

## INDEPENDENT CONTRACTOR OR EMPLOYEE?

---

## TRAINING MATERIALS

---

THIS MATERIAL WAS  
DESIGNED SPECIFICALLY  
FOR TRAINING PURPOSES  
ONLY. UNDER NO  
CIRCUMSTANCES  
SHOULD THE CONTENTS  
BE USED OR CITED  
AS AUTHORITY FOR  
SETTING OR SUSTAINING  
A TECHNICAL POSITION.

---



## F O R E W O R D

Examiners and other Internal Revenue Service (IRS) representatives are sometimes faced with the difficult task of making a determination of the classification of workers who provide products and services for others. The status of a worker as either an independent contractor or employee must be determined accurately to ensure that workers and businesses can anticipate and meet their tax responsibilities timely and accurately. Businesses decide whether to hire employees or independent contractors depending on individual needs, customer expectations, and worker availability. **Either worker classification -- independent contractor or employee -- can be a valid and appropriate business choice.**

The majority of classifications of workers are not challenged by the IRS. When they are, there is usually agreement between the IRS and the business after the facts and circumstances are jointly reviewed. Nonetheless, when the IRS determines there may be a need for reclassification to accurately reflect the relationship of the worker and the business, the legal standard for distinguishing between independent contractor and employee can be difficult to apply. Also, the importance of indicators that might help in applying the legal standard can change and should be reviewed from time to time.

This training addresses the application of section 530 of the Revenue Act of 1978. Section 530 can in certain circumstances relieve businesses of employment tax liability resulting from worker classification. This training provides you with the tools to make legally correct determinations of worker classifications. It also discusses facts that may indicate the existence of an independent contractor or an employer-employee relationship and guides you in determining which facts are most relevant under the common law standard. It emphasizes that relevant facts may change over time because business relationships and the work environment change over time. In addition, it addresses how to determine whether workers are statutory employees.

**IRS policy requires its employees to exercise strict impartiality in the conduct of their duties. Thus, you must approach the issue of worker classification in a fair and impartial manner and actively consider section 530 relief at the beginning of an examination. This includes furnishing taxpayers with a summary of section 530 at the beginning of an examination. Additionally, you may need to assist taxpayers in identifying facts which establish either worker classification.**

October 30, 1996

**In this course**

This course has been developed to provide Employment Tax Specialists and Revenue Officer Examiners with the tools to make worker classifications. The lessons will cover a review of the issues, law, and examination techniques for making a correct determination; as well as a review of Section 530 relief.

<b>Topic</b>	<b>See Page</b>
LESSON 1 EMPLOYEE OR INDEPENDENT CONTRACTOR: DOES SECTION 530 APPLY?	1-1
Introduction	1-1
530 relief	1-1
Objectives	1-1
Overview of requirements	1-2
Historical background	1-3
Service must consider section 530	1-4
Time to claim section 530 relief	1-4
Section 530 limits guidance	1-4
Section 530 considered first	1-5
Change from prior policy	1-5
Other tax consequences for workers	1-5
Consistency Test: Reporting Consistency: Information returns	1-6
Filing information returns	1-6
Example 1	1-6
Example 2	1-6
Revenue Ruling 81-224	1-7
Example 3	1-7

<b>Topic</b>	<b>See Page</b>
Best source: IRS records	1-8
Relevant cases	1-8
Consistency Test: Substantive Consistency	1-9
Substantive consistency required	1-9
Substantially similar position	1-9
Defining treatment	1-10
Demonstrating treatment important - relevant rulings and cases	1-11
Treatment for state purposes	1-11
Treatment by predecessor	1-12
Changing treatment of workers	1-12
Dual status	1-12
Cases about "substantially similar"	1-13
Example 4	1-14
Reasonable Basis Test	1-15
Moving to the next step	1-15
Reasonable basis test	1-15
Liberal construction	1-16
The burden of proof	1-17
When burden of proof shifts	1-17
Which burden of proof shifts	1-17
Prima facie case	1-18
Reasonable requests for information	1-18
Reasonable reliance on safe haven required	1-18
Reasonable Basis Test - Prior Audit	1-19
Prior audit	1-19
Pre 1997 audits	1-19

<b>Topic</b>	<b>See Page</b>
Post 1996 audits	1-19
Assessment offset by claims	1-19
Change in work relationship	1-19
Related entities	1-20
Examination of records	1-20
Items that are not audits	1-21
Audits by other agencies	1-21
Establishing the fact of prior audit	1-22
Example 5	1-22
Example 6	1-23
Available for officers	1-23
Reasonable Basis Test - Judicial Precedent	1-24
Judicial precedent	1-24
Reasonable reliance - judicial precedent	1-24
Qualifying TAMS and PLRs	1-24
Non-qualifying precedents	1-25
Reasonable Basis Test - Industry Practice	1-26
Industry practice	1-26
Industry defined	1-26
Geographic area	1-26
Long-standing	1-27
Example 7	1-27
Significant segment	1-28
Reasonable showing	1-29
Establishing industry practice	1-29
Reasonable reliance	1-30
Reliance	1-30

<b>Topic</b>	<b>See Page</b>
Establishing reliance	1-31
Interviews for reliance	1-31
Establishing that reliance was reasonable	1-31
<b>Other Reasonable Basis</b>	1-32
Other reasonable basis	1-32
Advice of accountant or attorney	1-32
State and non-tax federal law and determinations	1-33
Common law rules	1-33
Prior audit of predecessor	1-34
PLR/TAM to predecessor	1-34
Good faith	1-34
Penalties	1-34
Other situations	1-35
<b>Workers Covered by Section 530</b>	1-36
Who is covered	1-36
Officers: IRC section 3121(d)(1)	1-36
Common-law employees: IRC section 3121(d)(2)	1-36
Statutory employees: IRC section 3121(d)(3)	1-37
Limited applicability to state and local workers covered under 218 Agreement: IRC section 3121(d)(4)	1-37
Applies to state and local employees not covered under 218 agreement	1-37
<b>Workers Not Covered by Section 530</b>	1-38
Section 530(d)	1-38
Applies to three-party situations	1-38
Section 530(d)	1-39
Example 8	1-39

<b>Topic</b>	<b>See Page</b>
Prohibition against regulations and rulings lifted	1-39
Effect of Section 530 Relief on Employee	1-40
Status of employee not changed by section 530	1-40
Liabile for employee share of FICA	1-40
Summary	1-41
Review of lesson	1-41
Exercises	1-43
Case Studies	1-48
Instructions	1-48
Case Study 1-1	1-49
Case Study 1-2	1-50
Exhibit 1-1, Text of Section 530 including amendments	1-51
Exhibit 1-2, Small Business Job Protection Act	1-53
Exhibit 1-3, Plain Language Summary, Publication 1976	1-57
<b>LESSON 2: INDEPENDENT CONTRACTOR OR EMPLOYEE: THE COMMON LAW STANDARD</b>	2-1
Introduction	2-1
A worker is an employee if....	2-1
A worker is not an employee if....	2-1
In this lesson...	2-2
Objectives	2-2
Common Law Employee: Control Standard	2-3
Common law standard	2-3
The right to direct and control	2-3
Control test	2-3
Control facts change over time	2-4
Understand business operations	2-4



