the meaning of Section 6205 until all levels of appeal are exhausted. Therefore, no interest is due on taxes covered by Section 6205 if paid:

   (a) following an agreement with the examining office,

   (b) following an agreement with the IRS Appeals Office, or

   (c) before notice and demand following unsuccessful negotiations with the Appeals Office (even if payment is made so that a refund claim may be filed and the reclassification litigated). Rev. Rul. 75-464, 1975-2 CB 474.

2. Interest free adjustments are not permitted in the following cases:

   (a) No agreement is reached with the examining officer or Appeals Office and the employer does not pay the liability prior to receipt of notice and demand,

   (b) the IRS determined additional tax to be due in audits of prior years with respect to the identical issue involved in the current audit, or
the employer knowingly underreported employment tax liability after notification of its status as an employer.

3. If an employer only pays a portion of the tax due prior to receipt of notice and demand, the employer will not be liable for interest on the amount paid. The employer will have to pay interest on the balance of the unpaid liability either from:

(a) the due date of the return for the period in which the employer executed Form 2504 (Agreement to Assessment and Collection of Additional Tax and Acceptance of Overassessment),

(b) filed a supplemental return with respect to the additional liability, or

(c) the due date of the returns for the periods for which the liabilities in issue have been asserted. See Rev. Proc. 60-17, 1960-2 CB 942, as modified by Rev. Proc. 84-66, 1984-2 CB 637; PLR 8548004 (Aug. 26, 1985).

4. The interest free adjustments of Section 6205 do not apply to FUTA tax liability. Rev. Rul. 75-464, 1975-2 CB 474. Section 6601(i), however, provides that interest shall not apply to failure to make a payment of FUTA tax.

VII. PLANNING STRATEGIES FOR INDEPENDENT CONTRACTOR STATUS

A. An employer should develop a strategy to reduce the risk of recharacterizations of ICs. The strategy needed will depend on when the reclassification issue arises. If the issue arises at the beginning of employment, the employer should consider applying for a determination of a worker's status from the IRS. If the issue is raised at examination, a settlement and litigation strategy should be developed. In developing strategies, an employer should examine each worker's tasks and duties and group workers with similar responsibilities.

B. Certain industries, at various times, seem to constitute an IRS audit hit list. For example, trucking industries, courier services and nurses registries have been frequent subjects of audits in recent years. Employers in such industries must be especially careful to document IC status.

C. Form SS-8. The safest approach to settle worker status is to request a determination letter from the district
director of the employer's district by submitting Form SS-8. As a practical matter, a Form SS-8 will primarily be useful for employers questioning the characterization of a worker in a new position. It may not be advisable to file a Form SS-8 on a worker presently classified as an IC since an IRS determination of employee status could trigger an audit. Sumutka and Bonnier, "Independent Contractor or Employee?", 59 CPA Journal 54, 62 (Nov. 1989).

1. The Form SS-8 applies to the worker in question and may be applied to workers in the same class where the facts are similar.

2. The Form SS-8 consists of 20 questions relating to the common law factors discussed at III.B. above such as:
   (a) type of work,
   (b) training,
   (c) instructions to worker,
   (d) ability to direct worker,
   (e) supervision of worker,
   (f) routine or schedule of worker,
   (g) time records furnished by worker,
   (h) tools and equipment furnished by worker,
   (i) expenses incurred by worker,
   (j) location of services done by worker,
   (k) guaranteed minimum payment provided to worker,
   (l) eligibility of benefits by worker, and
   (m) noncompetition of worker.

3. The Form SS-8 must be filled out correctly. If it later appears that the facts contained on the Form SS-8 are different than the actual facts, protection will be lost.

4. The worker may also request a status determination on Form SS-8. If the worker performs services for more than one firm, a separate Form SS-8 must be filed for each firm.
5. The determination resulting from an inquiry made on a Form SS-8 is employee status in the vast majority of cases.

D. Employment/IC Contracts. Employment or IC agreements detailing duties and terms of the relationship may strengthen an employer's case for a worker's employee or IC status. CAVEAT: Even a perfect independent contractor agreement cannot convert an employee into an IC. A good IC agreement should be drafted with the following in mind:

1. The contract should be prepared considering the twenty common law factors and should indicate that the parties intend to treat their relationship as an employer-IC relationship. Clauses providing for termination at will should especially be avoided, and provisions permitting termination for cause or on notice should be used instead.

2. The contract should require the worker to report income in a manner consistent with IC status. If the contract requires the IC to prove such treatment to the employer, the employer will have evidence to support the offsets of liability permitted by Sections 6521 and 3401(d).

3. If the employer must supply facilities or assistants to the worker, the contract should specify that these services and facilities will be paid for by the employee.

4. If possible, compensation should be based on services rather than on an hourly, weekly or monthly basis. The worker can bill the employer as necessary.

E. Form 1099. All compensation paid to an IC should be reported on a Form 1099 unless an exception to the reporting requirement exists. See, §§ 6041, 6041A; Treas. Reg. § 1.6041-3(c).

F. Fringe Benefits. An employer should not allow an IC to participate in fringe benefit plans provided for employees even if the IC reimburses the employer for the premiums.

G. Corporate Payees. Workers who have incorporated are more likely to be characterized as ICs than unincorporated workers.