2016

Tax Status: Employee vs Independent Contractor and Employee vs Partner

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I. OVERVIEW

Employees and employers face substantially different treatment from sole proprietors, partners and other independent contractors and their clients under a wide range of laws, including federal and state employment tax, income tax and labor laws. This outline describes some major differences in treatment between employees and employers on the one hand and independent contractors and their clients on the other, the factors used to distinguish between them under selected state and federal statutes, and the processes for making these determinations.

II. FEDERAL TAX LAW

A. Differences in Treatment

1. Employment Taxes

Social Security and Medicare. Compensation paid to employees is subject to Social Security and Medicare taxes, if at all, under the Federal Insurance Contributions Act ("FICA"). By contrast, compensation paid to independent contractors generally is subject to Social Security and Medicare taxes, if at all, under the Self-Employment Contributions Act ("SECA").

Since 1990, the combined tax rates on employees and their employers on the one hand and independent contractors and their clients on the other have been virtually identical under both FICA and SECA. Before 1983, the tax rates on independent contractors were substantially lower, even though they were generally eligible for the same Social Security and Medicare benefits as employees. Legislation in 1983 mostly eliminated the rate differential effective in 1984, and made other conforming changes that became fully effective in 1990.

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2 The combined Social Security and Medicare tax rate is the same (15.3%) under both. Internal Revenue Code of 1986 ("Code") §§ 1401, 3101 & 3111. Under both, only the first $118,500 of compensation (in 2016) is subject to Social Security tax, while the entire amount is subject to Medicare tax. Special deductions also are provided to self-employed individuals subject to SECA, which produce substantially the same effect as the fact that employees are not subject to income or FICA taxes on the employer's share of FICA. Code §§ 164(f) & 1402(a)(12).

Since 2013, an additional 0.9% Medicare tax has been imposed on self-employment income and wages that exceed certain thresholds ($250,000 in the case of taxpayers filing joint returns). The regulations allow an employer to disregard an employee's actual filing status and wages received from other employers in determining its withholding obligation. Also since 2013, a 3.8% tax has been imposed on the net investment income of individuals, estates and trusts that exceeds certain thresholds. Code § 1411. The tax was designed to parallel the uncapped Medicare portion of FICA and SECA taxes (which total 3.8% when the new 0.9% surtax is included).

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Some differences still remain, however. In some cases they are substantial. For example, unlike a contribution on behalf of a common-law employee, a contribution to a qualified plan on behalf of an independent contractor may not be deducted in computing the independent contractor’s SECA income. On the other hand, trade or business expenses may be deducted from compensation before SECA compensation is calculated, but cannot be so deducted for FICA purposes.

In computing FICA taxes on a new employee’s wages, an employer generally may not take into account the fact that the employee already has received wages in excess of the taxable wage base from another employer. If this results in an overpayment, the employee may be entitled to a refund, but not the employer. This result can be avoided if the employers are affiliated and use a “common paymaster.” However, the common paymaster rule is available solely to affiliated corporations (including nonprofits), and therefore is not available to affiliated partnerships or LLCs taxed as partnerships. This is particularly unfortunate since many partnerships and LLCs are parts of larger groups of partnerships and LLCs, and their employees often perform services for other entities that are part of the group.

FICA wages of an employee-shareholder of a corporation are limited to amounts distributed to him as compensation, even if the corporation is an S corporation, whereas the SECA income of a general partner generally includes his entire distributive share of partnership income. The employment tax treatment of a limited partner is similar to the employment tax treatment of an employee-shareholder. Specifically, it includes only guaranteed payments.

3 Code § 1402(a); GCM 39807 (Jan. 16, 1990); cf. LaFlamme v. Comm’r, 103 T.C.M. (CCH) 1201 (2012) (self-employed taxpayer may deduct contribution to pension plan when calculating income tax liability, but not when calculating self-employment tax liability). Accident and health plan contributions are included in SECA compensation even though they are deductible for income tax purposes. (The Small Business Jobs Act of 2010 allowed self-employed individuals to deduct health insurance costs in determining self-employment income, effective for calendar year 2010 only.)


5 Code § 6413(b); Treas. Reg. § 31.6413(c)-1; Rev. Rul. 55-584, 1955-2 C.B. 394.

6 Code § 3121(s); Treas. Reg. § 31.3121(s)-1.

7 Rev. Rul. 59-221, 1959-1 C.B. 225. If actual wage payments are low relative to the value of the services being provided, but dividends are high, the IRS might seek to recharacterize some of the dividends as wages. See, e.g., Rev. Rul. 74-44, 1974-1 C.B. 287; David E. Watson, P.C. v. United States, 668 F.3d 1008 (8th Cir.), cert. denied, 133 S. Ct. 364 (2012); Dunn & Clark, P.A. v. Comm’r, 57 F.3d 1076 (9th Cir. 1995); Spicer Accounting, Inc. v. United States, 918 F.2d 996 (7th Cir. 1990). If, on the other hand, wages are too high to leave enough funds to provide an adequate return to the shareholders, the IRS might seek to recharacterize some of the wages as dividends. See Brinks Gilson & Lione P.C. v. Comm’r, T.C. Memo. 2016-20 (Feb. 10, 2016).

8 Code § 1402(a); Treas. Reg. §§ 1.1402(c)-1 & 1.1402(a)-2(d); Ding v. Comm’r, 74 T.C.M. (CCH) 708 (1998); aff’d, 200 F.3d 587 (9th Cir. 1999); Rev. Rul. 59-221, 1959-1 C.B. 225.

9 Code § 1402(a)(13).

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described in Section 707(c)\textsuperscript{10} that he or she receives for services, and not on his or her entire
distributive share of partnership income.

In 1997 the Internal Revenue Service (the “IRS”) issued proposed regulations\textsuperscript{11} that
would have made the employment tax treatment of limited partners and LLC members who
participate in the management of the entity more consistent with the employment tax treatment
of general partners. The regulations also would have clarified when members of an LLC are
treated as general or limited partners. The regulations were vilified as a “stealth tax,” and later
that year Congress prohibited the IRS from finalizing the regulations any time before July 1,
1998.

The moratorium has since lapsed. In the absence of guidance, LLCs taxed as partnerships
have had to find their own way, and many have concluded that LLC members generally may be
treated as limited partners. The IRS has said that an individual may be a limited partner only if
he is a partner in an entity formed under a state limited partnership law.\textsuperscript{12} However, it also has
said that whether LLC members are limited partners depends on their involvement in the
management of the business.\textsuperscript{13} For several years, the President’s budget proposal has included a
provision imposing SECA tax on the distributive shares of owners of S corporations, limited
partnerships, general partnerships, and LLCs taxed as partnerships if they materially participate
in the business.\textsuperscript{14} The courts have emphasized the same factors.\textsuperscript{15}

\textit{Unemployment Insurance.} The first $7,000 of wages paid to an employee generally is
subject to tax under the Federal Unemployment Tax Act (“FUTA”). Under the integrated
federal/state system, part of the tax is ordinarily paid to the state of employment, while part is

\textsuperscript{10} Unless otherwise indicated, all references in the text to sections are to sections of the Code.
\textsuperscript{12} See, e.g., PLR 9525058 (March 28, 1995); PLR 9432018 (May 16, 1994); 2015 Instructions for Form
1065, page 2.
\textsuperscript{13} See, e.g., ILM 201436049 (May 20, 2014) (“Partners perform extensive investment and operational
management services for the partnership in their capacity as partners (i.e., acting in the manner of self-employed
persons) and Management Company derives its income described in § 702(a)(8) from the investment management
services performed by Partners. [Therefore, the] income earned by Partners through Management Company is not
income which is basically of an investment nature of the sort that Congress sought to exclude from self-employment
tax when it enacted the predecessor to § 1402(a)(13).”); CCA 201640014 (June 15, 2016) (individual who was the
operating manager, president, and CEO of a partnership that operated restaurants was not a “limited partner”
because he was “the only partner of Partnership involved with the business and is not a mere investor, but rather
actively participates in the partnership’s operations and perform[ed] extensive executive and operational
management services for Partnership in his capacity as a partner).
\textsuperscript{14} See, e.g., The Treasury Department’s Office of Tax Policy’s General Explanations of the
Administration’s Fiscal Year 2017 Revenue Proposals (Feb. 2016).
\textsuperscript{15} Compare Norwood v. Comm’r, 79 T.C.M. (CCH) 1642 (2000) (“A limited partnership must be created in
the form prescribed by State law.”), with Renkemeyer, Campbell & Weaver LLP v. Comm’r, 136 T.C. 137 (2011)
(limited partners are those who “lack management powers but enjoy immunity from liability for debts of the
paid to the federal government; the combined rate is 6%. The federal portion of the tax is paid quarterly. Independent contractors are not subject to FUTA tax, but likewise generally are not eligible to receive any unemployment benefits.

2. Income Taxes

Collection Mechanisms. Income taxes on employees are collected mainly through the withholding system, whereas income taxes on independent contractors are collected mainly through the estimated tax system. Both systems are backed up by information reporting requirements imposed on service-recipients. Unless certain exceptions apply, both employees and independent contractors must pay their estimated income tax liabilities for the current year in quarterly installments throughout the year. Because of withholding, however, employees generally do not have to make any estimated tax payments. That is because withholding generally requires earlier payments than would be necessary under the estimated tax system, and these amounts are credited towards employees’ estimated tax obligations. Thus, employees generally are required to make estimated tax payments only if they have substantial non-wage income.

Partnerships and LLCs taxed as partnerships might be able to “withhold” income taxes for their partners and members, despite the lack of a legal requirement, by paying estimated taxes on their behalf and reducing their other compensation accordingly. State wage payment laws generally apply only to employees, so no special election rules need to be followed. One downside of this approach is that the arrangement is not treated as actual wage withholding for purposes of the various Code provisions that are designed to ensure that the individual gets credit for the withheld amounts and that they are, in fact, paid over to the IRS. The IRS also has the authority to allow voluntary withholding arrangements under Section 3402(p) to be extended to non-wage payments, although so far it has not done so for payments to partners or LLC members. (Triggering backup withholding under Section 3406 is not an option because compensation reported on Form K-1 is not a “reportable payment” under that provision.)

Employers generally must report all wages paid to an employee annually on Form W-2. Similarly, clients generally must report all compensation paid to an independent contractor annually on Form 1099-MISC; no Form 1099-MISC generally is required, however, for payments to a corporation (unless the corporation provides medical, health care, or legal services, or is involved in billing and collecting payments with respect to medical and health care

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16 Code §§ 3301 & 3306(b).
17 Eligibility generally is a matter of state rather than federal law.
18 See Code §§ 31(a)(1) (amount withheld by an employer as tax from an employee’s wages “shall be allowed to the recipient of the income as a credit” against his or her income tax liability for that year) and 6513(b)(1) (employee deemed to have paid tax on April 15th following close of the tax year only when tax has been “actually deducted and withheld at the source”); Treas. Reg. § 1.31-1(a) (credit available only “[i]f the tax has actually been withheld at the source”).
19 See, e.g., Code § 6672 (the “responsible person” penalty).

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services), payments that are not made by a business, or payments to a service-provider that aggregate less than $600 in a calendar year.

Forms W-2 must be sent to the employee and to the Social Security Administration. The Social Security Administration subsequently sends information from the forms to the IRS. In addition, the employee is required to attach Forms W-2 that he or she receives to his or her income tax return. Using this information, the IRS can determine whether wages have been under-reported. While Forms 1099-MISC must be sent to the independent contractor and the IRS, there is no requirement that they be attached to the individual’s income tax return.

The same penalties generally apply to failures to file or provide an accurate and timely Form W-2 as apply to failures to file or provide an accurate, complete and timely Form 1099-MISC.\textsuperscript{21}

Although they are similar, generally more information must be reported on Form W-2 than on Form 1099-MISC. For example, employers that provide health plans for their employees must report the value of the coverage under the plans on the employees’ Forms W-2.\textsuperscript{22}

3. Trade or Business Expense Deductions

Independent contractors face somewhat fewer restrictions on their ability to deduct trade or business expenses than do employees.

Independent contractors’ trade or business expenses generally are deductible “above-the-line,” \textit{i.e.}, as a direct reduction in their business income reported on Schedule C.\textsuperscript{23} Employees’ trade or business expenses, by contrast, generally are deductible only “below-the-line,” \textit{i.e.}, as itemized expenses. In addition, employees’ trade or business expenses generally are deductible only to the extent that these expenses (plus any other miscellaneous itemized deductions) exceed 2\% of the employee’s adjusted gross income from all sources. The 2\% floor does not apply to an employee’s trade or business expenses to the extent that these expenses are reimbursed by his or her employer tax-free under an “accountable plan”; to be an “accountable plan,” the plan must require the employee to account to the employer for any expenditures and return any excess.\textsuperscript{24}

\begin{footnotes}

\textsuperscript{21} Code §§ 6721-22. The penalties generally are $260 for each incorrect, incomplete or untimely Form W-2 or 1099-MISC, which is increased to 10\% of the amount that is not correctly reported if the failure is due to “intentional disregard” of the correct information reporting requirement.


\textsuperscript{23} See Quintanilla v. Comm’r, T.C. Memo. 2016-5 (Jan. 7, 2016) (a production worker on TV commercials was an independent contractor and therefore could deduct business expenses on Schedule C without regard to the 2\% floor).

\textsuperscript{24} Code § 62(c); Treas. Reg. § 1.62-2; cf. Treas. Reg. § 1.132-5(a)(1)(v) (similar rules for working-condition fringe benefits).
\end{footnotes}
Unlike independent contractors, employees may not deduct interest expenses incurred in their trade or business of being an employee: such interest is considered a personal expense.25

Home office expenses and rental and depreciation expenses associated with “listed property” are subject to special deduction limits unless these expenses meet certain business use requirements.26 The limits for employees and independent contractors generally are the same except that, in the case of home office expenses, the employee’s business use also must be “for the convenience of the employer,”27 and, in the case of listed property such as home computers, such use must be “for the convenience of the employer and required as a condition of employment.”28 These standards are difficult for many employees to meet.29

For purposes of the alternative minimum tax, miscellaneous itemized deductions are an adjustment item.30 Trade or business expenses are a miscellaneous itemized deduction for employees. Accordingly, for purposes of the alternative minimum tax, trade or business expenses are not deductible for employees but are deductible for independent contractors.

4. Qualified Plans

For the most part, the rules governing qualified plans are the same regardless of whether employees or independent contractors participate in the plan. However, several noteworthy differences remain.

Independent Contractors Generally: As a plan qualification matter, independent contractors may not participate in plans maintained by their clients.31 They may, however, participate in plans they maintain for themselves and their employees, because they are treated as employees of their own trades or businesses.32

Consistent with this, contributions to a qualified plan of an independent contractor on behalf of that individual are not deductible to the extent that they exceed the earned income of

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26 See generally Code §§ 280A & 280F. Generally, in the case of a home office, the space must be used exclusively on a regular basis as the taxpayer’s principal place of business. In the case of listed property, the property must be used predominantly in the taxpayer’s trade or business.
27 See Code § 280A(c)(1).
29 See, e.g., Rev. Rul. 86-129, 1986-2 C.B. 48. On the other hand, the Supreme Court’s “principal place of business” test also has made it difficult for independent contractors to establish their home office as their principal place of business if they render services elsewhere. See Soliman v. Comm’r, 506 U.S. 168 (1993); Rev. Rul. 94-24, 1994-1 C.B. 87.
30 Code § 55(b).
31 Code § 401(a); Rev. Rul. 70-411, 1970-2 C.B. 91; Professional & Executive Leasing, Inc. v. Comm’r, 89 T.C. 225 (1987), aff’d, 862 F.2d 751 (9th Cir. 1988); cf. Rev. Proc. 2002-21, 2002-1 C.B. 911 (plans maintained by professional employer organizations for the benefit of worksite employees of their clients will be disqualified unless they are terminated or converted into multiple employer plans).
32 See Code § 401(c)(2)(A)(i); Treas. Reg. § 1.401-10(c)(1).
the individual from the trade or business with respect to which the plan is established. “Earned income” for this purpose generally means the individual’s net earnings from self-employment for SECA purposes from the trade or business, minus the contributions themselves. Because the plan contributions themselves reduce “earned income,” an algebraic formula is necessary to ensure that the contribution amount for an independent contractor is not in excess of earned income. Similar calculation problems exist for compensation definitions based on the definition of earned income, including the Section 415 and Section 414(s) definitions of compensation, which are used for purposes of qualified plan discrimination testing and the limits on contributions to qualified plans.