<b>Topic</b>	<b>See Page</b>
Examining the relationship	2-5
Dual status/split duties	2-5
Developing the facts	2-5
Important preliminary points	2-6
A Look At The Evidence	2-7
Categories of evidence	2-7
Behavioral Control	2-8
Background	2-8
Instructions	2-8
Types of instructions	2-9
Prior approval	2-9
Example 1	2-9
Example 2	2-10
Degree of instruction	2-10
Example 3	2-11
Example 4	2-11
Presence of instructions or rules mandated by governmental agencies or industry governing bodies	2-11
Instructions by customers	2-12
Suggestions v. instructions	2-12
Business identification as instructions	2-13
Nature of occupation for instructions	2-13
Nature of work for instructions	2-14
Evaluation systems	2-14
Training	2-15
Financial Control	2-16
Economic aspects of relationship	2-16

<b>Topic</b>	<b>See Page</b>
Economic dependence	2-16
Significant investment	2-16
No dollar limitation on investment	2-17
Example 5	2-17
Business expenses	2-18
Reimbursed expenses	2-18
Unreimbursed expenses	2-19
Services available	2-19
Example 6	2-19
Method of payment	2-20
Salary or hourly wage	2-20
Flat fee	2-20
Commissions	2-20
Realization of profit and loss	2-21
Not all facts required	2-21
Relationship of the Parties	2-22
Relationship of business and worker	2-22
Intent of parties/written contract	2-22
Forms W-2	2-22
Incorporation	2-23
Employee benefits	2-23
State law characterization	2-24
Discharge/termination	2-24
Discharge/termination - traditional analysis	2-25
Limits on ability to discharge worker	2-25
Limit on worker's ability to quit	2-25
Termination of contracts	2-25

<b>Topic</b>	<b>See Page</b>
Nonperformance by employee	2-26
Discharge/termination - limited usefulness	2-26
Permanency	2-27
Indefinite relationship	2-27
Long-term relationship	2-27
Temporary relationship	2-28
Regular business activity	2-28
Facts of Lesser Importance	2-29
Introduction	2-29
Part-time or full-time work	2-29
Place of work	2-29
One location	2-30
Different locations	2-30
Hours of work	2-30
Weighing the Evidence	2-31
Control and autonomy both present	2-31
Which predominates?	2-31
Example 7	2-31
Summary	2-32
Review of lesson	2-32
Case Studies	2-34
Instructions	2-34
Case Study 2-1	2-35
Case Study 2-2	2-36
Case Study 2-3	2-37
Exhibit 2-1, Selected Cases	2-38

<b>Topic</b>	<b>See Page</b>
LESSON 3: STATUTORY EMPLOYEES, STATUTORY NON-EMPLOYEES, AND OTHER CLASSES OF WORKERS	3-1
Introduction	3-1
In this lesson	3-1
Objectives	3-1
Corporate Officers	3-2
Exception	3-2
Example 1	3-3
Payments to officers	3-3
Statutory Employees	3-4
Statutory employee	3-4
General requirements	3-5
Work performed personally	3-5
No substantial investment	3-5
Continuing relationship	3-6
Categories of Statutory Employees	3-7
Agent drivers or commission drivers	3-7
Example 2	3-7
Full-time life insurance salespersons	3-7
Home workers	3-8
Specific requirements for home workers	3-8
\$100 rule for home workers	3-9
Traveling or city salesperson	3-9
Specific requirements for traveling or city salespersons	3-10
Principal business activity defined for traveling or city salespersons	3-10
Types of purchasers for traveling or city salespersons	3-11

<b>Topic</b>	<b>See Page</b>
Classes of purchasers not included for traveling or city salespersons	3-12
Resale or use for traveling or city salespersons	3-12
Example 3	3-12
Service may be part of the sale for traveling or city salespersons	3-13
Statutory employees' expenses	3-13
Statutory employee treatment	3-14
Statutory employee benefit plans	3-15
State and Local Government Employees	3-16
218 Agreement	3-16
Can be employees for FICA purposes under common law	3-16
Statutory Non-employees	3-17
Introduction	3-17
Qualified real estate agents	3-17
Direct sellers	3-17
Litigation of definition of consumer products	3-18
Consumer products - definition expanded	3-18
Newspaper carriers and distributors	3-19
Companion sitters	3-19
Quick reference	3-19
Summary	3-20
Review of lesson	3-20
Exercises	3-22
Case Studies	3-24
Instructions	3-24
Case Study 3-1	3-25

October 30, 1996

<b>Topic</b>	<b>See Page</b>
Case Study 3-2	3-27
Exhibit 3-1, Treatment by Business under Different Employment Taxes	3-29
Answers to Exercises	4-1
Lesson 1	4-1
Lesson 2	4-8
Lesson 3	4-13

---

## Lesson 1

### INDEPENDENT CONTRACTOR OR EMPLOYEE:

### DOES SECTION 530 APPLY?

#### INTRODUCTION

---

##### 530 relief

Section 530 provides businesses with relief from federal employment tax obligations if certain requirements are met. It terminates the business's, **not the worker's**, employment tax liability under Internal Revenue Code (IRC) Subtitle C (Federal Insurance Contributions Act (FICA) and Federal Unemployment Tax Act (FUTA) taxes, federal income tax withholding, and Railroad Retirement Tax Act taxes) and any interest or penalties attributable to the liability for employment taxes (Rev. Proc. 85-18, 1985-1 C.B. 518).

Section 530(e)(3) of the Revenue Act of 1978, as amended by the Small Business Job Protection Act of 1996, clarifies that the first step in any case involving whether the business has the employment tax obligations of an employer with respect to workers is determining whether the business meets the requirements of section 530. If so, the business will not have an employment tax liability with respect to the workers at issue.

---

##### Objectives

At the end of this lesson, you will be able to:

1. Explain the two consistency requirements that must be met for a business to obtain relief under section 530.
  2. Explain the reasonable basis test that must be met for a business to obtain relief under section 530.
  3. Explain the three safe havens under the reasonable basis test.
  4. Determine whether relief is applicable in a particular situation.
-

## INTRODUCTION

---

### Overview of requirements

The business must meet the following consistency and reasonable basis requirements before the relief provisions of section 530 apply:

#### Consistency Test

The business must meet both aspects of the consistency test by:

- filing **all required Forms 1099** (reporting consistency)
- **treating all workers** in similar positions **the same** (substantive consistency)

#### Reasonable Basis Test

The business must **reasonably rely** on one of the following:

- prior audit safe haven
- judicial precedent safe haven
- industry practice safe haven
- other reasonable basis

Meeting the consistency and reasonable basis tests will give the business relief from employment taxes with respect to the workers whose status is in question.

---



## INTRODUCTION

---

### Historical background

Section 530 of the Revenue Act of 1978, as amended, is not part of the Internal Revenue Code (IRC). However, some publishers include its text after IRC section 3401(a). It is also reprinted in **Exhibit 1-1** of this material. It was originally intended as an "interim" relief measure, but was extended indefinitely by the Tax Equity and Fiscal Responsibility Act of 1982.

Section 530 was amended by section 1706 of the Tax Reform Act of 1986 (1986-3, C.B. (Vol.1) 698). Section 530(d) denies relief for certain technically skilled workers who provide services under a three party situation. It will be discussed in detail later in this lesson.

Section 530(e) was added by section 1122 of the Small Business Job Protection Act of 1996 (H.R. 3448). Section 530(e), which is generally effective after December 31, 1996, contains a number of provisions that affect conditions under which a business will be eligible for section 530 relief. It is discussed throughout this lesson. In addition, the text of section 1122 is reproduced in **Exhibit 1-2**.

---

## INTRODUCTION

---

**Service must consider section 530**

It is not necessary for the business to claim section 530 relief for it to be applicable. In order to correctly determine tax liability, as required by the IRS mission, you must explore the applicability of section 530 even if the business does not raise the issue. In addition, a plain language summary of section 530 must be provided to the taxpayer at the beginning of an examination of worker classification. The plain language summary is reproduced as **Exhibit 1-3**.

---

**Time to claim section 530 relief**

The section 530 analysis is, itself, fact intensive. You will identify the possible application of section 530 relief before beginning the development of the worker classification issue. The relief is available, however, throughout the examination or administrative (including appeals) process, as well as, any subsequent judicial proceeding.

---

**Section 530 limits guidance**

When Congress enacted section 530, the IRS was barred from issuing any regulations or revenue rulings pertaining to worker classification. As a result, the IRS cannot issue new revenue rulings or even modify existing revenue rulings to reflect new developments.

At the same time, courts have been able to modify their applications of the common law standard in response to factual developments. As a result, courts may now look at the employee versus independent contractor issue somewhat differently -- possibly making outstanding IRS revenue rulings outdated and in conflict with judicial decisions.

Section 530 imposes no prohibition on private letter rulings or technical advice memoranda. Also there is no prohibition on published guidance dealing with section 530 itself.

---

## INTRODUCTION

---

**Section 530 considered first**

Section 530 is a relief provision that should be considered as the first step in any case involving worker classification.

---

**Change from prior policy**

Considering section 530 first is a change from prior policy and results from the Small Business Job Protection Act of 1996. New section 530(e)(3) specifies that a worker does not have to be an employee of the business in order for relief to apply. **Additionally, the business need not concede or agree to the determination that the workers are employees in order for section 530 relief to be available.**

---

**Other tax consequences for workers**

A business may be entitled to relief under section 530 but workers may find, through a determination letter or some other means, that they have been misclassified and are employees. However, section 530 relief does not extend to the worker. It does not convert a worker from the status of employee to the status of independent contractor. As noted above, misclassified employees are liable for the employee share of FICA rather than for tax under the Self Employment Tax Contributions Act (SECA).

Workers may have filed and paid their own employment tax. If the worker paid SECA, the worker may file a claim for refund for the difference between SECA tax and the employee share of FICA. *See*, Rev. Proc. 85-18, section 3.08; Treas. Reg. section 31.3102-1(c).

There are other tax consequences for the worker as well. Workers as employees generally cannot deduct unreimbursed business expenses above the line on Schedule C, but must deduct them, if at all, as miscellaneous itemized deductions on Schedule A, Form 1040, subject to the two-percent limitation of IRC section 67. This sometimes results in liability for the alternative minimum tax. Further, the worker as an employee cannot adopt or maintain a self-employed retirement plan. Finally, certain benefits provided by the business to a worker as an employee may be excludable from income by the employee due to specific IRC exclusions provided only to employees (*e.g.*, employer provided accident and health insurance).

---

## CONSISTENCY TEST: REPORTING CONSISTENCY

### Information Returns:

---

**Filing  
information  
returns**

The first requirement a business must meet to obtain relief under section 530 is timely filing of all required Forms 1099 with respect to the worker for the period, on a basis consistent with the business's treatment of the worker as not being an employee. This provision applies only "for the period." Rev. Proc. 85-18, section 3.03(B). That is, if a business in a subsequent year files all required returns on a basis consistent with the treatment of the worker as not being an employee, then the business may qualify for section 530 relief for the subsequent period. **If a business is not "required to file," relief will not be denied on the basis that the return was not filed.**

---

#### EXAMPLE 1

C owns a small insurance agency. Four times a year C mails information packets to all current and prospective clients. C employs four high school students to stuff envelopes. Each is paid \$400. C treats the students as independent contractors. No Forms 1099 were filed for the \$400 paid to each student.

Section 530 relief will not be denied on the basis of failure to file required information returns. C is NOT "required to file" information returns because the \$600 threshold has not been met.

---

#### EXAMPLE 2

In 1992, C increased the number of mailings to five per year and raised the payment to the students to \$750. C continued to treat the four students as independent contractors. In 1992, no Forms 1099 were filed for the \$750 paid to each student. All required information returns were filed for 1993, 1994, and 1995.

C would not be entitled to relief for the 1992 year as the "required" information returns were not filed. However, C may still qualify for section 530 relief for the subsequent years.

---

## CONSISTENCY TEST: REPORTING CONSISTENCY

### Information Returns:

---

**Rev. Rul. 81-224** Rev. Rul. 81-224, 1981-2 C.B. 197, addresses specific questions about timely filing of Forms 1099. It provides that:

- businesses that do not file timely Forms 1099 consistent with their treatment of the worker as an independent contractor, may not obtain relief under the provisions of section 530 for that worker in that year
- businesses that mistakenly, in good faith, file the wrong type of Form 1099 do not lose section 530 eligibility

---

### EXAMPLE 3

R corporation has 30 workers whom it treated as independent contractors in 1995. You requested copies of all Forms 1099 filed with the IRS and found none were filed. The due date for these filings has passed. You discuss this with the controller, who states that R corporation forgot to file Forms 1099 but will see that they are prepared and filed next week.

R corporation should have filed Forms 1099 with the IRS by the end of February, 1996, in order to qualify for the relief provisions of section 530. However, if R corporation has other workers for whom Forms 1099 were filed, section 530 relief may be available with respect to those workers. You should continue the examination and consider the relationship between the 30 workers and R corporation.

## CONSISTENCY TEST: REPORTING CONSISTENCY

### Information Returns:

---

**Best source:  
IRS records**      The best source for determining whether Forms 1099 were filed timely is internal IRS records. Service Centers maintain information on the Payer Master File which records the taxpayer's history of filing information returns. These transcripts can be requested internally.

Recall that Form 1099, reporting payments of \$600 or more, must generally be filed by the last day of February following the close of the year in which the payment for the services was made. However, businesses may apply for extensions of time to file information returns.

---

**Relevant cases**      *General Investment Corp. v. United States*, 823 F. 2d 337 (9th Cir. 1987) -- The business was not entitled to section 530 relief for the year it failed to file information returns; *Claire W. Murphy v. United States*, 93-2 USTC par. 50,610 (W.D. WI 1993) -- The business was not entitled to protection under section 530 where the business did not provide the required information returns.

---

## CONSISTENCY TEST: SUBSTANTIVE CONSISTENCY

---

**Substantive consistency required**

You will recall from reading section 530 that its provisions do not apply if the business or a predecessor treated the worker, or any worker holding a substantially similar position, as an employee at any time after December 31, 1977. In other words, treatment of the class of workers must be consistent with the business's belief that they were independent contractors.