In addition, contributions to the qualified plan that are used to purchase life, accident, health or other insurance for the independent contractor are not deductible.

Elective and Matching Contributions. For plan years beginning before January 1, 1998, any matching contributions to a partner covered by a Section 401(k) plan were treated as elective deferrals by the partner for purposes of the limit on elective deferrals under Section 402(g) and the non-discrimination requirements of Section 401(k)(3). This rule was reversed by statute in 1997. Despite the change, partners are still able to deduct matching contributions made to a qualified plan on their behalf under Treas. Reg. § 1.404(e)-1A(f)(1). The same rules probably apply to members of an LLC taxed as a partnership.

Because, for qualified plan purposes, a partnership is considered to be the employer of each of its partners, a partner may not, on his own, establish a qualified plan with respect to his services to the partnership. The same rule probably also applies to members of an LLC taxed as a partnership.

Employer Securities. Subject to certain limitations, a retirement plan sponsored by a corporation may hold securities of the sponsoring corporation. However, a retirement plan sponsored by a partnership probably may not hold any non-debt securities of the partnership (such as profits or capital interests), even if the partnership is publicly traded or elects to be taxed as a “C” corporation. The same rule probably also applies to LLCs taxed as partnerships.

33 Code § 404(a)(8).
34 Code § 401(c)(2).
35 Code § 415(c)(3)(B); see Treas. Reg. §§ 1.414(s)-1(b)(3) & 1.401(a)(17)‑1(b)(6), Examples 4 & 5.
36 Code § 404(a)(8), (e); Treas. Reg. § 1.404(e)-1A(g).
37 Code § 402(g), as amended by Taxpayer Relief Act of 1997, § 1501.
39 ERISA § 407.
40 A plan may not acquire or hold an employer security unless it is a “qualifying employer security,” and a capital or profits interest in a partnership qualifies only if the interest is publicly traded and the partnership was an existing partnership as of the effective date of the Revenue Act of 1987. ERISA § 407(a), (d)(5). Debt securities will qualify only if they qualify as “marketable obligations” under ERISA § 407(e). Cf. PTCE 2004-07, 69 Fed. Reg.
Separation from Service. There are no clear standards for determining when a partner or member of an LLC has had a “severance from employment” that entitles him to a distribution under a tax-qualified plan.\textsuperscript{41}

5. Welfare and Fringe Benefit Plans

Health Plans. Independent contractors cannot exclude from gross income the value of employer-provided health plan coverage because Sections 105 and 106 apply solely to coverage provided to an employee. They cannot even do so under plans they maintain for themselves, because there is no rule similar to the one in the qualified plan context treating them as employees of their own trades or businesses for this purpose. If a corporation elects to be taxed as a Subchapter S corporation and his or her ownership interest in the corporation exceeds 2%, he or she will be treated as a partner for purposes of these and other “fringe benefit” provisions of the Code.\textsuperscript{42}

Instead of an exclusion, independent contractors are allowed to deduct the amount they pay for health insurance for themselves and their families, but generally only if (1) they are not eligible to participate in any other tax-subsidized health plan, and (2) if they are partners or 2% S corporation shareholders the partnership or corporation either pays the premiums directly or reimburses the partner or shareholder for the premiums, and the payments are treated as guaranteed payments (in the case of a partner) or wages (in the case of a shareholder).\textsuperscript{43} Health insurance for this purpose can include coverage under a self-insured plan if it exhibits the appropriate degree of risk-shifting.\textsuperscript{44} Based on a technical reading of Sections 104(a)(3) and 105(e), the IRS previously took the position that amounts received under a self-insured accident

\textsuperscript{41} Cf. Treas. Reg. § 1.409A-1(f)(2)(i) ("An independent contractor is considered to have a separation from service with the service recipient upon the expiration of the contract (or in the case of more than one contract, all contracts) under which services are performed for the service recipient if the expiration constitutes a good-faith and complete termination of the contractual relationship. An expiration does not constitute a good faith and complete termination of the contractual relationship if the service recipient anticipates a renewal of a contractual relationship or the independent contractor becoming an employee.").

\textsuperscript{42} Code § 1372. For this purpose, employee fringe benefits include most employee benefits other than pension benefits. See, e.g., Durando v. United States, 70 F.3d 548, 551 (9th Cir. 1995); Rev. Rul. 91-26, 1991-1 C.B. 184.

\textsuperscript{43} Code § 162(l)(1)(A); Notice 2008-1, 2008-2 I.R.B. 251; CCA 200524001 (May 17, 2005); see FSA 3042 (Dec. 19, 1995) (cafeteria plan is tax-subsidized for this purpose). The deduction may not exceed the taxpayer’s earned income from the trade or business with respect to which the plan is established. Code § 162(l)(2)(A).

\textsuperscript{44} Section 162(l) clearly covers self-insured arrangements, and, in the IRS’s view, the presence of risk-shifting is the touchstone of insurance for this purpose. Compare PLR 9814023 (Dec. 23, 1997) with PLR 200007025 (Nov. 19, 1999). However, it is not clear whether it can include coverage under a mere reimbursement arrangement such as a health flexible spending account ("FSA"), even if the FSA complies with the uniform coverage requirement, the “use-it-or-lose-it” rule, and other requirements in the proposed cafeteria plan regulations which are designed to make FSAs more like insurance.
and health plan must be included in gross income, even if taxpayer paid for the coverage himself.\textsuperscript{45} This position was reversed by statute effective January 1, 1997.\textsuperscript{46}

The IRS takes the position that benefits, such as the payment of accident and health insurance premiums, that are provided to a partner without regard to partnership income for services performed in his capacity as a partner are "guaranteed payments" subject to Section 707(c). Section 707(c) treats a guaranteed payment as a payment by the partnership to someone who is not a partner, but solely for purposes of Sections 61 and 162. Therefore, the IRS takes the position that such benefits are deductible by the partnership as a compensation expense under Section 162 and are included in the partner's gross income under Section 61, but that (consistent with the general rule explained above) the benefits may not be excluded from the partner's gross income under any of the provisions of the Code excluding employee benefits from gross income, even though such provisions could be viewed as aspects of the definition of gross income in Section 61.\textsuperscript{47} Additionally, because the FICA exclusions for employee benefits do not apply, and because there generally are no comparable SECA exclusions, such benefits are included in SECA income as well.\textsuperscript{48} The same rules probably also apply to members of an LLC taxed as a partnership.

The same eligibility rules apply to employees and independent contractors with respect to Health Savings Accounts ("HSAs"). The IRS has said that contributions to HSA that are provided to a partner without regard to partnership income for services performed in his capacity as a partner are either "guaranteed payments" subject to Section 707(c) or distributions.\textsuperscript{49}

Independent contractors are not entitled to employer-provided benefits under the "employer mandate" in Section 4980H. The IRS has interpreted that provision to apply solely to common-law employees. The special rule for 2% shareholders of S corporations applies for this purpose, as well.\textsuperscript{50}

Section 36B makes a health insurance premium tax credit available to certain low-income individuals, including independent contractors who might be eligible to deduct the premiums under Section 162(f). Adjusted gross income is necessary to compute the premium tax credit, but the § 162(f) deduction reduces adjusted gross income, creating a circular relationship. The IRS

\textsuperscript{45} See PLR 9320004 (Feb. 5, 1993).

\textsuperscript{46} Health Insurance Portability and Accountability Act of 1996, § 311(b). The amendment added the language "or through an arrangement having the effect of accident or health insurance" to Code § 104(a)(3).


\textsuperscript{48} Some taxpayers take the position that health benefits provided by a partnership can be excluded from partners’ SECA income as Code § 132(d) "working condition fringe benefits" to the extent that they would have been deductible at the individual level under Code § 162(f).

\textsuperscript{49} See Notice 2005-8, 2005-4 I.R.B. 368.

\textsuperscript{50} Treas. Reg. § 54.4980H-1(a)(15).
has issued guidance, including safe harbor calculation methods, to use in resolving this circularity. 51

Other welfare and fringe benefits. Independent contractors cannot participate in a cafeteria plan, since all participants in a cafeteria plan must be common-law employees. 52 In addition, independent contractors cannot exclude from gross income the value of group term life insurance under Section 79, 53 meals and lodging expenses furnished for the convenience of the employer under Section 119, 54 transportation fringe benefits under Section 132(f), 55 or qualified moving expense reimbursements under Section 132(g).

On the other hand, independent contractors generally can exclude from gross income benefits received under an education assistance program, 56 dependent care benefits under Section 129 (unless provided through a cafeteria plan), 57 no-additional-cost services and employee discounts under Section 132(e), working-condition fringe benefits under Section 132(d), 58 and de minimis fringe benefits under Section 132(e). 59

6. Nonqualified Plans

Subject to some noteworthy exceptions, incentive and deferred compensation plans and arrangements maintained by partnerships and LLCs taxed as partnerships generally are subject to the same rules as plans and arrangements maintained by “C” corporations.

Golden parachute restrictions. The golden parachute rules, which disallow a deduction for and impose a 20% excise tax on certain “excess parachute payments,” generally do not apply to payments made by a partnership or LLC. This is because the rules apply solely to payments to individuals providing services to a “corporation” that are contingent on a change in ownership of

52 Code § 125(d)(1)(A).
53 Treas. Reg. § 1.79-0(b).
54 See, e.g., Wilson v. United States, 376 F.2d 280, 296 (Ct. Cl. 1967); Comm’r v. Moran, 236 F.2d 595, 598 (8th Cir. 1956); Comm’r v. Robinson, 273 F.2d 503, 504-05 (3d Cir. 1959), cert. denied, 363 U.S. 810 (1960); Rev. Rul. 53-80, 1953-1 C.B. 62. The rationale for these cases and revenue ruling is that a partnership is not a separate entity from the individual partners, and therefore a partner cannot be an employee of the partnership for purposes of the “convenience of the employer” test in Code § 119. Compare Armstrong v. Phinney, 394 F.2d 661 (5th Cir. 1968) (remanding to district court to determine whether a partner can function as an employee for purposes of Code § 119, in view of Code § 707(a)).
56 Code § 127(a). Code § 127(c)(2) treats self-employed individuals (as defined under Code § 401(c)(1)) as employees, although no more than 5% of the benefit under the program may be paid to employees who own greater than 5% of the stock or capital or profits interest in the employer. Code § 127(b)(3).
57 Code § 129(a). Code § 129(e)(3) treats self-employed individuals (as defined under Code § 401(e)) as employees, although no more than 25% of the benefit under the program may be paid to employees who own greater than 5% of the stock or capital or profits interest in the employer. Code § 129(d)(4).
58 Treas. Reg. § 1.132-1(b)(1), (2).

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the corporation. “Corporation” for this purpose means an entity classified as a corporation or a publicly traded partnership. Note that in determining whether the golden parachute rules apply to payments by a corporation, payments from related partnerships and LLCs might have to be taken into account.

Limit on deductible compensation. The $1 million dollar limit on deductible compensation does not apply to payments by a partnership or LLC. The exception for a partnership applies even if the partnership is publicly traded.

Qualified stock options. The rules establishing favorable tax treatment for the holders of incentive stock options (“ISOs”) and participants in employee stock purchase plans generally do not apply to interests or options for interests in a partnership or LLC because the rules apply solely to arrangements involving “stock” in a “corporation.” “Corporation” for this purpose means an entity classified as a corporation or a publicly traded partnership. Employees of an LLC that is a subsidiary of a corporation may not receive ISOs or options under an employee stock purchase plan from the corporation since they are not employees of a corporate subsidiary. (Presumably this would not be true if the LLC were wholly owned by the corporation and thus its separate existence were disregarded for tax purposes.)

Section 83. Most benefits practitioners assume that the usual rules in Section 83 that govern the taxation of individuals receiving restricted stock or nonstatutory stock options in connection with the performance of services for a corporation, also govern the taxation of individuals receiving interests in, or options with respect to interests in, a partnership or LLC in connection with the performance or services for the partnership or LLC. Courts seem to agree.

Assuming that Section 83 (or principles similar to those in Section 83) govern, the difference between the current value of the interest and the amount that the individual pays for

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60 Code § 280G(b)(2)(A), (c).
61 Treas. Reg. § 1.280G-1, Q&A-45.
62 See, e.g., Treas. Reg. § 1.280G-1, Q&A-10.
63 Code § 162(m)(1).
64 See PLR 200837024 (May 30, 2008); PLR 200614002 (Dec. 14, 2005); PLR 199915036 (April 16, 1999).
65 Code §§ 422(b), 423(a); Treas. Reg. § 1.421-7(d).
66 Treas. Reg. § 1.421-7(i)(1).
67 However, it is not 100% clear that assumption is correct. Subchapter K has its own rules governing the admission of new partners. Under those rules, the admission of a new partner generally does not result in the immediate recognition of income by the partner unless he contributes no property to the partnership but nevertheless receives a capital interest, in which case he is taxed on the fair market value of the interest under Code § 61, either at the time the interest is transferred if the transfer is for past services or at the time the services are rendered if the transfer is for future services. The time when the income is realized also depends on all of the facts and circumstances. Treas. Reg. § 1.721-1(b)(1).

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the interest is included in the individual’s gross income when the interest is transferred or, if later, when the interest vests. Also, as in the case of a transfer of stock, under Section 83(h) the partnership or LLC is entitled to deduct the amount that is included in the individual’s income. Similarly, as in the case of a transfer of unvested stock, the individual may make an election under Section 83(b) to include the value of the interest in income before it vests, so as to “lock in” the value of the interest that must be characterized as ordinary income while the amount is still low. Finally, as in the case of a nonqualified stock option, the grant of an option to purchase an interest in a partnership or LLC generally is not a taxable event unless the option itself is publicly traded.\(^{69}\)

However, even assuming that Section 83 governs, some variations and special considerations clearly exist under current law with respect to compensatory transfers of partnership or LLC interests. Of particular interest:

- If an individual receives a profits interest in exchange for services to a partnership in a partner capacity or in anticipation of becoming a partner, the IRS will not treat the receipt of such an interest as a taxable event for the individual or the partnership, unless (i) the interest relates to a “substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease,” (ii) within two years of receipt, the partner disposes of the profits interest, or (iii) the partnership is publicly traded.\(^{70}\)

- It is not clear whether the IRS’s position is based on the conclusion that a mere profits interest is not the kind of “property” to which Section 83 applies, that a profits interest is property but has no ascertainable value, or that Section 83 does not apply to transactions of this sort and whatever other rule applies does not require taxation.