---

**Substantially similar position**

A substantially similar position exists if the job functions, duties, and responsibilities are substantially similar and the control and supervision of those duties and responsibilities are substantially similar.

In addition, section 530(e)(6), added by the Small Business Job Protection Act, states that the determination of whether workers hold substantially similar positions requires consideration of the relationship between the taxpayers and those individuals. This includes, but is not limited to, the degree of supervision and control. This statutory change appears to be designed to enable differences in managerial responsibilities and differences in reporting requirements to be taken into account, along with differences in job duties. Presumably, the contractual relationship and the provision of employee benefits are also entitled to some weight.

The determination of what is substantially similar work rests on analysis of the facts. The day-to-day services that workers perform and the method by which they perform those services are relevant in determining whether workers treated as independent contractors hold substantially similar positions to workers treated as employees. Comparison of job functions is an important fact. Workers with significantly different, though overlapping, job functions are not substantially similar.

---

## CONSISTENCY TEST: SUBSTANTIVE CONSISTENCY

---

**Defining  
treatment**

Rev. Proc. 85-18 provides examples of treatment consistent or inconsistent with payments to an independent contractor:

- |  |
|--|
| 1. The withholding of federal income tax or FICA tax from a worker's wages is treatment of the worker as an employee, whether or not the tax is paid to the Government.  |
| 2. Filing a Form 940, 941, 942, 943, or W-2 with respect to a worker, whether or not tax was withheld from the worker, is treatment of the worker as an employee for that period. NOTE: Beginning in 1995, household employers report wages paid to household employees on their individual income tax returns using Schedule H rather than Form 942.  |
| 3. The filing of a delinquent or amended employment tax return for a particular tax period is not treatment of the worker as an employee if the filing was a result of IRS compliance procedures. However, filing the returns for periods after the period under audit is "treatment" of the workers as employees for those later periods, regardless of the time at which the return was filed. |
| 4. Neither the use of an IRC section 6020(b) return prepared by the IRS nor the signing of Form 2504 (Agreement to Assessment and Collection of Additional Tax and Acceptance of Overassessment) constitutes treatment.  |
-



## CONSISTENCY TEST: SUBSTANTIVE CONSISTENCY

---

**Demonstrating  
treatment  
important --  
relevant rulings  
& cases**

Both revenue rulings and cases illustrate the importance of demonstrating treatment of workers in periods prior to those under consideration.

- Rev. Rul. 83-16, 1983-1 C.B. 235 -- Section 530 relief was unavailable to three doctors who had been treated as employees of a medical corporation in 1979 and 1980, but were not treated as employees in 1981 after the doctors created individual trusts to which the corporation made payments for the doctors' services.
- Rev. Rul. 84-161, 1984-2 C.B. 202 -- A trucking company that had treated its drivers as employees from 1970-1978 began treating them as independent contractors in 1979; section 530 relief was unavailable because the trucking company had treated them as employees for "any period beginning after 12-31-77."
- *Institute for Resource Management, Inc. v. United States*, 90-2 USTC par. 50,586 (Cl. Ct. 1990) -- No safe haven was available for employment tax treatment of any worker who was treated as an independent contractor if the business treated any worker holding a substantially similar position as an employee for employment tax purposes.
- *In re Critical Care Support Services, Inc.*, 138 B.R. 378 (Bankr. E.D. N.Y. 1992) -- Section 530 relief was not available because the business, through its predecessor, treated the nurses as employees, the business did not timely file appropriate tax forms, and the business had no reasonable basis for not treating its nurses as employees.

---

**Treatment for  
state purposes**

Only federal tax treatment as an employee is relevant. Thus, if a business treats workers as employees for state unemployment or state withholding tax purposes, that is not treatment for purposes of section 530. However, if the business uses a federal form, such as Form W-2, to report state tax withholding, the filing of the federal form is treatment for purposes of section 530.

---

## CONSISTENCY TEST: SUBSTANTIVE CONSISTENCY

---

**Treatment by predecessor**

Section 530 specifically states that the treatment by predecessor entities will be taken into account when evaluating substantive consistency. This ensures that the substantive consistency rule is not avoided by the formation of new entities. *See* Rev. Proc. 85-18.

---

**Changing treatment of workers**

If the business begins to treat misclassified workers as employees, relief is available under section 530 for the years it treated them as independent contractors, provided it meets both consistency requirements (reporting and substantive consistency) and reasonable basis for the years prior to the change in treatment. *See* Rev. Proc. 85-18, section 3.04. The Small Business Job Protection Act added this rule as section 530 (e)(5).

---

**Dual status**

Some workers perform services in two capacities. For example, a business's bookkeeper might be separately engaged to design and print an advertising brochure. The fact that the bookkeeper is treated as an employee with respect to the bookkeeping services does not preclude application of section 530 if it is determined that the bookkeeper is an employee, and not an independent contractor, with respect to the design and printing services.

---

## CONSISTENCY TEST: SUBSTANTIVE CONSISTENCY

---

### Cases about "substantially similar"

Several cases have discussed the meaning of "substantially similar". Caution should be exercised in using these "substantially similar" cases due to the later enactment of section 530 (e)(6).

- *Lowen Corporation v. United States*, 785 F.Supp. 913 (D. Kan. 1992) -- The court granted summary judgment for the Government on the issue of whether the business was entitled to section 530 relief because the business had treated workers holding substantially similar positions as employees. On the issue of worker status, the court (*Lowen v. United States*, 72 AFTR 2d par. 6,350 (D. Kan. 1993)) found that all but 15 of 113 salespersons were independent contractors.
  - *REAG, Inc. v. United States*, 801 F. Supp. 494 (W.D. Okla. 1992) -- Differing treatment of owner/appraisers and non-owner/appraisers was not inconsistent treatment since the owners had managerial control and performed substantial duties.
  - *World Mart, Inc. v. United States*, 93-1 USTC par. 50,304 (D. Ariz. 1992) -- No inconsistent treatment was found where probationary telemarketers were treated as independent contractors on the basis that the probationary workers did not hold the "same position" as the regular telemarketers. *Compare In re Compass Marine Corporation*, 146 B.R. 138 (Bankr. E.D. Pa. 1992) -- Court states that a strong argument could be made that the business failed the consistency requirement of section 530(a)(3) where workers were treated as independent contractors for a probationary period and then reclassified as employees.
-

## CONSISTENCY TEST: SUBSTANTIVE CONSISTENCY

---

### EXAMPLE 4

V corporation's 1992 returns were examined and it was found that 100 workers, all doing the same job, were being treated as independent contractors. The examiner discovered that five of these 100 workers were, in 1988, treated as employees while they performed substantially the same job as in 1992.

V corporation cannot claim relief under section 530 in 1992 for any of these 100 workers because of inconsistent treatment of workers as employees in 1988.

---

## REASONABLE BASIS TEST

---

**Moving to the next step** Once you have determined that the business has met the consistency test, you will address the reasonable basis test.

---

**Reasonable basis test** The business must reasonably rely on one of the following ways to meet the reasonable basis test, as listed in Rev. Proc. 85-18:

<b>REASONABLE BASIS TEST</b>	<b>EXPLANATION</b>
Judicial Precedent Safe Haven	Reasonable reliance on judicial precedent; published rulings; a technical advice memorandum, private letter ruling, or determination letter pertaining to the business.
Past Audit Safe Haven	Reasonable reliance on a past IRS audit of the business for employment tax purposes, if the audit began after December 31, 1996, and entailed consideration of, but no assessment attributable to the business's employment tax treatment of workers holding positions substantially similar to the position held by the worker whose status is at issue. (NOTE: A business may continue to rely on any audit that began before January 1, 1997, even though the audit was not related to employment tax matters.)
Industry Practice Safe Haven	Reasonable reliance on a long-standing recognized practice of a significant segment of the industry in which the business is engaged. The practice need not be uniform throughout an entire industry.
Other Reasonable Basis	A business which fails to meet any of the three safe havens may nevertheless be entitled to relief, if the business can demonstrate, in some other manner, any reasonable basis for not treating the worker as an employee.

---

## REASONABLE BASIS TEST

---

**Liberal  
construction**

The Conference Agreement on section 530 of the Revenue Act of 1978 explains Congress' intent that the reasonable basis requirement be construed liberally.

**Extract**

H.R. Rep. No. 1748, 95th Cong. 2nd Sess. 4 (1978), 1978-3 C.B. (Vol. 1) 629, 633.

\* \* \* \* \*

Generally, the bill grants relief if a taxpayer had any reasonable basis for treating workers as other than employees. The committee intends that this reasonable basis requirement be *construed liberally* in favor of taxpayers. (Emphasis added).

\* \* \* \* \*

The Congressional direction to liberally construe section 530 means that **facts** which indicate that the conditions of section 530 have been satisfied by a particular business are to be viewed liberally in favor of the business.

Liberal construction does not mean that the **conditions** for obtaining section 530 relief should be discounted or ignored. Failures to satisfy one or more of the conditions for eligibility for section 530 relief are not cured by the requirement of liberal construction of the reasonable basis requirement.

---

## REASONABLE BASIS TEST

---

**The burden of proof** In the Small Business Job Protection Act, Congress indicated that the business's burden of proof differs from that in ordinary tax cases. As is generally true in tax matters, the business has the initial burden of proof in demonstrating that it is entitled to relief under section 530. *See, Boles Trucking, Inc. v. United States*, 1996 77 F.3rd 236 (8th Cir. 1996).

---

**When burden of proof shifts** However, section (e)(4) shifts the burden of proof to the IRS if two requirements are satisfied:

- The taxpayer establishes a prima facie case that it was reasonable not to treat an individual as an employee.
- The taxpayer cooperates fully with reasonable requests from the examiner.

---

**Which burden of proof shifts** Section 530(e)(3)(4) is designed to codify the holding in *McClellan v. United States*, 900 F.Supp. 101 (E.D. Mich. 1995). In *McClellan*, the court held that if the taxpayer came forward with an explanation and enough evidence to establish prima facie grounds for a finding of reasonableness, then the burden shifted to the IRS to verify or refute the taxpayer's explanation.

The shift applies to the reporting consistency requirement (section 530(a)(1)(B); the substantive consistency requirement (section 530(e)(3)); and the three safe havens (judicial precedent, prior audit and industry practice) contained in section 530(a)(2). The shift does not apply in determining whether the taxpayer had any other reasonable basis for treating the worker as an independent contractor.

---

## REASONABLE BASIS TEST

---

**Prima facie case** "Prima facie" means "at first sight" or "on the face of it." A prima facie case means that the taxpayer has presented evidence that will allow the taxpayer to prevail unless the government presents other evidence that contradicts and overcomes the taxpayer's evidence.

---

**Reasonable requests for information** The legislative history of section 530 (e)(4) indicates that the burden of proof shifts only if the taxpayer cooperates fully with all reasonable requests for information relevant to treatment of the worker as an independent contractor. This includes reasonable requests for information relative to filing of returns, treatment of other workers, prior audits, precedent relied upon, and industry practice. However, requests are not reasonable if compliance would be "impracticable given the particular circumstances and relative costs involved." In addition, requests are not reasonable if they relate to a basis other than the one on which the taxpayer relied for establishing its reasonable basis.

Examiners should work with the business to determine what information is needed to conclude whether the business has met the requirements described above. Examiners must exercise caution to ensure requested information is both relevant and reasonable.

---

**Reasonable reliance on safe haven required** Remember that if the business establishes the existence of a safe haven, the business must show reliance on the safe haven. Section 530 requires that the reliance must be reasonable. You should explore with the business **why** it treated the workers as independent contractors. The business's stated reasons should be set forth in your workpapers. This is important if the case is unagreed, as it provides invaluable information to the appeals officer or attorney. However, the business's stated reasons should also be recorded in agreed cases, as the taxpayer may later file a claim for refund.

---



## REASONABLE BASIS TEST - PRIOR AUDIT

---

**Prior audit** We will discuss the second reasonable basis safe haven first because section 530 relief is most easily established by reliance on a prior audit. A business is treated as having reasonable basis if it relied on a prior audit.

---

**Pre 1997 audits** For examinations that began before January 1, 1997, the prior IRS audit does not have to have been an audit for employment tax purposes as long as the audit entailed no assessment attributable to the business's treatment, for employment tax purposes, of workers holding positions substantially similar to the position held by the workers whose treatment is at issue. The business need only show that, at the time of the earlier examination, it was treating the same type of workers -- as those at issue in the present audit -- as independent contractors, and that the treatment went unchallenged or was sustained by the IRS.

---

**Post 1996 audits** Section 530(e)(2)(A) limits the prior audit safe haven to audits that included an examination for employment tax purposes of the status of the class of workers at issue or of a substantially similar class of workers. This restriction only applies, however, to audits that begin after December 31, 1996. Taxpayers may continue to rely on any audit that began before January 1, 1997, even though the audit was not related to employment tax matters.

---

**Assessment offset by claims** A business does not meet the prior audit test if, in the conduct of a prior examination, an assessment attributable to the business's treatment of the worker(s) was offset by other claims asserted by the business.

---

**Change in work relationship** The prior audit safe haven does not apply if the relationship between the business and the workers is substantially different from that which existed at the time of the audit.

---

## REASONABLE BASIS TEST - PRIOR AUDIT

---

**Related entities** The prior audit safe haven is limited to past audits conducted on the business itself. Therefore, a business is not entitled to relief based upon a prior audit of any of its workers. Nor would a subsidiary corporation usually be entitled to relief based upon a prior audit of its separately filing parent corporation. Even if a consolidated return was filed in the year the parent was audited, the subsidiary would only be entitled to relief if the subsidiary was examined in connection with the parent.

If a corporation which was previously audited begins conducting a new line of business, that corporation is not entitled to relief based upon the audit of the corporation's original line of business. However, if there has only been a change of form and the successor entity is in the same line of business, the corporation may nevertheless be entitled to section 530 relief, if the corporation can demonstrate in some other manner, any reasonable basis for not treating the worker as an employee.

---

**Examination of records** A business will be able to claim that it was subject to a prior audit if the IRS previously inspected the business's books and records. Mere inquiries or correspondence from a Service Center will not constitute an audit.