- An unvested interest is treated as received on the date of grant, and thus its status as a profits interest for this purpose is tested at that time, as long as the partnership and the individual treat the individual as the owner of the interest from the date of its grant and the individual takes into account the distributive share of partnership income, gain, loss, deduction, and credit associated with that interest in computing the individual’s income tax liability for the entire period during which the individual has the interest, and the partnership and its partners do not take a deduction for the fair market value of the interest.\(^{71}\)

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\(^{69}\) This is because only options with “readily ascertainable values” are Code § 83 property and the IRS interprets readily ascertainable very narrowly. Code § 83(e)(3), (4); Treas. Reg. § 1.83-7(b).

\(^{70}\) Rev. Proc. 93-27, 1993-2 C.B. 343. A profits interest is one that would give the holder no share of the proceeds if the partnership’s assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership. Id.; cf. Notice 2005-43, 2005-24 I.R.B. 1221. Treas. Reg. § 1.704-1(b) was revised in 2004 to make it easier to book-up other partners’ capital accounts immediately before the admission of a new partner, to ensure (if desired) that what the new partner receives is a profits interest.

Section 409A. Section 409A requires all amounts deferred under a nonqualified deferred compensation plan after December 31, 2004 (including earnings on those amounts) to be included in income to the extent they are not subject to a substantial risk of forfeiture and have not previously been included in income unless the plan complies, both in form and in operation, with certain rules regarding the timing of deferral elections and the timing of payouts and payout elections. If these rules are violated, the service-provider also must pay interest at the IRS underpayment rate plus 1% on the underpayment that would have occurred if the amounts had been included in income when first deferred or, if later, when they were not subject to a substantial risk of forfeiture. In addition, the amounts is subject to an additional 20% tax.

Section 409A applies to nonqualified deferred compensation plans for independent contractors, including partners and members of LLCs taxed as partnerships, as well as employees. But it is unclear when compensation is deferred in this context. The guidance avoids some of these questions by suggesting that payments to partners acting in their capacity as partners are exempt and expressly exempting arrangements described in Section 736 (unless they’re subject to Section 1402(a)(10)), and guaranteed payments for services described in Section 707(c) (unless the partner does not include the payment in income within 2½ months after the end of the taxable year of the partner in which the right to the payments vests).

The guidance defines nonqualified deferred compensation in such a way as to exclude most grants of restricted stock, grants of stock options that are not in the money when they are granted, and stock-settled SARs with respect to publicly traded stock that likewise are not in the money when they are granted. “Until additional guidance is issued” the guidance allows taxpayers to treat grants of partnership interests, and options and appreciation rights with respect to partnership interests, in the same way as transfers of corporate stock, stock options and SARs for this purpose. It also specifically provides that the issuance of a profits interest in exchange for services that is properly treated under existing guidance as not resulting in inclusion of income by the service provider at the time of issuance is not treated as a deferral of compensation.

One of the distribution events permitted by Section 409A is a change in the ownership or effective control of the corporation, or in the ownership of a substantial portion of the assets of the corporation. It is not clear whether this distribution event applies to plans maintained by partnerships or LLCs taxed as partnerships, unless they are treated as corporations for tax purposes.

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73 See Treas. Reg. § 1.409A-3(i)(5).
B. Determination of Employment Status

The status of a worker as an employee or independent contractor for federal tax purposes is, with few exceptions, determined under the common law test for determining whether a master-servant (employment) relationship exists.

Background. The common law test focuses exclusively on the employer’s control or right to control how an employee does his job.\(^74\) It first assumed importance under the employment tax provisions of the Code. The original Social Security Act simply defined an “employee” as including “an officer of a corporation.”\(^75\) Treasury regulations issued in 1936 used the common law test to determine employee status.\(^76\) The lower courts, however, applied a variety of different tests, some relying less than others on common law precedents.\(^77\) In 1947, the Supreme Court issued a pair of opinions that attempted to clarify the governing tests.\(^78\) In these opinions, the Court applied an “economic realities” test under which “employees are those who as a matter of economic reality are dependent on the business to which they render services.”\(^79\) Obviously, the economic realities test, which focused on dependency, had the potential to treat many more workers as employees than the common law test, which focused on control.

The IRS and the Social Security Administration proposed amendments to their regulations to incorporate the Court’s new economic realities test, but these never took effect: Congress reacted immediately by passing (over President Truman’s veto) the so-called Gearhart Resolution, endorsing the use of the common law test.\(^80\)

Current Rules. Current Treasury regulations provide that an individual generally is an employee if, under the common law test, the relationship between the individual and the person for whom he or she performs services is the legal relationship of employer and employee. Such a relationship generally exists if the person for whom the services are performed

has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the

\(^74\) See Restatement (Second) of Agency § 220(1) (1958) (“A servant is a person employed to perform services in the affairs of another and who with respect to the physical conduct in the performance of the services is subject to the other’s control or right to control.”).

\(^75\) Social Security Act § 1101(a)(6), Pub. L. No. 74-271, 49 Stat. 620, 647 (1935). FICA was in Title VIII of the original act. SECA was enacted on August 28, 1950.

\(^76\) Reg. 91, article 3, 1 Fed. Reg. 2049, 2052 (Nov. 11, 1936). The regulations state, inter alia, that “[i]n general, if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he is an independent contractor. An individual performing services as an independent contractor is not as to such services an employee.” This closely resembles the language in the current regulations.


\(^79\) Bartles, 332 U.S. at 130.

employer not only as to what shall be done but [also] how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so. The right to discharge is also an important factor indicating that the person possessing that right is an employer. Other factors characteristic of an employer, but not necessarily present in every case, are the furnishing of tools and the furnishing of a place to work, to the individual who performs the services. In general, if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he is an independent contractor.\(^{81}\)

Over the years, the IRS has identified 20 important factors for determining when the common law test is satisfied.\(^{82}\) These factors are listed in Table A. In the 1990s, the IRS began emphasizing that these factors are not the only ones that may be taken into account, or even the best way to approach the classification issue. The IRS has not departed from the basic common law test, which focuses on control. However, the IRS instructs its agents to take all of the facts and circumstances into account in determining whether sufficient control exists, and to organize them according to whether they relate to behavioral control, financial control or the relationship of the parties.\(^{83}\) This approach is compared with the 20-factor test in Table B.

**Statutory Employees.** Congress and the courts have overridden the common law test in some situations:

- Licensed real estate agents who work on commission pursuant to a written contract and certain direct sellers generally are treated as independent contractors for all tax purposes.\(^{84}\)
- Clergy generally are treated as independent contractors for employment tax purposes regardless of the circumstances.

\(^{81}\) Treas. Reg. §§ 31.3121(d)-1(c)(2), 31.3306(i)-1(b) & 31.3401(e)-1(b).

\(^{82}\) Rev. Rul. 87-41, 1987-1 C.B. 296. These factors originally were compiled by the Social Security Administration in determining entitlement to benefits.

\(^{83}\) IRS, *Independent Contractor or Employee? Training Materials* (March 4, 1997) ("IRS Training Materials"); PLR 201311002 (Dec. 6, 2012) (relevant facts for determining whether an individual is an employee or an independent contractor under the common law "generally fall into three categories: (1) behavioral controls, (2) financial controls, and (3) the relationship of the parties"); Information Letter 2004-0087 (April 8, 2004). This approach is generally consistent with the approach taken by courts applying the common law. See, e.g., *CCNV v. Reid*, 490 U.S. 730, 740 (1989); *Butts v. Comm'r*, 66 T.C.M. (CCH) 1041 (1993), aff'd per curiam, 49 F.3d 713 (11th Cir. 1995); Restatement (Second) of Agency § 220(2).

Courts are not always consistent, however. See, e.g., *Bruecher Foundation Services, Inc. v. United States*, 383 Fed. Appx. 381 (5th Cir. 2010), which applied the factors from *Silk* and whether the worker "is in business for himself" to determine whether workers in question were employees or independent contractors. The court cited a previous Fifth Circuit precedent for the rule that, "[a]lthough the determination of employee status is to be made by common law concepts, a realistic interpretation of the term 'employee' should be adopted, and doubtful questions should be resolved in favor of employment in order to accomplish the remedial purposes of the legislation involved."

\(^{84}\) Code § 3508.
• Corporate officers generally are treated as employees for FICA, FUTA and income tax withholding purposes unless they do not perform any services or perform only minor services and do not receive any remuneration. 85

• Certain full-time life insurance salesmen, agent-drivers and commission-drivers engaged in the distribution of specific kinds of products, homeworkers and traveling or city salesmen generally are treated as employees for FICA and FUTA purposes unless the individual has a substantial investment in the facilities used in the performance of the services (other than an automobile). 86

Partners. Mere ownership of an interest in one’s employer generally is not taken into account in determining whether an individual is an employee. 87 Thus, employees who receive stock as compensation for services are treated as owners, not employees, with respect to any dividends, gains and losses from the stock from the time that the stock vests, 88 but do not lose their status as employees with respect to their other income.

Existing law suggests that whether a partner or member of an L.L.C is an employee or an employer under the common-law test is determined based on all of the facts in the same way as it is for other service-providers. 89 However, the IRS has long taken the position that an individual cannot be both a partner and an employee of the same partnership, even with respect to different streams of income. 90 Rev. Rul. 69-184 states that:

85 Code §§ 3121(d), 3306(i) & 3401(c); Treas. Reg. § 31.3121(d)-1(c); see also CCA 200009043 (Jan. 4, 2000) and 200038045 (Aug. 9, 2000). SBSE-04-0709-039, Officer Compensation: IRC Sections 3509 and 7436, and Section 530 of the Revenue Act of 1978 (July 6, 2009), advises examiners that “[t]he conclusion that a corporate officer is a statutory employee may not apply to the extent that he or she performs services in some other capacity.”


87 See Rev. Rul. 87-41, 1987-1 C.B. 296; Publication 1779, Independent Contractor or Employee.


89 See Treas. Reg. §§ 31.3401(c)-1(e) & 31.3121(d)-1(a)(3) (“If the relationship of employer and employee exists, the designation or description of the relationship by the parties as anything other than that of employer and employee is immaterial. Thus, if such relationship exists, it is of no consequence that the employee is designated as a partner . . . .”).

90 E.g., Rev. Rul. 69-184, 1969-1 C.B. 256, GCM 34001 (Dec. 23, 1969); see also, e.g., GCM 34173 (July 25, 1969) (partners cannot be employees for income tax purposes); CCA 200117003 (April 27, 2001) (partners cannot be employees for employment tax purposes). In other contexts, the IRS takes the position that an individual can serve in two capacities with respect to the same employer, provided that the two capacities are not interrelated.
[A b]ona fide member[ ] of a partnership . . . who devotes his time and energies in the conduct of the trade or business of the partnership, or in providing services to the partnership as an independent contractor, is, in either event, a self-employed individual rather than an individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee.

The references to a “bona fide member of the partnership” and the “conduct of the trade or business of the partnership” suggest that the drafters had in mind traditional service partners, for whom such a conclusion might be correct in most situations. But in practice the IRS’s position seems to be that granting a partnership interest to an employee always turns the employee into a partner for tax purposes even if the interest is small and the employee does not have a significant role in management.

Outside of the tax context, courts have suggested that partners in large partnerships who have little management authority might be partners in name only and should in fact be classified as employees. However, the IRS has not given any indication that it is changing this position.

One way to limit the potential for conflict between the IRS’s position and the common law test is to treat the regular compensation of an employee who receives a partnership interest as income for services that he performs other than in his capacity as a partner. Section 707(a) suggests the possibility of such an approach, and at least one court has endorsed it. However,

91 Under the common law test, it is difficult for a partner to qualify as an employee because the very things that distinguish a partner of a business from an employee of a business, e.g., the fact that a partner participates in the management of the business and shares in its gains and losses, are some of the most important things that distinguish independent contractors from employees under the common law. See Hishon v. King & Spalding, 467 U.S. 69, 79 (1984) (Powell, J., concurring) (listing, in a Title VII case, the types of distinguishing management decisions made by law firm partners).

92 E.g., Simpson v. Ernst & Young, 100 F.3d 436, 443 (6th Cir. 1996), cert. denied, 520 U.S. 1248 (1997) (depending on the facts partners can qualify as employees under the ADEA); EEOC v. Sidley Austin Brown & Wood, 315 F.3d 696, 707 (7th Cir. 2002) (same); Clackamas Gastroenterology Associates, P.C. v. Wells, 538 U.S. 440 (2003) (depending on the facts partners can qualify as employees under the ADA). In two similar letters dated July 25 and July 29, 2013, the EEOC Office of Legal Counsel stated that:

It is well established that in some instances individuals who have the job title of “partner” may qualify as employees for purposes of the EEO laws, including the ADEA. This principle does not represent an expansion of the ADEA. The relevant question in each case is whether the individual acts independently and participates in managing the organization (not an employee), or whether the individual is subject to the organization’s control (an employee). . . . Thus, if a determination were made in a particular case that individuals holding the title of “partner” are actually employees, it would be a factual determination guided by existing law. It would neither be an expansion of the ADEA nor the result of an EEOC plan “to expand coverage of the [ADEA] as to accounting firm partners.”

Cf. Bates van Winkelhof v Clyde & Co LLP, [2014] UKSC 32, [2014] 1 W.L.R. 2047 (Supreme Court, May 21, 2014) (a law partner can be a “worker” entitled to protection under the Employment Rights Act 1996. “As the case of the controlling shareholder in a company who is also employed as chief executive shows, one can effectively be one’s own boss and still be a ‘worker’.”).

93 Armstrong v. Phinney, 394 F.2d 661 (5th Cir. 1968).
this is exactly the approach the IRS rejected in its guidance. It appears to have done so for administrative as much as for legal reasons. GCM 34001 (Dec. 23, 1968) explained that:

To introduce the possibility of dual “status” into the application of the statutes in question so that the determination of “wages” under Section 3121(a) would virtually have to be on a transaction by transaction basis (rather than one based on a single continuing relationship) would render it almost impossible to administer the employment taxes of subtitle C. It is hardly rational to assert that Congress intended or would approve such a result merely because the statute which it wrote did not link up an individual’s “status of an employee” with the person for whom the individual performs services . . . .

The IRS’s position has a particularly harsh impact on individuals historically treated as employees who receive (often small) partnership or LLC interests as compensation for services. They are transformed into independent contractors with respect to all of their compensation, causing them to be subject to different employment tax rules, and potentially resulting in a loss of employee benefits and even disqualifying employee benefit plans in which they participate. Partnerships and LLCs taxed as partnerships have used various planning techniques to avoid these consequences, including employing the individuals at one entity while granting them partnership or LLC interests from another entity. But the effectiveness of some of these techniques has been questioned.94

New proposed regulations95 and conversations with officials in the IRS National Office suggest that the IRS might be reconsidering its position, and several groups have submitted comments on the issue. But it is too soon to predict whether any change will occur.

Section 530. Section 530 of the Revenue Act of 1978 provides statutory relief from reclassification for certain employers involved in employment tax controversies with the IRS.96 Generally speaking, Section 530 prohibits the IRS from challenging an employer’s treatment of an employee as an independent contractor for employment tax purposes if the employer has a reasonable basis for such treatment, including:

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94 See, e.g., Treas. Reg. § 301.7701-2T, which was added by T.D. 9766, 81 Fed. Reg. 26693 (May 4, 2016), and addresses the technique of employing an individual at one entity while granting the individual a partnership or LLC interest from a disregarded entity immediately below the employing entity.