If, for example, a correspondence contact was made to verify a discrepancy disclosed by an information matching program, such as Information Returns Processing, self-employment tax, and similar Service Center programs, such contacts do **not** constitute a prior audit. They are referred to as **adjustments**.

However, if correspondence contacts entailed the examination or inspection of the business's records to determine the accuracy of deductions claimed on a return, such contacts do constitute an audit for purposes of section 530.

---

## REASONABLE BASIS TEST - PRIOR AUDIT

---

**Items that are not audits**

Even prior to the Small Business Job Protection Act, no prior audit safe haven was created in the following instances:

- an application for status determination, such as an application for recognition for exemption from federal income tax as an exempt organization or an application for a determination letter for an employee benefit plan made on Forms 5300 or 5301
- an examination of an employee benefit plan or consideration of Form 5500 (Annual Return/Report of Employee Benefit Plan) (the plan is generally not the business that engages the workers in question) -- (However, an audit that began prior to January 1, 1997, of the business's pension plan that leads to an examination of the business's books and records, such as payroll records, to determine whether coverage requirements have been met may create a safe haven for the business.)
- compliance checks, which ask if a business has filed all required returns, if conducted properly -- (However, compliance checks would create a prior audit safe haven, if the IRS asked about the reason for worker classification or examined books and records other than those IRS forms that are required to be filed or maintained.)

---

**Audits by other agencies**

Audits conducted by agencies other than the IRS will not qualify a business for relief based upon the prior audit safe haven.

---

## REASONABLE BASIS TEST - PRIOR AUDIT

---

### Establishing the fact of prior audit

For examinations that began before January 1, 1997, the business can establish a prima facie case that a prior audit was, in fact, conducted by furnishing a copy of correspondence connected with an IRS audit. If the business states that an audit was conducted in a particular year, and the IRS can verify by existing records that an audit was conducted, the business will be deemed to have met its burden of establishing a prima facie case of the existence of a prior audit. **The business also has to show reliance on the prior audit. To show reliance, the business need only show that the same class of workers currently under consideration was treated as independent contractors during the period covered by the prior examination.** Of course, the prior audit can only be relied upon for periods after the audit took place.

To establish reliance on examinations that began after December 31, 1996, the business must also show that the prior examination included consideration of whether the individual involved (or any individual holding a position substantially similar to the position held by the individual involved) should be treated as an employee of the taxpayer.

---

### EXAMPLE 5

U corporation's federal income tax return for 1989 was examined in 1991 and the status of two workers who were paid by the corporation as independent contractors was not questioned. U corporation's 1992 federal income tax return was examined in 1994 and the status of 45 workers holding positions substantially similar to the positions held by the two workers treated as independent contractors in the 1989 return was questioned. The failure to raise the issue in the 1991 examination of the 1989 return has created a prior audit safe haven for the U corporation. U corporation can continue to treat the 45 workers as independent contractors as well as any others who perform substantially similar services provided the other requirements of section 530 are met.

---

**REASONABLE BASIS TEST - PRIOR AUDIT**

**EXAMPLE 6**

<b>U CORPORATION</b>			
1991		1992	
Jan	Oct	Jan	Aug.
9012	8912	9112	9012
F941	F1120	F941	F1120
filed	examined	filed	examined

U corporation's federal income tax return for 1989 was examined in October 1991 and the status of two workers who were paid by the corporation as independent contractors was not questioned. In August 1992, the status of U corporation's workers as independent contractors was challenged for 1990. U corporation cannot rely on the prior audit because the audit took place **after** the year currently being examined.

**Available for officers**

A corporation that has failed to treat officers as employees may rely on a prior audit which included the issue of the corporation's treatment of officers as other than employees.

## REASONABLE BASIS TEST - JUDICIAL PRECEDENT

---

### Judicial precedent

Another safe haven provided by section 530 is judicial precedent. To obtain relief under this section, the business must demonstrate reasonable reliance on a judicial precedent, a published ruling, technical advice relating to that business, or a letter ruling to that business.

---

### Reasonable reliance -- judicial precedent

The business must make a prima facie case showing that it reasonably relied upon a **particular** judicial precedent or published ruling.

Because the business must show reasonable reliance, the facts in the case relied upon must be similar to the business's situation. The facts need not be identical and the precedent relied upon need not deal with exactly the same industry as the business's. In addition, the judicial precedent or published ruling relied upon must have been in existence at the time the business began treating workers as independent contractors.

As long as these requirements are met, one case is sufficient to establish a precedent that creates a safe haven. This is true even if case law can be found to support either side of the independent contractor/employee issue.

---

### Qualifying TAMS and PLRs

A technical advice memorandum (TAM) or a private letter ruling (PLR) addressing the employer-employee relationship can be used by the business to which it was issued for purposes of the judicial precedent safe haven. If a private letter ruling is issued to a member of a group of related corporations, the business may rely upon the ruling only if it is specifically addressed to that business entity. Note that every corporation included in a related group is considered a separate business entity.

A private letter ruling issued to a business may not be relied upon by its successor. However if there has merely been a change in form, the business may have some "other reasonable basis" on which it could rely. Even a private letter ruling or determination letter issued to the business itself cannot be relied upon if the facts were materially misstated or omitted. Further, if there has been a substantial change in the facts since the ruling or determination was obtained, the precedent does not apply.

---

## REASONABLE BASIS TEST - JUDICIAL PRECEDENT

---

**Non-qualifying precedents**

Section 530 gives businesses relief from federal employment tax obligations. Only federal court decisions and revenue rulings interpreting the IRC are relevant. Businesses are not entitled to the judicial precedent safe haven based upon a state court decision.

The term "published rulings" refers to revenue rulings which are intended for general use by all businesses. Neither rulings by state administrative agencies, including agencies which regulate employment, nor rulings from federal agencies other than the IRS can be used to support a judicial precedent safe haven.

Under some circumstances, however, state court decisions and state and federal agency rulings may be the basis for findings that the business reasonably relied on some other reasonable basis.

---

## REASONABLE BASIS TEST - INDUSTRY PRACTICE

---

**Industry practice** The safe haven most commonly argued, and the one which causes the most controversy between businesses and the Government, is industry practice. Section 530 states that the business can claim reasonable basis if it can show **reasonable reliance** on a long-standing recognized practice of a significant segment of the industry in which the business is engaged. It makes sense to begin by defining "industry" since this establishes the group of businesses to be analyzed.

---

**Industry defined** The classic case on the definition of industry is *General Investment Corp. v. United States, supra*. In this case, the Court held that for purposes of the industry practice safe haven, the business's industry consisted of small mining businesses located in the business's county, rather than all mining businesses throughout the country.

---

**Geographic area** An industry generally consists of businesses located in the same geographic or metropolitan area which compete for the same customers. For example, the landscaping industry will generally consist of businesses within a single metropolitan area. However, if the area includes only one or a few businesses in the same industry, the geographic area may be extended to include contiguous areas in which there are other businesses competing for the same customers. If businesses compete in regional or national markets, the geographic area may include the competitors in that region or throughout the United States. For example, the commercial film production industry competes in a national market.