95 The preamble to REG-115452-14, supra note 71, contains the cryptic statement that “if an arrangement is subject to section 707(a), taxpayers should look to relevant authorities to determine the status of the service provider as an independent contractor or employee. See, generally, Rev. Rul. 69-184, 1969-1 C.B. 256. More directly, the preamble to T.D. 9766, supra note 94, requests comments on “the impact on employee benefit plans (including, but not limited to, qualified retirement plans, health and welfare plans, and fringe benefit plans) and on employment taxes if Rev. Rul. 69-184 were to be modified to permit partners to also be employees in certain circumstances.”

96 Section 530 is codified as a note to Code § 3401 in the United States Code, but is not actually a part of the Internal Revenue Code. Congress intended Section 530 “to be liberally construed in favor of the taxpayer.” See H.R. Rep. No. 95-1748, at 5 (1978). For IRS procedures regarding the application of Section 530, see generally Internal Revenue Manual (Examinations) ¶¶ 4.23.5.2 et seq.

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• Classifying the employee as an independent contractor is supported by judicial precedent, published rulings, a technical advice memorandum issued with respect to the taxpayer, or a letter ruling issued to the taxpayer.

• A past employment tax or other IRS audit resulted in no assessment of employment taxes for improperly classified employees in substantially similar positions. Employers may not rely on an audit commencing after 1996 unless the audit included an employment tax examination of whether the worker involved (or a similarly situated worker) should be classified as an employee.

• The independent contractor classification is supported by a long-standing and recognized practice in a significant segment of the taxpayer’s industry. A taxpayer does not have to show the practice of more than 25% of an industry in order to meet this requirement. An industry practice need not have continued for more than 10 years in order to be considered long-standing, and will not fail to be longstanding merely because it began after 1978.

In order for the relief to be available, the employer must treat all employees in substantially similar positions as independent contractors (substantive consistency) and must file all federal tax returns, including Form 1099-MISC, on a basis consistent with treating them as an independent contractors (reporting consistency). In determining whether a worker holds a substantially similar position to another worker, the relationship of the parties must be taken into account.

At the beginning of a worker classification audit, the IRS must give the taxpayer a written notice regarding Section 530. A worker does not have to be an employee in order for Section 530 to apply. If a taxpayer establishes a prima facie case that it was reasonable not to treat a worker as an employee on one of the bases listed above in a Section 530 case, and the taxpayer cooperates with reasonable IRS requests, the burden of proof shifts to the IRS. If a taxpayer prospectively changes its treatment of workers from independent contractors to employees for employment tax purposes, the change will not affect the applicability of Section 530 to those workers for prior periods.97

Section 530 also generally prohibits the IRS from issuing regulations or publishing revenue rulings addressing the status of workers as employees or independent contractors for employment tax purposes.98 Section 1706 of the Tax Reform Act of 1986 excludes taxpayers that broker the services of technical services workers from coverage under Section 530.


98 H.R. 5804, the Taxpayer Responsibility, Accountability, and Consistency Act, would repeal Section 530 and replace it with a new safe harbor provision that the bill’s sponsors believe would more clearly define who can be classified as an independent contractor.
Section 530 relief does not apply to employees. They remain responsible for employee half of FICA (but not for SECA taxes, because they are not, in fact, independent contractors).\(^\text{99}\)

Section 530 applies solely to federal employment taxes, but many states will follow it if federal Section 530 relief has been granted.

**Relevance of Incorporation.** An employee generally cannot change his or her status to that of an independent contractor via incorporation. The common law test focuses on the relationship between the individual performing the services and the service-recipient; if an employment relationship exists, it generally is irrelevant whether payments are made directly or through a corporation controlled by the individual.\(^\text{100}\)

An independent contractor cannot change his or her status to that of an employee of his or her client simply by forming a wholly-owned corporation and becoming an employee of the corporation. He or she may, however, be treated as an employee of the corporation for certain purposes,\(^\text{101}\) and take advantage, *inter alia*, of various employee benefit provisions of the Code. The individual will, moreover, not be subject to the 2% floor on itemized deductions or other limits on employee trade or business expense deductions to the extent he or she causes such expenses to be deducted at the corporate level. However, if the corporation elects to be taxed as a Subchapter S corporation under Section 1362 and his or her ownership interest exceeds 2%, he or she will be treated as a partner for purposes of the employee fringe benefit provisions of the Code.\(^\text{102}\)

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99 Form 8919 (Uncollected Social Security and Medicare Tax on Wages) is used for this purpose.

100 The Tax Court and the IRS essentially take the position that providing personal services through a wholly-owned company (sometimes called a "loan-out company") has no effect on whether the individual providing the services is treated as an employee of the company receiving the services. *Leavell v. Comm'r*, 104 T.C. 140 (1995); Rev. Rul. 87-41, 1987-1 C.B. 296; Rev. Rul. 74-330, 1974-2 C.B. 278 (examples (1), (2)); H.R. Conf. Rep. No. 99-841, at II-835 (1986); 132 Cong. Rec. S8088-89 (June 20, 1986); *cf. Johnson v. Comm'r*, 78 T.C. 882 (1982), *aff'd* without published opinion, 734 F.2d 20 (9th Cir. 1984). Thus, if the company receiving the services has enough control over how the individual performs the services to be considered the employer, it does not matter whether the service contract specifies that the individual is an employee of his wholly-owned company and that any directions are to be sent through the wholly-owned company. In its most recent decision, the Tax Court quoted with approval another judge's observation in a case involving professional hockey players that "[t]he idea that the coach issued orders to [the players] in their capacity as corporate officers, which orders they then relayed to themselves as corporate employees, is fanciful."

On the other hand, the Eighth and Ninth Circuits have issued decisions treating such language in the service contract as controlling as long as the wholly-owned company is not a sham. *See Idaho Ambucare Center, Inc. v. United States*, 57 F.3d 752 (9th Cir. 1995); *Sargent v. Comm'r*, 929 F.2d 1252 (8th Cir., 1991), *rev'g* 78 T.C. 1014 (1981) (affirming allocation of income attributable to physician's medical practice to his wholly-owned professional corporation rather than to him as an individual). Citing the Eighth Circuit decision, the IRS's training materials for its agents note that courts are reluctant to disregard loan-out companies that are not shams.

101 See, *e.g.*, *Darrell Harris, Inc. v. United States*, 770 F. Supp. 1492 (W.D. Okla. 1991); *Spicer Accounting*, 918 F.2d at 94.

102 *See supra* note 42.
Relevance of Contract. Language in a contract is not dispositive in determining whether a worker is an employee or independent contractor for federal tax purposes. Nevertheless, a contract might be relevant in making that determination to the extent it provides evidence of the parties’ intent, the extent to which the service-recipient can control and direct the worker, and other factors taken into account in making that determination. A contract also can be used to clarify the effect of a worker’s status as an employee or independent contractor. For example, a contract with a worker generally can provide that the worker, despite being classified as an employee, may not participate in any of employee benefit plans maintained by the employer for its employees.

Treatment under state law also is not dispositive.

C. Identification of Employer

Multi-Party Arrangements. Sometimes more than one entity controls at least some aspects of the employment relationship. For example, a leasing company might have the right to determine the amount of wages and benefits that leased employees will receive, and to hire or fire the employees, while the service-recipient might have the right to supervise their work on a daily basis. In such a situation it might not be clear which entity is the employee’s common law employer.

The exact identity of the common law employer is somewhat less relevant for employment tax purposes. The IRS recognizes at least three ways for common law employers to transfer some of their employment tax obligations to another party:

- Under the “statutory employer” rule, if an entity other than the common law employer controls the payment of wages to the employee, it is treated as an employer for purposes of withholding, reporting and paying employment taxes, even if it controls no other aspect of the employment relationship. The entity uses its own EIN and is solely liable.

103 E.g., Professional & Executive Leasing, 862 F.2d at 754.

104 E.g., Sargent, 929 F.2d at 1256-58.

105 See, e.g., Treas. Reg. § 1.401(k)-1(a)(3)(v) (recognizing validity of one-time election not to participate in a plan); Rev. Rul. 80-47, 1980-1 C.B. 83 (a qualified plan may deny participation to employees who decline to authorize salary withholding or to take a physical exam); cf. Rev. Rul. 80-351, 1980-2 C.B. 152 (waiver by employer’s only nonhighly compensated employee causes plan to fail to meet minimum coverage requirements). Of course, language giving effect to the provision should be included in any plan to which it applies. Without such language, the provision might not be part the plan and thus might not be able to modify the eligibility conditions in the plan.

106 See, e.g., CCA 200827007 (March 10, 2008) (addressing whether the employees of an employee leasing company’s client companies are its employees for FUTA tax refund purposes, where state law treats the employees as performing services for the leasing company for state unemployment insurance purposes).


108 Code § 3401(d)(1); Treas. Reg. § 31.3401(d)-1(f); Otte v. United States, 419 U.S. 43 (1974); General Motors Corp. v. United States, 91-1 U.S.T.C. ¶ 50,032 (E.D. Mich. 1990); CCA 199932002 (Feb. 26, 1999); GCM 38441 (July 11, 1980); GCM 38208 (Dec. 19, 1979). In GCM 38208 (Dec. 19, 1979), the IRS concluded that the General Accounting Office (“GAO”) had “control,” within the meaning of Code § 3401(d), over back wage payments that a court had ordered paid to employees of certain government agencies, because the GAO controlled the
for any unpaid taxes, penalties and interest.\textsuperscript{109} However, the identity of the common law employer is still used to determine whether there is any liability for employment taxes in the first place (e.g., whether an exemption is available), and the amount of the liability (e.g., whether wages paid to an employee working multiple jobs are aggregated to determine whether they exceed the taxable wage base).\textsuperscript{110}

- Section 3504 allows a common law employer to appoint an agent to perform some or all of its employment tax obligations. The entity uses its own EIN but is jointly liable with employer for any unpaid taxes, penalties and interest. Generally an agent is appointed by filing a Form 2678.\textsuperscript{111} However, the regulations were amended recently\textsuperscript{112} to treat a

appropriations account from which the payments were made. The IRS concluded that the court did not have “control” because it merely ordered the payments to be made, and that the Treasury Department agency that issued the checks and performed other bookkeeping functions did not have “control” because it could perform those ministerial functions only with the approval of the GAO. See also CCA 20131801F (March 29, 2013) (county is statutory employer of constables because “the constables’ payment for [their] services is controlled by the County, as the funds come from County checking accounts and the County Manager of Constable Services verifies all submissions for payments”); \textit{General Motors Corp. v. United States}, 91-1 U.S.T.C. \textsuperscript{¶} 50,032 (E.D. Mich. 1990) (design firm was employer and not mere agent of General Motors responsible for “ministerial task” of disbursing paychecks to designers).

The issue comes up frequently in the PEO context. In that regard, TAM 201347020 (Aug. 15, 2013) states that “the Office of Chief Counsel has consistently stated that a PEO or similar employee leasing company is not in control of the payment of wages [for purposes of Code § 3401(d)(1)] if the payment of wages is contingent upon, or proximately related to, the PEO having first received funds from its clients.”

It is not clear how the rule applies to tip income. See TAM 201347020 (Aug. 15, 2013) (“While we have not answered the specific question of whether a section 3401(d)(1) employer with respect to non-tip wages can also be a section 3401(d)(1) employer with respect to liability for the employer FICA tax on tip wages by virtue of section 3121(q), as discussed above, there is statutory support for that position and it is consistent with the desire (as reflected by the courts’ extension of section 3401(d)(1) to the other federal employment taxes) to consolidate the employment tax liability on wages with the person who is in control of the payment of the wages.”).

\textsuperscript{109} See REG-102966-10, \textit{supra} note 107; Internal Revenue Manual \textsuperscript{¶} 5.1.24.3.2.2 (08-15-2012).

\textsuperscript{110} See, e.g., \textit{Blue Lake Rancheria v. United States}, 653 F.3d 1112 (9th Cir. 2011) (FUTA exemption for services performed for Indian tribe does not apply not when tribe is merely a “statutory employer” that operates as common paymaster); \textit{Cencast Services, L.P. v. United States}, 62 Fed. Cl. 159 (2004), aff’d, 729 F.3d 1352 (Fed. Cir. 2013), \textit{cert. denied}, 134 S. Ct. 2831 (2014) (payroll service company that supplied production employees to movie industry required to apply separate wage cap with respect to each production company that had employment relationship with each production worker during year, and thus “the common law employers cannot decrease their liability by retaining entities such as Cencast to actually make the wage payments to the employees”).

Section 346 of Division Q (also called the Protecting Americans from Tax Hikes Act of 2015) of the Consolidated Appropriations Act, 2016 (Pub. L. No. 114-113) effectively reversed \textit{Cencast}. It treats remuneration paid by a “motion picture project employer” to a “motion picture project worker” as remuneration paid for employment of the motion picture project worker. A “motion picture project employer” is a kind of leasing company that treats the motion picture project workers as its employees and has signed a CBA with a union that represents the workers.


person that pays wages to the employees of a client (and is not the actual common-law employer or the statutory employer under Section 3401(d), and has not obtained a Form 2678 from the client) as the client’s agent under Section 3504 for employment tax (including FICA, FUTA and RRTA taxes and federal income tax withholding) purposes if the person has a written or oral agreement with the client pursuant to which it (1) asserts that it is the employer (or co-employer) of the employees and (2) assumes responsibility to collect, report, and pay, or assumes liability for, any employment taxes with respect to the wages. A person would be treated as asserting that it is the employer (or co-employer) of the employees if it agrees to (i) recruit and hire the employees or assign the employees as permanent or temporary members of the client’s workforce, (ii) hire the employees as its own and then provide them back to the client to perform services for the client, or (iii) file employment tax returns using its own EIN that include wages or compensation paid to the employees.

- An employer may contract with a payroll service provider (PSP) or reporting agent to perform some or all of its some of its employment tax obligations. In this situation, the employer remains solely liable for any unpaid taxes, penalties and interest. Reporting agents are appointed using a Form 8655.

- Section 3511 treats a “certified” PEO as the sole employer for purposes of complying with its clients’ payroll tax obligations, and treats the PEO and the client, respectively, as successor employers when employees are transferred between them. Section 7705 defines a certified PEO as a PEO that has applied for that certification and satisfies certain requirements, including bonding, financial review requirements, and reporting and recordkeeping requirements. Regulations opening the program were issued in 2016, and the initial application deadline was September 30, 2016.

PEO has failed to pay employment taxes on wages attributable to any client employees before April 1, 2014 (when Treas. Reg. § 31.3504-2 became effective), if the facts and circumstances indicate that the clients remained the employers, the IRS assess the appropriate amount of employment taxes against the clients and abate any corresponding tax liability previously assessed against the PEO.


Sometimes there is an issue whether funds handed over by a client to a PSP for deposit with the government are nevertheless reachable by the PSP’s own creditors. Compare In re FirstPay, Inc., 773 F.3d 583 (4th Cir. 2014) (not reachable), cert. denied, 135 S. Ct. 2890 (2015), with Slobodian v. United States, 2014 WL 2041815 (M.D. Pa., May 12, 2014) (potentially reachable).


The identity of the common law employer also remains important for income tax purposes. For example, only the common law employer of an employee may provide him or her with benefits that are limited to employees, and entities that are not common law employers are not subject to any nondiscrimination or other obligations imposed on common law employers with respect to their employees.

Typically, which of two or more entities in a multi-party employment situation is the employer of a particular worker is determined by analyzing each entity’s relationship with the worker in light of the usual common law factors. This analysis has obvious limitations where no single party has enough control clearly to satisfy the common law test.

Under the common law, two or more entities may be treated as an employee’s “joint employer” or “co-employers” if they share control over the employee. The IRS has recognized that, because the rule is based on the common law, it applies for employment tax purposes. Under the related “borrowed servant” rule, an employee who is sent by one employer to work for another may be considered an employee of both “so long as, by the service rendered another, he is performing the business entrusted to him by the general employer. There is no inference that because the general employer has permitted a division of control, he has surrendered it.” Since the common law also applies for purposes of the employee benefit provisions of the Code, these rules presumably apply in that context, as well. However, in practice the IRS has not been inclined to apply it in either context.

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116 See, e.g., Rev. Proc. 2002-21, 2002-1 C.B. 911 (“Courts have also found that common law factors are applicable to determine which of two entities is the employer for purposes of retirement plans”); Rev. Rul. 87-41, 1987-1 C.B. 296 (applying common law test to identify employer in multi-party employment situation); Vizcaino v. Microsoft Corp., 173 F.3d 713 (9th Cir. 1999), cert. denied, 528 U.S. 1105 (2000) (rejecting lower court’s application of slightly different test in multi-party employment situation in order to determine whether workers were entitled to certain employee benefits); Professional & Executive Leasing, supra note 31 (applying common law test to identify employer in employee leasing situation in order to determine whether leasing company’s plans were tax-qualified).

117 See Restatement (Second) of Agency §§ 226 (joint employment) and 227 (borrowed servants).

118 Rev. Rul. 66-162, 1966-1 C.B. 234; see Alford v. United States, 116 F.3d 334 (8th Cir. 1997) (rejecting in dictum government’s approach, which had been adopted by the district court, of combining the control exercised by several entities over an individual in determining whether he was an employee).

119 Restatement (Second) of Agency § 227 (1958); cf. Rev. Rul. 59-68, 1959-1 C.B. 95 (officer’s employment with original employer was not terminated for purposes of statutory stock option rules when he was assigned to perform services for an affiliated company).

120 Cf. Vizcaino v. Microsoft Corp., supra note 116 (“Even if for some purposes a [temporary worker hired through an agency] is considered an employee of the agency, that would not preclude his status [as] common law employee of Microsoft. The two are not mutually exclusive. . . . . At common law, ‘a servant . . . permitted by his master to perform services for another may become the servant of such other in performing the services.’”).

121 Proc. 2002-21, 2002-1 C.B. 911, which required plans maintained by PEOs for the benefit of worksite employees of their clients to be terminated or converted into multiple employer plans to avoid being disqualified, implicitly rejected the position espoused by the PEO industry that they and their clients were co-employers of the worksite employees. See also, e.g., PLR 200017041 (March 3, 2000) (stating that “[t]he concept of a ‘co-employer’ is not recognized in Subtitle C [the employment tax provisions] of the Internal Revenue Code,” despite the fact that it was applied in that context in Rev. Rul. 66-162). But see CCA 200415008 (Jan 9, 2004) (stating that “[i]f a client
The Code contains a few special rules for dealing with multi-party arrangements. For example, Section 414(n) provides that a leased employee who has worked for a service-recipient on a substantially full-time basis for at least a year may be allowed to participate in the service-recipient’s employee benefit plans as a common law employee and must be considered an employee in determining whether those plans discriminate in favor of highly compensated employees, but only if the service-recipient exercises “primary direction or control” over the employee.\(^{122}\) Section 3506 provides that a sitter-referral agency will not be treated as the employer of the sitter.

**Affiliated Entities.** Sometimes an employer is affiliated with other entities. If so, it might not be clear whether the affiliate is part of the employer, with the same rights and responsibilities towards employees of the employer as the employer itself, or instead is a separate entity. Entities that are legally separate, such as separate corporations, are not aggregated for employment tax purposes regardless of their degree of affiliation. However, if a group of related corporations pays wages through a single member of the group—the “common paymaster”—that member may be treated as the employer of all of the entities’ employees who are concurrently employed by all of the entities for employment tax purposes.\(^ {123}\)

**Disregarded Entities.** Previously, the owner of a single-member partnership or LLC that was disregarded as an entity separate from its owner for federal tax purposes had two choices for filing employment tax returns: either calculate, report, and pay the employment taxes of the disregarded entity’s employees under its own name and EIN, or allow the disregarded entity to separately calculate, report, and pay the employment tax obligations incurred with respect to employees of the entity under the entity’s name and EIN.\(^ {124}\) Since 2009, however, disregarded entities have been treated as separate entities for employment tax and related reporting requirement purposes (but not backup withholding and related information reporting requirement purposes).\(^ {125}\) Most states apply similar rules.

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\(^{122}\) The “primary direction or control” requirement was added in 1996, replacing a requirement that the services performed be “of a type historically performed, in the business field of the [employer], by employees.” Primary direction or control means that the employer exercises the majority of the direction and control over the individual. H.R. Conf. Rep. No. 104-737, at 259 (1996).

\(^{123}\) See Code § 3121(s); Treas. Reg. § 31.3121(s)-1.


III. OTHER LAWS

A. Differences in Treatment

1. Federal Labor Laws

Most federal labor laws apply only or primarily to employees.

ADA (Title I). Title I of the Americans with Disabilities Act ("ADA") generally prohibits an employer with 15 or more employees from discriminating on the basis of disability with respect to the terms, conditions and privileges of employment, including the provision of employee benefits. Independent contractors are not covered by this prohibition.\(^\text{126}\) However, in appropriate circumstances they might be covered by prohibitions found in other titles of ADA.

ADEA. The Age Discrimination in Employment Act ("ADEA") generally prohibits an employer with 20 or more employees from discriminating on the basis of age with respect to the terms, conditions and privileges of employment, including the provision of employee benefits. Independent contractors are not covered by this prohibition.\(^\text{127}\)

COBRA. The Consolidated Omnibus Budget Reconciliation Act of 1985 ("COBRA") amended the Code and ERISA generally to require a group health plan maintained by an employer with 20 or more employees to give covered employees and their beneficiaries the right to continue coverage under the plan after their coverage has ceased, if coverage ceases on account of certain qualifying events.\(^\text{128}\) This requirement applies to employees and independent contractors, provided that plan covers at least some common law employees.\(^\text{129}\)

ERISA (Title I). Employee pension and welfare benefit plans are subject to various coverage, funding, fiduciary, reporting, and other requirements under Title I of ERISA. Title I does not apply to plans benefiting only nonemployees, and many of the specific requirements of Title I extend only to employee-participants.\(^\text{130}\)

Because plan coverage typically is limited to employees, an employer’s unilateral reclassification of an employee as an independent contractor, or discharge followed by rehire as an independent contractor (e.g., outsourcing), can under some circumstances be viewed as a violation of ERISA § 510, which prohibits any person from discharging or discriminating against

\(^{126}\) 42 U.S.C. §§ 12111(4) & 12112.


\(^{128}\) Code § 4980B, ERISA §§ 601-08.

\(^{129}\) Code § 4980B(f)(7); ERISA § 607(2).

\(^{130}\) ERISA §§ 3(3), (6), 4(a) & 4021(a); 29 C.F.R. § 2510.3-3; Texas v. Alliance Employee Leasing Corp., 797 F. Supp. 542 (N.D. Tex. 1992).
a participant “for the purpose of interfering with the attainment of any right to which such participant may become entitled under the plan” or ERISA. 131

FMLA. The Family and Medical Leave Act (“FMLA”) generally requires an employer with 50 or more employees to allow employees to take up to 12 weeks of unpaid leave (with the right to reinstatement) for certain family and/or medical purposes. Independent contractors need not be allowed to take such leave. 132

WARN Act. The Worker Adjustment and Retraining Notification (“WARN”) Act requires an employer that employs 100 or more employees to notify employees affected by a plant closing or their union representatives at least 60 days before the closing occurs. Independent contractors are not required to receive such notice. 133

Affordable Care Act. The Patient Protection and Affordable Care Act, as amended by the Health Care and Education Reconciliation Act of 2010 (together the “Affordable Care Act” or “ACA”), imposes an excise tax on a large employer (generally one with at least 50 full-time employees, determined on a full-time equivalent basis, during the previous year) if it either does not make a health plan meeting certain standards available to all of its full-time employees, or makes one available and it is not affordable, thus permitting a lower-income employee to obtain a government subsidy to purchase coverage on one of the health insurance exchanges established under the ACA. Employers subject to this requirement must file information returns with the IRS detailing the coverage they provide, and give similar statements to all full-time employees. The excise tax does not apply with respect to independent contractors. 134

Other Labor Laws. Independent contractors generally are not covered by the National Labor Relations Act (“NLRA”), and therefore generally may not engage in collective bargaining or similar protected activities. 135 They also receive no protection under the nondiscrimination requirements of the Equal Pay Act (“EPA”) 136 or Title VII of the Civil Rights Act of 1964, 137 the safety requirements of the Occupational Safety and Health Act (“OSHA”) 138 or the minimum wage and overtime requirements of the Fair Labor Standards Act (“FLSA”). 139 Independent

134 Notice 2015-17, 2015-14 I.R.B. 845, announces that, until further guidance is issued and in any event through 2015, the excise tax will not be imposed on S corporations with respect to the coverage of their 2% shareholders.
137 42 U.S.C. § 2000e(b), (f). See Knight v. United Farm Bureau Mutual Insurance Co., 950 F.2d 377 (7th Cir. 1991); accord EEOC Compliance Manual Section 605, Appendix H.
contractors who leave to perform military service are not entitled to reemployment or seniority rights under the Uniformed Services Employment and Reemployment Rights Act of 1994 ("USERRA"). Furthermore, employers are not subject to penalties under the Immigration Reform and Control Act ("IRCA") with respect to the receipt of services from independent contractors. Also, independent contractors are not covered by the Employee Polygraph Protection Act ("EPPA"), which prohibits most private employers from using lie detector tests, either for pre-employment screening or during the course of employment.

Unlike the income and employment tax provisions of the Code, no laws comparable to the laws described above apply to independent contractors. For example, while independent contractors are not subject to FICA taxes, they are subject to roughly the same level of SECA taxes. By contrast, if a worker is classified as an independent contractor under a federal law prohibiting a particular form of discrimination, he generally has no protection from that form of discrimination under federal law.

2. Federal Patent and Copyright Laws

Under the "work made for hire" doctrine, an employer generally is considered the author of any work prepared during the course of an employee's employment for purposes of the federal copyright laws; no such presumption exists with respect to work prepared by independent contractors, and the client owns the work only if it obtains a written assignment of copyright ownership, or enters into a written agreement explicitly stating that the work is for hire. By contrast, the traditional principle under federal patent law is that ownership of a patent vests in the inventor unless there is an express agreement to the contrary, and generally no legal distinction is drawn between employees and independent contractors for this purpose. In practice, however, independent contractors might find it somewhat easier to secure patent protection for on-the-job creations than employees, since this issue often turns on a court’s

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140 38 U.S.C. §§ 4303 & 4312; see, e.g., Wilson v. Toledo Area Sheet Metal Joint Apprenticeship Committee, 560 F.2d 222 (6th Cir. 1977); Brown v. Luster, 165 F.2d 181, 184 (9th Cir. 1947) (prior law).

141 8 U.S.C. § 1324a. However, this exception is subject to an anti-abuse rule. 8 U.S.C. § 1324a(a)(4); 8 C.F.R. §§ 274a.1(j) & 274a.5.


analysis of the bargain struck between the parties. Courts have come to differing decisions regarding trade secrets.

3. State Labor Laws

Many state laws also impose different requirements on employers and employees on the one hand and independent contractors and their clients on the other. In particular, employers generally are required to contribute a portion of the wages paid to each of their employees to state workers’ compensation and unemployment funds. Clients of independent contractors generally are not required to do so, and, as a consequence, independent contractors generally are not eligible for benefits under these systems. Employee wages also might be protected under state wage payment laws, while payments to independent contractors are not. To the extent that employers’ right to discharge employees at will has been limited, the limits apply solely to employees. Non-employees also generally are not covered by state workplace safety laws.

B. Determination of Employment Status

In Nationwide Mutual Ins. Co. v. Darden, the Supreme Court held that, when a statute uses the term “employee” without defining it, Congress is presumed to have intended to apply the common law test. Many of the federal labor laws discussed above do not contain useful definitions of the term “employee.” Thus, employment status under those laws—including Title I

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145 This is especially true of the so-called “shop right” doctrine, under which an employer or client may claim royalty-free use of an invention. See, e.g., Hobbs v. United States, 376 F.2d 488, 495 (5th Cir. 1967); Crom v. Cement Gun Co., 46 F. Supp. 403, 404 (D. Del. 1942).


147 See, e.g., N.Y. Workers’ Compensation Law § 210 (Consol. 1997); N.Y. Labor Law §§ 560 & 570 (unemployment insurance).

148 See, e.g., N.Y. Workers’ Compensation Law § 50 (requirement that employer provide security for payment of wage compensation).

149 States with such laws include Alaska, Arizona, California, Hawaii, Indiana, Iowa, Kentucky, Maryland, Michigan, Minnesota, Nevada, New Mexico, North Carolina, Oregon, Puerto Rico, South Carolina, Tennessee, Utah, Vermont, Virginia, Washington, and Wyoming.

of ADA, ADEA, COBRA, Title I of ERISA, the Medicare secondary payer rules, NLRA, USERRA, and Title VII—is determined using the common law test.

That has not always been true. Before Darden, agencies and courts were more inclined to apply a version of the economic realities test adopted by the Supreme Court in 1947 and subsequently rejected by Congress in the Gearhart Resolution. Moreover, in applying that test for purposes of a particular law, they tended to focus on whether the worker was a potential victim

151 Clackamas Gastroenterology Associates, P.C. v. Wells, 538 U.S. 440 (2003) (agreeing with EEOC’s “focus on the common-law touchstone of control” to determine whether physician-shareholders were employees of PC).


155 NLRB v. United Ins. Co. of America, 390 U.S. 254, 256 (1968); see also Roadway Package System, Inc., 326 NLRB No. 72 (1998); Dial-A-Mattress Operating Corporation, 326 NLRB No. 75 (1998); cf. FedEx Home Delivery v. NLRB, 563 F.3d 492, 497 (D.C. Cir. 2009) (noting that “both this court and the Board, while retaining all of the common law factors, ‘shift[ed] the emphasis’ away from the unwieldy control inquiry in favor of a more accurate proxy: whether the ‘putative independent contractors have ‘significant entrepreneurial opportunity for gain or loss.’ ’ . . . Thus, while all the considerations at common law remain in play, an important animating principle by which to evaluate those factors in cases where some factors cut one way and some the other is whether the position presents the opportunities and risks inherent in entrepreneurialism.”).

156 Brown, 165 F.2d at 185 (contractor status determined using common law test under pre-USERRA law).

157 Cilecev v. Inova Health System Services, 115 F.3d 256, 259 (4th Cir. 1997), cert. denied, 522 U.S. 1049 (1998); Lamberts v. Utah Department of Corrections, 79 F.3d 1024, 1028 (10th Cir. 1996); Wilde v. County of Kandiyohi, 15 F.3d 103, 106 (8th Cir. 1994); Blagg v. Technology Group, Inc., 303 F. Supp. 2d 1181 (D. Colo. 2004); EEOC Enforcement Guidance at note 10. See also Mariotti v. Mariotti Building Products Inc., 714 F.3d 761 (3d Cir.), cert. denied, 134 S. Ct. 437 (2013) (applying test in Clackamas Gastroenterology Associates, supra note 151, to business entities that are not professional corporations in actions brought under Title VII). But see Juino v. Livingston Parish Fire Dist. No. 5, 717 F.3d 431 (5th Cir. 2013) (“We apply the ‘economic realities/common law control test,’ a variation of the common law agency test, in determining whether a party is an employee or an independent contractor [for purposes of Title VII]. [citation omitted] The economic-realities portion of the test asks whether putative employees, ‘as a matter of economic reality, are dependent upon the business to which they render service.’ [citation omitted] The common law control portion of the test, which courts should emphasize over the economic realities portion, assesses ‘the extent to which the one for whom the work is being done has the right to control the details and means by which the work is to be performed.’ ”).