---



## REASONABLE BASIS TEST - INDUSTRY PRACTICE

---

**Long-standing** Whether a practice is long-standing depends on facts and circumstances. However, as confirmed by section 530(c)(2)(C), a practice that has existed for 10 years or more should always be treated as long-standing. The business may use the industry practice safe haven even if it began to provide a product or service after 1978. Similarly, a taxpayer may use the industry practice safe haven even if the industry came into existence after 1978. The legislative history clarifies that the 10 year rule is a safe haven. However, a shorter period may be long-standing, depending on the facts and circumstances.

Of course, the business could not have relied on industry practice unless the industry practice was to treat workers as independent contractors prior to the time the business joined the industry. Moreover, if the industry's practice changed by the time the business joined the industry, the business cannot rely on the former practice. Exploring when industry practice began may be necessary in order to determine whether the practice was long-standing.

---

### EXAMPLE 7

Business A, the first business in the industry, began to sell its product in 1989, treating all of its salespeople as independent contractors. Business B, the second business to enter the industry, started its operations in 1991. Business B copies Business A's treatment of its workers as independent contractors. Business B cannot obtain section 530 relief, because two years of industry practice do not constitute a long-standing recognized practice. However, if Business A had been treating workers as independent contractors for a ten-year period before Business B began its operations and its independent contractor treatment, the industry practice created by Business A is long-standing for purposes of determining whether Business B is entitled to section 530 relief.

---

## REASONABLE BASIS TEST - INDUSTRY PRACTICE

---

**Significant  
segment**

How prevalent must the practice be to constitute a significant segment and/or recognized practice? Until the Small Business Job Protection Act amended section 530, neither the statute nor the legislative history provided any additional guidance on the appropriate standard for "significant." The determination was made on the basis of facts and circumstances, and it was an issue that often presented difficult analytical issues.

Prior to the Small Business Job Protection Act, courts had indicated that the term "significant segment" did not necessarily require that the practice be followed by a majority of the industry. *See, In re: Joey L. Bentley*, 94-1 USTC par. 50,140 (Bankr. E.D. Tenn. 1994) *aff'd* 94-2 USTC par 50,560 (The court rejected a majority standard as contradicting the plain language of the statute).

Section 530 (e)(2)(B) provides that 25 percent of the taxpayer's industry (determined without taking the taxpayer into account) is deemed to constitute a significant segment of the industry. The legislative history notes that a lower percentage may be a significant segment, depending on the facts and circumstances.

---

## REASONABLE BASIS TEST - INDUSTRY PRACTICE

---

**Reasonable showing**

Section 530(e)(2)(B) requires a "reasonable showing" of industry practice by the taxpayer. Although this language is not explained in the legislative history, it would appear to conform to the burden of proof change discussed above.

---

**Establishing industry practice**

Independent contractor treatment often flows from the business's general knowledge of competition in the industry or from communications with competitors or business advisers knowledgeable about the industry. Seldom will the business have performed a formal survey of industry practice at the time treatment of workers as independent contractors began. The fact that a formal survey was not conducted when independent contractor treatment began is relevant to, but is not conclusive of, whether the business relied on industry practice.

Do not automatically reject as irrelevant or immaterial a survey performed at or near the time of the audit. Such a survey can be relevant in establishing a business's prima facie case. The fact that a current survey confirms long-standing industry practice can buttress other evidence that the business relied on industry practice during the relevant period. Discuss with the business, before it begins any survey, the desired sample size, method of selecting the sample, and questions to be asked. The survey should be verifiable or, if anonymity for the businesses contacted is sought, should be conducted by an independent third party.

If the business presents material concerning industry practice that you consider inadequate, do not simply reject that material. Instead, you will need to develop evidence showing why the business's demonstration of industry practice is incorrect or insufficient.

---

## REASONABLE BASIS TEST - INDUSTRY PRACTICE

---

### Reasonable reliance

In addition to showing the industry practice at the time it began treating workers as independent contractors, the business must show that its reliance on the industry practice was reasonable.

Reasonable reliance contains two concepts that are simple to state but are harder to apply -- reasonableness and reliance. The first question to ask is whether the business claiming the industry practice safe haven actually relied on industry practice.

---

### Reliance

At a minimum, reliance requires knowledge. If you don't know something you cannot possibly rely on it.

A claim of reliance on industry practice necessarily requires that the business knew of the industry practice at the time when independent contractor treatment began. Thus, the date on which the business's independent contractor treatment began must be determined. The long-standing industry practice must have existed **at that time** in order to be relied upon.

Some evidence of the year of the business's treatment of workers is found by the business's first filing of Forms 1099 for those workers. Evidence of when an industry practice began and of the business's knowledge of that practice is harder to locate and substantiate.

---

## REASONABLE BASIS TEST - INDUSTRY PRACTICE

---

### **Establishing reliance**

Whether the business relied on industry practice can be established by several types of evidence. Examine business records, such as corporate minutes or unanimous consents in lieu of directors' meetings, to determine whether any written record exists that shows the reason for treatment of workers as independent contractors. Interview the workers themselves to determine what reasons were given to them by the business when establishing their status as independent contractors.

---

### **Interviews for reliance**

Interviewing key workers in the business is also important. In some cases, the business may disclose, or other objective evidence may show, that some reason other than industry practice drove its decision to treat its workers as independent contractors. *See*, for example, Rev. Rul. 82-116, 1982-1 C.B. 152, in which the business treated workers as independent contractors because as illegal aliens they failed to obtain social security numbers, not because there was a bona fide dispute about their status as employees. When an industry practice began is not material in this case, because it is clear that an industry practice was not relied upon as the basis for treating the workers as independent contractors.

---

### **Establishing that reliance was reasonable**

The reliance required to satisfy the industry practice safe haven must be reasonable. Defining "reasonable" is a difficult task, but you might ask yourself: Would a reasonably prudent business under similar circumstances have relied upon such evidence of industry practice to treat workers as independent contractors? The extent of the business's knowledge of industry practice, whether obtained through personal experience, a survey, or through an advisor is relevant in this regard. The reasonableness or unreasonableness of the reliance may turn on the source of the information from which the business derived knowledge of the industry practice.

The business's mistaken, but good faith belief concerning industry practice does not qualify it for relief under this safe haven. However, you should be aware that in light of *Diaz v. United States*, 90-1 USTC par. 50,209, a business's good faith misperception of the status of the workers may constitute reasonable cause for waiver of penalties associated with employment tax deficiencies.

---

## OTHER REASONABLE BASIS

---

**Other reasonable basis** A business that fails to meet any of these three safe havens may still be entitled to relief if it can demonstrate that it relied on some other reasonable basis for not treating a worker as an employee. The legislative history indicates that "reasonable basis" should be construed liberally in favor of the taxpayer. H.R. Rep. No. 1748.

Remember, the burden of proof does not shift to the IRS here. However, if the business presents an argument that you consider inadequate, you will still need to develop evidence showing why the business's demonstration of other reasonable basis is incorrect or insufficient.

---

**Advice of accountant or attorney**

Reliance on the advice of an attorney or accountant may constitute a reasonable basis. The court cases tend to require the business to present (1) evidence of the educational and experiential qualifications of the attorney or accountant, and (2) evidence that the attorney or accountant issued the advice after reviewing relevant facts furnished by the business. *See, In re McAtee*, 90-1 USTC par. 50,242 (N.D. Iowa 1990) *vacating In re McAtee*, 89-2 USTC par. 9,625 (Bankr. N.D. Iowa 1989); *Overeen*, 91-2 USTC par. 50,459 (W.D. Okla. 1991); and *Smokey Mountain Secrets, Inc. v. United States*, 76 AFTR 2d par. 95-5509 (1995).