158 See also AM 2009-002 (Jan. 27, 2009) (where the language of a statute that authorizes a federal agency to hire a worker pursuant to a personal service contract does not directly address how the worker is to be classified for federal employment tax purposes, and where no other federal statute or regulation provides specific direction on this question, the worker’s status is determined using the common law test).
of the “wrong” being “righted” by that law. This resulted in a test that was result-driven and even more complex and subjective than the common law test.

The economic realities test continues to apply where it is required or authorized by statute, including FMLA, EPA and FLSA.159 Many state wage payment, workers’ compensation and unemployment insurance statutes also apply (or are interpreted by the courts or the agencies responsible for interpreting them to apply) definitions that are more expansive than the common law.160

Even in contexts where it applies, the common law test is taking a while to sink in. For example, the IRS Training Materials list financial control as a factor to be taken into account in determining whether a worker is an employee. However, they carefully note that

The question to be asked is whether the recipient has the right to direct and control business-related means and details of the worker’s performance. The question is not whether the worker is economically dependent on or independent of the business for which the services are performed. This analysis has been rejected by Congress and the Supreme Court as a basis for determining worker classification. . . . As a result, a worker’s economic status is inappropriate for use in analyzing worker status.

159 See 29 U.S.C. § 2611 (“employee” has same meaning under FMLA and FLSA); 29 C.F.R. § 1620.8 (“Economic reality rather than technical concepts determine whether there is employment within the meaning of EPA. The common law test based on the power to control the manner of performance is not applicable to the determination of whether an employment relationship subject to EPA exists.”); Darden, 503 U.S. 326 (distinquishing definition of “employee” in ERISA from definition in FLSA); Annotation, Determination of “Independent Contractor” and “Employee” Status for Purposes of § 3(e)(1) of the Fair Labor Standards Act (29 U.S.C.S. § 203(e)(1)), 51 A.L.R. Fed. 702; Glatt v. Fox Searchlight Pictures Inc., 293 F.R.D. 516 (S.D.N.Y. 2013) (holding that that Fox was the joint employer of two unpaid interns for purposes of the FLSA and New York Labor Law minimum wage and overtime requirements), vacated and remanded, 811 F.3d 528 (2d Cir. 2016).

Important recent guidance can be found in Wage & Hour Division Administrator Interpretation No. 2015-1 (July 15, 2015), which describes the “economic realities” test used to determine employment status under the FLSA. It asserts that “In applying the economic realities factors, courts have described independent contractors as those workers with economic independence who are operating a business of their own,” and concludes that “The very broad definition of employment under the FLSA as ‘to suffer or permit to work’ and the Act’s intended expansive coverage for workers must be considered when applying [those factors].” See also Wage & Hour Division Administrator Interpretation No. 2016-1 (Jan. 20, 2016) (emphasizing the difference between the “economic realities” test and the common law control test).

160 See generally 3 A. Larson & L. Larson, Larson’s Workers’ Compensation Law § 43 (1997); Annotation, Right to unemployment compensation or social security of one working on his own projects or activities, 65 A.L.R.2d 1182. See, e.g., Hargrove v. Sleepy’s, LLC, 220 N.J. 289, 106 A.3d 449 (2015) (applying employee-friendly “ABC” test used under New Jersey’s Unemployment Compensation Act to state wage payment and wage-and-hour disputes); cf. Craig v. FedEx Ground Package System, Inc., 792 F.3d 818 (7th Cir. 2015) (applying 20-factor test used by Kansas Supreme Court that “includes economic reality considerations, while maintaining the primary focus on an employer’s right to control” to wage payment dispute); compare Arnold v. Mutual of Omaha Ins. Co., 135 Cal. Rptr. 3d 213 (Cal. Ct. App. 2012) (applying “control test” in S.G. Borello & Sons Inc. v. Department of Industrial Rel., 48 Cal. 3d 341 (1989), and rejecting argument that Labor Code provides own definition of “employee”).

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By contrast, the \textit{EEOC Enforcement Guidance} lists a service-recipient’s control over how a
worker performs his job as only one of many factors to be taken into account in making that
determination.\textsuperscript{161}

The common law test is sometimes interpreted in particular ways based on the perceived
purposes of the act, as well. For example, courts interpreting the NLRA have found an exception
for certain student-employees,\textsuperscript{162} and courts interpreting Title VII have found an exception for
volunteers.\textsuperscript{163}

\textbf{Relevance of Contract.} Language in a contract is not dispositive in determining whether a
worker is an employee or independent contractor for labor law purposes.\textsuperscript{164} Nevertheless, a
contract might be relevant in making that determination to the extent it provides evidence of the
parties’ intent, the extent to which the service-recipient can control and direct the worker, and
other factors taken into account in making that determination.

A contract also can be used to clarify the effect of a worker’s status as an employee or
independent contractor. For example, ERISA generally limits participation in an employee
benefit plan to employees. However, it does not require an employee benefit plan to cover all
employees of an employer. Thus, a contract with a worker generally can provide that the worker,
despite being classified as an employee, may not participate in any of the employee benefit plans
maintained by the employer for its employees.\textsuperscript{165} A worker generally also can waive his right to

\textsuperscript{161} The INS has developed its own definition of “employee” for purposes of IRCA that is similar but not
identical to the common law test. 8 C.F.R. § 274a.1(j). Nevertheless, plaintiffs might find it difficult to convince a
in context of NLRA that, since the task of defining the term “employee” is one that has been assigned primarily to
the agency created by Congress to administer the Act, the agency’s construction of that term is entitled to
“considerable deference”).

\textsuperscript{162} \textit{See Brown University}, 342 NLRB 483 (2004) (University’s relationship with TAs, RAs and proctors
was “primarily educational” and thus they were not employees under the NLRA). But \textit{Columbia University}, 364
NLRB 90 (Aug. 23, 2016), recently overruled that decision. \textit{Compare Berger v. NCAA}, 162 F. Supp.3d 845 (S.D.
Ind. 2016) (rejecting a claim that Penn State athletes were employees under the NLRA).

\textsuperscript{163} \textit{See, e.g., Juino, supra note 157.} The court relied on the “threshold-remuneration test” adopted by the
Second, Fourth, Eighth, Tenth, and Eleventh Circuits, which requires a volunteer to receive enough compensation to
be considered “hired” and to create a situation “that plausibly approximate[s] an employment relationship.” The
court felt this was consistent with \textit{Darden} because “a prerequisite to considering whether an individual is one or the
other under common-law agency principles is that the individual have been hired in the first instance.”

\textsuperscript{164} \textit{E.g., Garcia v. Copenhaver, Bell & Assocs., M.D.’s, P.A.}, 104 F.3d 1256 (11th Cir. 1997) (ADEA);
\textit{Daughtrey v. Honeywell, Inc.}, 3 F.3d 1488, 1492-93 (11th Cir. 1993) (ERISA).

\textsuperscript{165} \textit{See Laniok v. Advisory Committee}, 935 F.2d 1360, 1368 (2d Cir. 1991); \textit{Boren v. Southwestern Bell
Telephone Co.}, 933 F.2d 891, 894 (10th Cir. 1991); \textit{Krackow v. Jack Kern Profit Sharing Plan}, 2002 WL 31409362
(E.D.N.Y 2002) (“the anti-alienation and anti-assignment provisions are designed to prevent a plan participant from
dissipating his benefits before retirement, not to bar an agreement by the employee with the employer to forego
benefits”).

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recover under a particular labor law if the waiver is knowing and voluntary and is not prospective.\footnote{166}

Relevance of Tax Treatment. The employment status of a worker for tax purposes is relevant in determining his status for labor law purposes, at least to the extent that his status is based on the common law test, which applies in both contexts. To the extent that his employment status for tax purposes is based on Section 530 or some other tax-specific rule, it has little, if any, relevance.

C. Identification of Employer

Most federal labor laws apply only to employers and only with respect to their own employees. There are some exceptions. However, they generally are limited in scope.\footnote{167}

\footnote{166} In determining whether a waiver is knowing and voluntary, courts generally have applied a “totality of the circumstances” test. E.g., Rivera-Flores v. Bristol-Myers Squibb Caribbean, 112 F.3d 9, 12 (1st Cir. 1997) (ADA); Griffin v. Kraft General Foods, Inc., 62 F.3d 368, 373 (11th Cir. 1995) (ADEA); Laniok, 935 F.2d at 1368 (ERISA); Bormann v. A.T. & T. Communications, Inc., 875 F.2d 399, 402-03 (2d Cir.), cert. denied, 493 U.S. 924 (1989) (ADEA). A waiver required as a condition of employment generally is not considered voluntary.

ADEA sets forth minimum standards that a waiver generally must meet in order to be enforceable. 29 U.S.C. § 626(f). These standards largely codify prior case law interpreting the knowing and voluntary standard. Although the standards do not apply to other labor laws, an employee’s waiver of his rights under another labor law is likely to be enforceable if it meets the standards. See, e.g., Wittorf v. Shell Oil Co., 37 F.3d 1151, 1154 (5th Cir. 1994).


According to the EEOC, a waiver cannot prevent an employee from filing a complaint with the EEOC or assisting with an EEOC investigation or lawsuit involving that complaint. EEOC Enforcement Guidance, No. 915.002, Non-Waivable Rights Under EEOC-Enforced Statutes (April 10, 1997). In addition, under some labor laws, waivers are subject to significant restrictions or are prohibited altogether. See, e.g., Brooklyn Savings Bank v. O’Neill, 324 U.S. 697, 704-06 (1945); Mumbower v. Callicott, 526 F.2d 1183, 1188 (8th Cir. 1975) (FLSA).

But see Capital Cities/ABC, Inc. v. Ratcliff, 141 F.3d 1405 (10th Cir.), cert. denied, 525 U.S. 873 (1998) (voluntariness of contract in which worker agrees not to be covered by plan is not an issue precluding summary judgment since contract is not a waiver of existing rights); compare Laniok v. Brainerd Manufacturing Co. Pension Plan Advisory Committee, 935 F.2d 1360 (2d Cir. 1991) (waiver of participation in plan required to be knowing and voluntary to same extent as waiver of ADEA rights in situation involving alleged age discrimination).

\footnote{167} 29 U.S.C. §§ 203(d) (FLSA) (“employer” generally includes any person acting directly or indirectly in the interest of an employer in relation to an employee), 1002(5) (ERISA) (“employer” means any person acting directly as an employer, or indirectly in the interest of an employer, in relation to an employee benefit plan) & 2611(4)(A)(ii) (FMLA) (“employer” includes any person who acts, directly or indirectly, in the interest of an employer to any of the employees of such employer, and includes any successor in interest of an employer); 38 U.S.C. § 4303(4)(A) (USERRA) (“employer” generally means any person, institution, organization, or other entity that pays salary or wages for work performed or that has control over employment opportunities); 42 U.S.C. § 2000e-2(b) (Title VII) (prohibiting employment agency from discriminating against any individual on the basis of his or her race, color, religion, sex, or national origin); 29 C.F.R. § 1620.8 (EPA) (“employer” means any person acting directly or indirectly in the interest of an employer in relation to an employee); cf. 29 C.F.R. § 1630.6 (prohibiting entity covered by ADA from entering into contractual arrangements with unrelated parties that have the effect of subjecting the covered entity’s employees to discrimination).
Multi-Party Arrangements and Affiliated Entities. The same problem of identifying the employer that arises under the Code arises under most federal labor laws. To resolve this problem, agencies and courts use some of the same rules that apply for purposes of the Code, although they derive them from different sources.

Most but not all of the aggregation rules that apply for purposes of the employee benefit provisions of the Code also apply for purposes of COBRA, Titles I and IV of ERISA, and the Medicare secondary payor rules. Other labor laws contain no specific aggregation rules. Instead, agencies and courts interpreting those laws use the common law “single employer” rule. That rule treats two or more entities as a single employer if they are closely integrated based on all of the facts and circumstances.

As noted above, under the common law two or more entities may be treated as an employee’s “joint employer” if they share control over the employee. Although this rule applies for federal tax purposes, it has been used very little in that context. By contrast, agencies and courts interpreting federal labor laws frequently use the rule in multi-party situations to treat the leasing company or broker and its client as employers of an employee, and therefore accountable for any violations of those laws involving the employee, whether or not they are directly responsible for the violations. The DOL’s Wage and Hour Division, interpreting the FLSA,

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168 E.g., ERISA §§ 3(40)(B)(iii) & 4001(b)(14)(B) (generally adopting the controlled group rules in the Code for purposes of Titles I and IV); Code § 5000(b)(2)(A); 42 U.S.C. § 1395f(b)(1)(E)(i); 42 C.F.R. § 411.106(d) (generally adopting the controlled group rules in the Code for purposes of the Medicare secondary payor rules).


Federal labor laws generally contain no rules comparable to the leased employee rules that apply for purposes of the employee benefit provisions of the Code. The common law “borrowed servant” rule can be applied to much the same effect. See Restatement (Second) of Agency § 227 (1958). However, so far it has not been. See, e.g., Nowlin v. Resolution Trust Corp., 33 F.3d 498, 505 (5th Cir. 1994) (Title VII).

171 See Wage & Hour Division Administrator’s Interpretation No. 2016-1 (Jan. 20, 2016), which “provides guidance on identifying those scenarios in which two or more employers jointly employ an employee and are thus jointly liable for compliance under the FLSA or MSPA [i.e., the Migrant and Seasonal Agricultural Worker Protection Act],” but also emphasizes the difference between the “economic realities” test and the common law control test.
the NLRB, interpreting the NLRA, and the Occupational Safety and Health Administration, interpreting the OSHA, have been particularly aggressive.

Finally, the EEOC and some courts aggressively interpret some labor laws to apply to employers with respect to individuals employed by other entities, if they employ the requisite number of employees to be considered "employers" under those laws and exercise control over one or more aspects of the employees' employment. The EEOC refers to this interpretation as the "third party interference" doctrine, and uses it and the joint employer rule to conclude that, in most circumstances, a leasing company or broker is accountable for violations of federal labor laws perpetrated by its clients, and vice versa.

IV. ESTABLISHING THE INDEPENDENT CONTRACTOR RELATIONSHIP

A. Relevance of Contract

As noted above, language in a contract is not dispositive in determining whether a worker is an employee or independent contractor for federal tax purposes, but might be relevant in making that determination to the extent it provides evidence of the parties' intent, the extent to which the service-recipient can control and direct the worker, and other factors taken into account in making that determination, and can be used to clarify the effect of a worker's status as an employee or independent contractor.

B. Form SS-8 Determinations

Since the parties cannot simply decide between themselves whether a worker is an employee or independent contractor, other methods have developed to help make that determination. The principal one is to apply for a determination from the IRS on Form SS-8. The application can be filed by either the worker or the service-recipient. If the worker asks for the

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172 See Browning-Ferris Indus. of California Inc. v. Sanitary Truck Drivers and Helpers Local 350, No. 32-RC-109684 (Aug. 27, 2015), which held that a company can be viewed as a single joint employer with its contractor under the NLRA even if it hasn't exercised any overt control over the workers. The NLRB explained that "Reserved authority to control terms and conditions of employment, even if not exercised, is clearly relevant to the joint-employment inquiry," citing Restatement (Second) of Agency §§ 2(1) & 220(1).

173 An undated draft OSHA internal memorandum obtained by FOIA request in August 2015 advises investigators that "a joint employer standard may apply where the corporate entity exercises direct or indirect control over working conditions, has the unexercised potential to control working conditions or based on the economic realities. As a general matter, two entities will be determined to be joint employers when they share or codetermine those matters governing the essential terms and conditions of employment and the putative joint employer meaningfully affects the matters relating to the employment relationship such as hiring, firing, discipline, supervision and direction.


determination, both the worker and the service-recipient are entitled to the determination. If the
service-recipient asks for the determination, only it is entitled to the determination. As part of the
application process, the IRS will contact the non-filing party for its version of the facts that are
relevant to the application. The IRS may contact the filing party for additional information. The
IRS generally makes a determination with respect to an application within several months. There
is no fee for filing a Form SS-8. There is no appeal from an adverse determination. However, the
filer may request a reconsideration if there are additional facts that were not considered, and the
filer may withdraw the application at any time prior to the IRS signing the determination letter.
The application is filed with the District Director for the jurisdiction in which the service-
recipient is located. A determination based on Form SS-8 is only binding on the IRS, so its
relevance is limited to actions initiated by the IRS.

Notice 989 (rev. July 2009) provides guidance on what a worker should do when the IRS
reclassifies the worker from an independent contractor to an employee.

State unemployment insurance agencies often make similar determinations in the course
of determining whether a worker is entitled to unemployment insurance benefits. Although they
apply only for that purpose, they can raise issues in the tax or other areas.

V. DISPUTES CONCERNING INDEPENDENT CONTRACTOR RELATIONSHIP

A. Government Audits, Litigation and Sanctions

1. Audits and Litigation

Even though the treatment of employees and independent contractors is essentially tax-
neutral, the IRS has historically worried that independent contractors are, as a group, less tax-
compliant than employees, largely because of the lack of mandatory withholding. Over the years
many estimates of the “tax gap” attributable to misclassification have been made, some of which
are frankly enormous. However, as the Congressional Research Service observed in a recent
report, “[a]ccurate data on the current size of the tax gap caused by misclassification are
unavailable. Furthermore, the magnitude of many effects of improved classification are [sic]
unavailable or inherently subjective. With the current state of knowledge, whether or not the
benefits of curtailing misclassification of workers outweigh the costs is a value judgment.”176

Despite this uncertainty, the IRS is, if anything, pursuing misclassification issues on audit
more vigorously now than at any time in the past. In a 2008 speech an IRS official stated that
30% of IRS audits in that year were expected to be based on employee classification issues,177

176 Tax Gap: Misclassification of Employees as Independent Contractors (CRS, March 25, 2010). In an
October 13, 2011, letter to the Joint Select Committee on Deficit Reduction, House Education and the Workforce
Committee Democrats said that ending employee misclassification could raise revenue, citing a 2010 Treasury
Inspector General for Tax Administration (“TIGTA”) report that estimated a $54 billion tax gap for employment
underreporting. However, TIGTA’s report actually found that the available data was old, that new data would not be
available for several years, and that in any event the IRS’s sample size was too small.

typically questioning whether the service-recipient has properly characterized workers as independent contractors.

The IRS primarily identifies employers to examine for potential misclassification through four sources: (1) the Determination of Worker Status (Form SS-8) Program, described above,\textsuperscript{178} (2) the Employment Tax Examination Program ("ETEP"), in which IRS uses specific criteria to identify for examination employers that have a high likelihood of having misclassified employees, such as reporting a relatively high percentage of compensation to workers on Form 1099-MISC,\textsuperscript{179} (3) general employment tax examinations,\textsuperscript{180} and (4) the Questionable Employment Tax Practices ("QETP") program, through which the IRS and states share information on worker classification-related examinations and other employment tax issues.\textsuperscript{181}

Other federal and state government agencies have become more active, as well. As noted above, the QETP is a collaboration between the IRS and the states. The DOL, particularly its Wage and Hour Division (WHD), also has become particularly active in pursuing employee misclassification cases, often in conjunction with state authorities.\textsuperscript{182} The DOL’s FY 2014-2018 Strategic Plan targets misclassification as a top priority. The WHD is representing the DOL on a joint DOL-Department of Treasury initiative to deter misclassification. This enforcement focus might eventually be picked up by other agencies within the DOL, such as the Employee Benefit Security Administration, and cause it to pursue or support suits against employers and insurance companies demanding employee benefits for individuals misclassified as independent contractors. At an ABA meeting on May 10, 2013, an IRS official (John Tuzynski) stated that the IRS intends to increase the number of worker classification cases that will be sent through the questionable employment tax program (QETP) as soon as it finishes an agency-wide national

\textsuperscript{178} In fiscal year 2008, 72% of all Form SS-8 requests resulted in IRS determinations that the workers in question were employees, 25% were closed without any advice given, and 3% resulted in IRS determinations that the workers in question were independent contractors. However, most employers determined to have misclassified employees under the Form SS-8 Program are very small businesses, which generally are not referred to audit because examining such businesses is generally not cost effective. As a result, for recent tax years, only about 2-3% of the employers it identified to have misclassified employees through the Form SS-8 Program were referred for examination, and an even smaller percentage resulted in examinations.

\textsuperscript{179} The IRS examines about 1-3% of the employers it identifies annually through ETEP to have potentially misclassified employees. For tax year 2006, IRS identified over 33,000 employers through ETEP.

\textsuperscript{180} 58% of the misclassification-related examinations of employers that SB/SE conducted in fiscal year 2008 arose through the course of IRS examining employers for other types of employment tax noncompliance.

\textsuperscript{181} Although IRS may not share individual taxpayer information gleaned from tax returns with the DOL, it may share such information with the states. At the ABA Tax Section meeting on May 10, 2013, John Tuzynski, head of IRS employment tax policy, said that the IRS intends to increase the number of worker classification cases that will be sent through the questionable employment tax program (QETP) as soon as it finishes an agency-wide national research project. The research project involves an inventory of more than 6,000 audit cases over a three-year period. He also said that many audit cases relating to worker classification are being reported through IRS's whistleblower program.

\textsuperscript{182} Wage and Hour Division Press Release Number 13-2180-NAT (Nov. 18, 2013) announces that the DOL’s Wage and Hour Division, the New York State Labor Department and the New York State Attorney General have signed “memoranda of understanding to protect the rights of employees by preventing their misclassification as independent contractors or other nonemployee statuses.”
research project. That research project involves an inventory of more than 6,000 audit cases over a three-year period. He also said that many audit cases relating to worker classification are being reported through IRS’s whistleblower program.

Audits involving employment classification issues, and any resulting litigation, generally are subject to the same rules as other audits and litigation, except for the following special rules:

- The burden of proof can shift to the IRS in some cases. As noted above, if a taxpayer establishes a prima facie case that it was reasonable not to treat a worker as an employee in a Section 530 case, and the taxpayer cooperates with reasonable IRS requests, the burden of proof in the case generally shifts to the IRS.\(^{183}\)
- The taxpayer has access to three special settlement programs:
  - The Classification Settlement Program ("CSP") generally is available for any businesses with open employment tax cases that have filed Forms 1099-MISC with respect to the workers at issue, i.e., met the reporting consistency requirement of Section 530.\(^{184}\) Using the CSP can avoid costly, time-consuming and adversarial appeals and litigation. Under the CSP, if the business met the reporting consistency requirement and had a colorable argument that it met the substantive consistency and reasonable basis requirements of Section 530, the IRS will offer an assessment of 25% of the employment tax liability otherwise due for the audit year. The CSP is not available to determine which business is the proper employer in multi-party situations.
  - The Early Referral to Appeals Program is available if the examiner and the taxpayer cannot agree on one or more employment tax issues after the issues have been developed. It allows the taxpayer to request an immediate meeting with an IRS Appeals officer to resolve the employment tax issues, provided that, among other things, (a) resolving the issues quickly can reasonably be expected to result in a quicker resolution of the entire case and (b) the other issues in the case are not expected to be completed before Appeals can resolve the early referral issue.\(^{185}\)
  - Fast Track Mediation ("FTM") is available under similar circumstances, but gives the IRS and the taxpayer access to an IRS mediator to try to resolve any unagreed employment tax issues. The mediator facilitates the discussion but cannot impose

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\(^{183}\) Other similar rules that might apply in employment classification disputes are (1) Code § 7430(c)(4)(B), which creates a presumption, for purposes of determining whether an award of litigation costs to the U.S. is permitted under that section, that the IRS’s position is not substantially justified if it does not follow its own published guidance (including private letter rulings, technical advice memoranda and determination letters) and (2) Code § 7491, which shifts the burden of proof in litigation to the IRS on any factual issue relevant in determining liability for income taxes (not employment taxes) once the taxpayer has introduced credible evidence.

\(^{184}\) See generally Internal Revenue Manual (Examinations) ¶¶ 4.23.6.1 et seq.

resolution. The IRS and the taxpayer must agree on any resolution. Issues not resolved can follow the normal appeal process.\textsuperscript{186}

- Unlike other controversies involving employment tax issues, before the IRS can assess the proposed employment taxes resulting from a reclassification of a worker as an employee or a determination that the worker is not eligible for Section 530, the taxpayer must be given a chance to petition the Tax Court to review the IRS's determination and the proper amount of employment taxes due under the determination.\textsuperscript{187}

In 2011 the IRS announced a new Voluntary Classification Settlement Program ("VCSP").\textsuperscript{188} Under the VCSP (1) an employer will agree to treat a class of workers as employees for future tax periods, and (2) in exchange, the employer (a) will pay 10\% of the employment tax liability that would have been due on compensation paid to the workers for the most recent tax year if they had been employees, using the reduced rates of Section 3509, but (b) will not be liable for any interest and penalties on the liability, and (c) will not be subject to an employment tax audit with respect to the worker classification of the workers for prior years. The program is available only if the employer has consistently treated the workers as non-employees and filed all required Form 1099-MISC for the workers for the previous three years.\textsuperscript{189} Unlike the current CSP, the VCSP is available only if the employer is not under an employment tax audit by the IRS, under audit concerning the classification of the workers by the DOL or by a state government agency, or contesting in court the classification of workers from a previous IRS or Department of Labor audit. Participation in the program is low but increasing.

\textsuperscript{186} See IRS Publication 3605, \textit{Fast Track Mediation: A Process for Prompt Resolution of Tax Issues} (Rev. Sept. 2002); see also Code § 7123.

\textsuperscript{187} Code § 7436; see \textit{American Airlines, Inc. v. Commissioner}, 144 T.C. 24 (2015) (listing four requirements needed for Tax Court to have jurisdiction under Code § 7436(a)); Notice 2002-5, 2002-3 I.R.B. 320; IRS Publication 3953, \textit{Questions and Answers About Tax Court Proceedings for Determination of Employment Status Under I.R.C. § 7436} (Rev. Jan. 2002); Chief Counsel Notice CC-2001-044 (Oct. 4, 2001). \textit{B G Painting Inc. v. Comm'r}, T.C. Memo. 2016-62 (April 5, 2016), held that the Form SS-8 process is voluntary and is not an "audit" or "examination" for purposes of Code § 7436(a), and therefore the court does not have jurisdiction to hear a challenge to a Form SS-8 determination.

Chief Counsel Notice CC-2016-002, \textit{Change in Litigation Position Regarding Section 7436 Tax Court Jurisdiction} (Dec. 17, 2015), superseded Chief Counsel Notice CC-2014-011 (renumbered CC-2015-001), and instructed IRS attorneys no longer to argue that a Notice of Determination of Worker Classification (NDWC) is a prerequisite to Tax Court jurisdiction under Code § 7436 provided certain other requirements are met.


\textsuperscript{189} However, in a speech on November 17, 2011, an IRS official said that the IRS will view Form 1099s filed within six months of their due dates as acceptable for this purpose.
2. Sanctions

When an employee is misclassified as an independent contractor, the consequences to the employer can be severe:

- If the misclassification is intentional, the service-recipient could owe 100% of any FUTA tax, FICA taxes, and required income tax withholding on the worker’s earnings.\(^{190}\) The service-recipient will be entitled to a credit for any income taxes and self-employment taxes that the worker certifies that he paid on Form 4669,\(^{191}\) and might be able to recover the income taxes and employee share of FICA taxes that it is required to pay from the worker. However, the employer is not thereby relieved “from liability for any penalties or additions to the tax otherwise applicable in respect of such failure to deduct and withhold.”\(^ {192}\)

- If the misclassification is unintentional, the service-recipient will owe 100% of any FUTA tax on the worker’s earnings, 100% of the employer share of FICA taxes on the earnings, 20% of the employee share of FICA taxes on the earnings (i.e., 1.53%), plus income tax withholding equal to 1.5% of the earnings.\(^ {193} \) If the service-recipient did not file Forms 1099-MISC for the worker other than for reasonable cause, the latter percentages increase to 40% (i.e., 3.06%) and 3% respectively.\(^ {194} \) These percentages are based on IRS estimates of the taxes lost as a result of misclassification. The worker’s liability is not affected by the service-recipient’s payment of taxes, the service-recipient cannot recover either the employee share of FICA taxes or the income tax withholding from the worker, and the service-recipient is not entitled to a credit for any taxes paid by the worker.\(^ {195} \)

\(^{190}\) An employer who is required to deduct and withhold income tax under Code § 3402 “is liable for the payment of such tax whether or not it is collected from the employee by the employer.” Treas. Reg. § 31.3403-1.

\(^{191}\) Code §§ 3402(d) & 6521; cf. SBSE-04-1108-064, *Interim Guidance on IRC 3402(d) Relief in an Examination* (Nov. 25, 2008). If the worker paid self-employment taxes on the earnings, he might be entitled to a refund of the amount he paid in excess of the employee’s share of FICA taxes. See Rev. Rul. 86-1111, 1986-2 C.B. 176; Rev. Proc. 85-18, § 3.08, 1985-1 C.B. 5.08. A misclassified employee who has not paid self-employment taxes on the earnings can File Form 8919 (Uncollected Social Security and Medicare Tax on Wages) to report and pay the employee share of FICA taxes and get social security credit for his earnings. Before 2007, employees used Form 4137 (Social Security and Medicare Tax on Unreported Tip Income) for this purpose.

\(^{192}\) Code § 3402(d).

\(^{193}\) Code § 3509(a).

\(^{194}\) Code § 3509(b).

\(^{195}\) Code § 3509(d). By its terms, Code § 3509(d) is mandatory, even if taking a credit for taxes paid by the employee would produce a better result. See SBSE-04-0709-039, *Officer Compensation: IRC Sections 3509 and 7436, and Section 530 of the Revenue Act of 1978* (July 6, 2009) (“The tax rates under IRC Section 3509 are required to be used in all reclassification cases unless there has been intentional disregard to treat the worker as an employee.”); FSA 483 (published in BNA Daily Tax Report, Thursday, October 8, 1998) (“We reiterate that it is the position of this office that section 3509 of the Code is a mandatory provision and that the taxpayer does not have the option to apply sections 3402(d) or 6521 to determine employment tax liability in lieu of section 3509.”). CCA ILM 200825043, *Voluntary Compliance under Sections 3509 and 6205* (May 13, 2008), concludes that employers (i) may use Code § 3509 rates, if that section applies, to determine their tax liability attributable to worker reclassification following receipt of a Form SS-8 determination letter from the IRS, but only for wages paid in prior years, (ii) may
• In either event, the employer could be liable for interest and penalties. The penalties could include the accuracy-related penalty (if the underpayments are due to negligence or disregard of rules or regulations or substantial understatements of income tax),\textsuperscript{196} the failure-to-deposit penalty on the employer share of FICA taxes,\textsuperscript{197} the failure-to-file penalty (if inaccurate or no employment tax returns such as Form 941 are filed),\textsuperscript{198} and the information-reporting penalties (if inaccurate or no information returns such as Form W-2 are filed and provided to employees).\textsuperscript{199} Interest would be due from the due date of the

\textsuperscript{196} Code § 6662. The penalty equals 20% of the “underpayment,” as defined in Code § 6664, of amounts required to be shown on a return if due to negligence or a “substantial understatement” of income tax. The IRS takes the position that the accuracy-related penalty applies to underpayments of employment taxes, including underpayments of income tax withholding. E.g., TAM 200214001 (Oct. 19, 2001). Abbey Carpet Co. v. United States, 97-2 U.S.T.C. ¶ 50,740 (Fed. Cl. 1997), agreed with the IRS that an employer that negligently failed to withhold the required amount of income taxes from an employee's wages, and to declare the underpayment on Form 941, was liable for the Code § 6662 penalty.

\textsuperscript{197} Code § 6656 provides that, in case of failure by any person to make a timely deposit of tax imposed under the Code, unless the failure is due to reasonable cause and not to willful neglect, there shall be imposed on such person a penalty equal to the applicable percentage of the amount of the underpayment. The applicable percentage increases from 2% if the failure is for not more than 5 days, to 5% if the failure is for 6-15 days, and to 10% if the failure is for more than 15 days. It increases to 15% if the tax is not deposited on or before the earlier of (i) 10 days after the person receives a delinquency notice from the IRS or (ii) the day on which the person receives a notice and demand for immediate payment from the IRS. In Rev. Rul. 75-191, 1975-1 C.B. 376, the IRS concluded that the failure-to-deposit penalty does not apply in case of failure to deposit income taxes and the employee portion of FICA taxes that should have been withheld from compensation paid to employees, but that were not withheld.

Like other penalties, the failure-to-deposit penalty does not apply if the taxpayer had reasonable cause for the failure. CCA 201414017 (Jan. 16, 2014) concluded that an employer was not entitled to the reasonable cause defense to the Code § 6656 failure-to-deposit penalty where its “claim to the reasonable cause defense [rested] primarily upon its reliance on a third-party payroll processing company to make the deposits,” because the defense “requires the taxpayer to demonstrate that[,] despite its exercise of ordinary business care and prudence, it was ‘rendered unable to meet its responsibilities,’” and the employer’s “reliance on a faulty system that led to the untimely deposits did not render it unable to meet its filing responsibilities.”

\textsuperscript{198} The penalty equals 5% of the amount due for failure to file an employment tax return. If the failure extends past a month, 5% is added for each additional month, up to 25%, with a minimum penalty of 100% of the tax or $100 (whichever is less) if the failure lasts for 60 days. In e-mailed advice dated March 30, 2012, the IRS confirmed that the failure-to-file penalty in Code § 6651(a)(1) can apply to a failure to file Form 945, Annual Return of Withheld Federal Income Tax. The advice responded to a request for guidance from the field “regarding how to protect the interests of the government in a worker classification case.” Exam had concluded that an employer had misclassified workers as independent contractors. It was suggested that, as an alternative, the employer could be penalized for failing to obtain the workers’ SSNs, resulting in a backup withholding obligation.

\textsuperscript{199} Code §§ 6721 (for failure to file information return on time or to include all of the information required to be shown on the return or the inclusion of incorrect information) & 6722 (parallel penalties for failures relating to statements required to be provided to employees). The penalties generally are $260 for each incorrect, incomplete or untimely Form W-2 or 1099-MISC, which is increased to 10% of the amount that is not correctly reported if the failure is due to “intentional disregard” of the correct information reporting requirement.
Form 941 for the relevant quarter,\textsuperscript{200} unless the underpayments are corrected in a timely manner.\textsuperscript{201}

- Congress has enacted two provisions specifically to address criminal employment tax issues. Section 7202 provides that any person required collect, account for, and pay over employment taxes and willfully fails to do so “shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $10,000, or imprisoned not more than 5 years, or both, together with the costs of prosecution.” Section 7215 provides that if the facts are the same but there was a reasonable doubt as to whether the law required collection of tax, or who was required to collect tax, the individual “shall... be guilty of a misdemeanor, and, upon conviction thereof, shall be fined not more than $5,000, or imprisoned not more than one year, or both, together with the costs of prosecution.”\textsuperscript{202}

- Section 7201 also makes an “attempt” to “evade or defeat any tax” a felony punishable by five years in prison and a $100,000 fine (for individuals). Section 7206 also punishes the “making” or “subscribing” of any return which is not believed to be “true and correct as to every material fact” or to otherwise engage in fraudulent conduct generally involving the tax system as a felony carrying three years imprisonment and a $100,000 fine.

- A reclassified worker might also be entitled to benefits under the service-recipient’s employee benefit plans (if reclassified workers are not specifically excluded or by law


\textsuperscript{201} See Code § 6205 and the regulations thereunder. Beginning in 2009, adjustments must be reported on an adjusted return for the return period when the wages were paid rather than on the employer’s employment tax return for the period when the error is ascertained. See T.D. 9405, 73 Fed. Reg. 37371 (July 1, 2008). Thus, for example, new Form 941-X must be used in lieu of old Form 941c to correct errors on a previously filed Form 941 if the error is discovered after December 31, 2008. New Form 941-X also will be used by employers instead of Form 843 for refunds or abatements of over-reported employment taxes.

\textit{Cf.} CCA 200846022 (Oct. 6, 2008) (if an employer makes an error that results in the underpayment of taxes associated with employee wages or compensation, an interest-free adjustment under Code § 6205 should not be denied solely because the accuracy-related penalty is imposed under Code § 6662(b)(1); CCA 200825043(May 13, 2008) (employer paying at reduced rates under Code § 3509 is still eligible for Code § 6205 interest-free adjustment treatment on those amounts); SBSE-04-0108-004 (Jan. 9, 2008) (“To be entirely interest-free, full payment of the underpayment adjustment must be made on or before the due date of the return for the return period in which the error was ascertained, e.g., the return period in which the Form 2504 or Form 2504-WC are signed. If the tax adjustment is not paid when due, interest will begin accruing on the day following the due date of the return for that period.”).

\textsuperscript{202} See also 18 U.S.C. §§ 3557 & 3571, potentially increasing these amounts significantly. \textit{Cf.} United States v. McLain, 646 F.3d 599 (8th Cir. 2011), cert. denied, 132 S. Ct. 1763 (2012) (upholding conviction, under Code § 7202, of owner and operator of temporary staffing agency for nurses for failing to account for and pay employment taxes, despite argument that he held good faith belief that nurses were independent contractors and thus did not have the requisite mens rea).
may not be excluded), and in any event will have to be taken into account when the
service-recipient runs nondiscrimination tests with respect to those plans.\textsuperscript{203}

Any IRS assessment generally must be made within the three-year statute of limitations, but if no
employment tax returns were filed then no statute of limitations applies.\textsuperscript{204} If the assessment is
paid, the taxpayer must file a refund suit within two years after the date of payment.\textsuperscript{205}
Employment taxes are “divisible taxes,” generally permitting a refund suit where the taxpayer
pays the tax assessed for one employee for one quarter.\textsuperscript{206}

The service-provider could also be subject to sanctions for misreporting his income, for
example if he knew his employer was failing to report taxable wages to him on his Form W-2.\textsuperscript{207}

State sanctions are possible, as well, under state tax or labor laws. In 2012 a California
law went into effect which makes it unlawful to willfully misclassify workers as independent
contractors and imposes fines of up to $15,000 per violation ($25,000 if there is “a pattern or
practice of these violations”) for doing so. The law defines willful misclassification as “avoiding
employee status for an individual by voluntarily and knowingly misclassifying that individual as
an independent contractor.” The State government has the authority to assess fines and liquidated
damages. In addition, individuals can file complaints with the State, asking for a determination
that an employer has misclassified them.

\section*{B. Private Litigation}

A worker can challenge a service-recipient’s classification of him as an employee or
independent contractor for employment tax purposes by filing a Form SS-8, as described above.
A worker can challenge a service-recipient’s classification of him as an employee or independent
contractor for purposes any benefits that depend on that classification by filing a claim for those
benefits.\textsuperscript{208} Some kinds of employee benefits are required to be provided to all common-law
employees (usually subject to certain limited exceptions), although the IRS allows the most
valuable kind of benefit—tax-qualified retirement plans—to exclude workers whom the service-
recipient does not treat as employees for employment tax purposes, even if a court or

\textsuperscript{203} In Kenney v. Comm’r, 70 T.C.M. (CCH) 614 (1995), a retirement plan was disqualified for failing to
benefit a sufficient number of nonhighly compensated employees as a result of mischaracterizing workers as
independent contractors.

\textsuperscript{204} Code § 6501(a). The period generally begins running on April 15 of the following year. See Code
§ 6501(b)(2).

\textsuperscript{205} Code § 6511.


\textsuperscript{207} See Treas. Reg. § 1.6664-4(b) (“A taxpayer’s reliance on erroneous information reported on a Form W-
2, Form 1099, or other information return indicates reasonable cause and good faith, provided the taxpayer did not
know or have reason to know that the information was incorrect.”).

\textsuperscript{208} See, e.g., Estrada v. FedEx Ground Package System, Inc., 154 Cal.App.4th 1, 64 Cal.Rptr.3d 327 (2nd
District 2007) (FedEx drivers were employees not independent contractors purpose of their entitlement to
reimbursement for work-related expenses).
administrative agency determines that such individuals are common law employees and not independent contractors.\textsuperscript{209}

There is little case law to support a private right of action against an employer for failing to withhold the correct amount of income or employment taxes.\textsuperscript{210} However, employees have sometimes prevailed when they have been able to recharacterize the lawsuit as one based on tort or contract.\textsuperscript{211}


TABLE A

FACTORS TRADITIONALLY USED BY IRS AND SOCIAL SECURITY ADMINISTRATION TO DETERMINE EMPLOYMENT STATUS UNDER COMMON LAW TEST

1. The worker must comply with employer's instructions about the work.
2. The worker receives training from or at the direction of the employer.
3. The worker provides services that are integrated into the business of the employer.
4. The worker provides services that must be rendered personally.
5. The worker hires, supervises, and pays assistants for the employer.
6. The worker has a continuing working relationship with the employer.
7. The worker must follow set hours of work.
8. The worker works full-time for an employer.
9. The worker does his work on the employer's premises.
10. The worker must do his work in a sequence set by the employer.
11. The worker must submit regular reports to the employer.
12. The worker receives payments of regular amounts at set intervals.
13. The worker receives payments for business and/or traveling expenses.
14. The worker relies on the employer to furnish tools and materials.
15. The worker lacks a major investment in facilities used to perform the service.
16. The worker cannot make a profit or suffer a loss from his services.
17. The worker works for one employer at a time.
18. The worker does not offer his services to the general public.
19. The worker can be fired by the employer.
20. The worker may quit work at any time without incurring liability.
**TABLE B**

**NEWER APPROACH USED BY IRS TO DETERMINE WHETHER A WORKER IS AN EMPLOYEE**

<table>
<thead>
<tr>
<th>Category</th>
<th>Examples of Factors Included in Category</th>
<th>Analogous Factors from Traditional 20-Factor Test</th>
</tr>
</thead>
<tbody>
<tr>
<td>Behavioral Control, <em>i.e.</em>, the right to direct or control how the worker performs the specific task for which he or she is engaged</td>
<td>Whether the worker must comply with the service-recipient's instructions about the work</td>
<td>Whether the worker must comply with the employer's instructions about the work (1)</td>
</tr>
<tr>
<td></td>
<td>Whether the instructions are detailed and communicated directly by the service-recipient</td>
<td>Whether the worker receives training from or at the direction of the employer (2)</td>
</tr>
<tr>
<td></td>
<td>Whether the worker receives training from or at the direction of the service-recipient</td>
<td>Whether the worker must submit regular reports to the employer (11)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Whether the worker hires, supervises, and pays assistants for the employer (5)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Whether the worker must do his work in a sequence set by the employer (10)</td>
</tr>
<tr>
<td>Financial Control, <em>i.e.</em>, the right to direct or control how the business aspects of the workers' activities are conducted</td>
<td>Whether the worker has a significant investment in equipment, etc.</td>
<td>Whether the worker receives payments of regular amounts at set intervals (12)</td>
</tr>
<tr>
<td></td>
<td>Whether the worker incurs significant unreimbursed expenses</td>
<td>Whether the worker receives payments for business and/or traveling expenses (13)</td>
</tr>
<tr>
<td></td>
<td>Whether the worker is free to seek out other business opportunities</td>
<td>Whether the worker relies on the employer to furnish tools and materials (14)</td>
</tr>
<tr>
<td></td>
<td>Whether the worker is paid a salary or hourly wage rather than a flat fee</td>
<td>Whether the worker lacks a major investment in facilities used to perform the service (15)</td>
</tr>
<tr>
<td></td>
<td>Whether the worker has the ability to realize a profit or loss (the preceding facts are relevant in making this determination)</td>
<td>Whether the worker cannot make a profit or suffer a loss from his services (16)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Whether the worker does not offer his services to the general public (18)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Whether the worker provides services that are integrated into the business of the employer (3)</td>
</tr>
<tr>
<td>Category</td>
<td>Examples of Factors Included in Category</td>
<td>Analogous Factors from Traditional 20-Factor Test</td>
</tr>
<tr>
<td>--------------------------------------</td>
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<td>---------------------------------------------------------------------------------------------------------------</td>
</tr>
<tr>
<td>Relationship of Parties, <em>i.e.</em>, how the parties perceive their relationship</td>
<td>Whether the worker is described as an employee in a contract with the service-recipient</td>
<td>Whether the worker provides services that must be rendered personally (4)</td>
</tr>
<tr>
<td></td>
<td>Whether the worker receives a Form W-2 from the service-recipient</td>
<td>Whether the worker has a continuing working relationship with the employer (6)</td>
</tr>
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<td></td>
<td>Whether the worker is treated as an employee for employee benefit purposes</td>
<td>Whether the worker can be fired by the employer (19)</td>
</tr>
<tr>
<td></td>
<td>Whether each party can terminate the arrangement at will, without penalty</td>
<td>Whether the worker may quit work at any time without incurring liability (20)</td>
</tr>
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<td></td>
<td>Whether the worker's relationship with the service-recipient is of indefinite duration</td>
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<td></td>
<td>Whether the services provided by the worker are a key aspect of the service-recipient’s regular business activity</td>
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<tr>
<td>Less Relevant Factors</td>
<td>Whether the worker is told when to work by the service-recipient</td>
<td>Whether the worker must follow set hours of work (7)</td>
</tr>
<tr>
<td></td>
<td>Whether the worker works on a full-time basis for the service-recipient</td>
<td>Whether the worker works full-time for an employer (8)</td>
</tr>
<tr>
<td></td>
<td>Whether the worker works on the business premises of the service-recipient</td>
<td>Whether the worker does his work on the employer’s premises (9)</td>
</tr>
<tr>
<td></td>
<td>Whether the worker works at only one location</td>
<td>Whether the worker works for one employer at a time (17)</td>
</tr>
</tbody>
</table>