The business need not independently investigate the credentials of the attorney or accountant to determine whether such advisor has any specialized experience in the employment tax area. However, the business should establish at a minimum, that it reasonably believed the attorney or accountant to be familiar with business tax issues and that the advice was based on sufficient relevant facts furnished by the business to the adviser. If other evidence shows that the adviser clearly was not qualified, the mere holding of a law or accounting license would not make the business's reliance on the advice reasonable. For example, reliance on the advice of a patent attorney would not be reasonable nor would reliance on the advice of a professional who does not explore the relevant facts.

Of course, advice could not have been relied upon unless it had been furnished when treatment of workers as independent contractors began. *See, In re Compass Marine Corporation*, 146 B.R. 138 (Bankr. E.D. Pa 1992) (advice issued three years after the treatment does not support the treatment).

---

## OTHER REASONABLE BASIS

---

### State and non-tax federal law and determinations

Prior state administrative action (*e.g.*, workers' compensation decisions) and other federal determinations (*e.g.*, determinations under the Federal Labor Standards Act (Wage and Hour Division)) may or may not constitute a reasonable basis. This will depend on whether they use the same common law rules that apply for federal employment tax purposes. If the state or federal agency uses the same common law standard and interprets it similarly, however its determination should constitute a reasonable basis. If the state or federal agency uses a different statutory standard or interprets the common law standard differently, its determinations should not constitute a reasonable basis.

- *Queensgate Dental Family Practice, Inc., v. United States*, 91-2 USTC No. 50,536 (M.D. Pa. 1991) -- The business treated licensed dentists as independent contractors based on the conclusion by the State Dental Board that state law prohibited a licensed dentist from being an employee of an unlicensed business corporation. The court found this to be "reasonable basis" for section 530 relief.
- *But see, Spicer Accounting, Inc. v. United States*, 918 F. 2d 90 (9th Cir. 1990) -- A state's determination that a worker was an independent contractor for state employment tax purposes does not preclude the federal government from challenging the worker's status for federal employment tax purposes if the federal government was not a party, not in privity with the state.

---

### Common law rules

A business that makes a reasonable effort to establish independent contractor treatment for its workers under the common law but falls just short of satisfying the common law standard, may present a valid section 530 safe haven under "other reasonable basis." A reasonable, albeit erroneous, interpretation of the common law rules was found to be sufficient for section 530 relief in *Critical Care Registered Nursing, Inc., supra*, and in *American Institute of Family Relations v. United States*, 79-1 USTC par. 9,364 (C.D. Cal. 1979). A nonacquiescence issued in *Critical Care Registered Nursing, Inc., supra*, (Action on Decision, CC-1194-05, August 8, 1994) does not address this issue.

---

## OTHER REASONABLE BASIS

---

**Prior audit of predecessor**

Although a prior audit of the business's predecessor does not satisfy the requirements of the prior audit safe haven, the business may qualify for relief if there has merely been a change in the form of the business. In addition, the successor must be in the same line of business.

---

**PLR/TAM to predecessor**

Although a private letter ruling or technical advice memorandum issued to the business's predecessor does not satisfy the requirements of the judicial precedent safe haven, the business may qualify for relief if there has merely been a change in the form of the business. In addition, the successor must be in the same line of business.

---

**Good faith**

While a number of types of evidence may support a showing of other reasonable basis, more than a mere good faith belief is required. *See, In re McAtee, supra.*

In *In re Compass Marine, supra*, the court cited Senate Report No. 1263, 95th Cong. 2d Sess., at 210 (1978), in dicta, as support for the concept that the business has a "reasonable basis" for section 530 relief if it acted in "good faith." However, the Senate report described actions by a business (such as negligence, intentional disregard of rules and regulations, or fraud) that would **not** be considered good faith treatment for section 530 relief. It did not cite "good faith" as an affirmative standard sufficient, by itself, to provide section 530 relief. Thus, although the actions described in the Senate report are sufficient to prevent section 530 relief, their absence is not enough to establish section 530 relief.

---

**Penalties**

Good faith, although not a sufficient basis for section 530 relief, may be a basis for not asserting penalties. *See, Diaz v. United States, supra.*

---



## OTHER REASONABLE BASIS

---

**Other situations** Lack of worker social security numbers is not a reasonable basis for not treating workers as employees. *See*, Rev. Rul. 82-116 -- Section 530 relief unavailable to employer who failed to treat illegal aliens as employees because they had no social security numbers.

Relief is not available solely because the business treats the workers as independent contractors for competitive cost reasons.

Demand by a worker not to have amounts withheld from wages does not constitute some other reasonable basis that entitles the business to relief. *See, Audie D. Moore, Individually and d/b/a A. Moore Distributing v. United States*, 92-2 USTC par. 50,401 (W.D. Mich. 1992) -- Workers' agreement to treatment as independent contractors does not constitute a reasonable basis.

---

## WORKERS COVERED BY SECTION 530

---

**Who is covered** If a business meets the requirements of section 530 with respect to a group of workers, it is generally not necessary to determine whether the workers are independent contractors or employees. However, it is important to understand the categories of workers to which section 530 can apply, and the category to which it does not apply.

The legislative history indicates that section 530 only applies to common law employees. H.R. Rep. No. 95-1748, 95th Cong., 2nd Sess. 4 (1978), 1978-3 C.B. (Vol 1) 629,632.

However, section 3.09 of Rev. Proc. 85-18 provides that section 530 applies to ALL employees under section IRC 3121(d).

---

**Officers: IRC section 3121(d)(1)**

Officers are generally employees under the IRC. However, as explained in Lesson 3, an officer of a corporation who does not perform any services or performs only minor services and who neither receives nor is entitled to receive directly or indirectly any remuneration is considered not to be an employee. A director, as such, is not an employee. In these two circumstances, the individuals are independent contractors, and section 530 relief would be not applicable. Treas. Reg. section 31.3121(d)-1(b) (FICA); Treas. Reg. section 31.3306(i)-1(e) (FUTA); Treas. Reg. section 31.3401(c)-1(f) (federal income tax withholding).

Rev. Rul. 82-83, 1982-1 C.B. 151 considered whether a corporation could claim section 530 relief with respect to officers' salaries that had been characterized as "draws." The ruling concluded that because there was no reasonable basis for not treating the officers as employees, relief was not available.

---

**Common-law employees: IRC section 3121(d)(2)**

Any worker who is an employee under the common law standard (described in detail in Lesson 2) would be an employee for purposes of section 530.

---

## WORKERS COVERED BY SECTION 530

---

**Statutory employees: IRC section 3121(d)(3)**

IRC section 3121(D)(3) identifies four categories of statutory employees. They are discussed in detail in Lesson 3. Statutory employees include:

- agent-drivers or commission drivers
- full-time life insurance salespersons
- home workers
- traveling or city salespersons.

Statutory employees are employees for purposes of section 530.

---

**Limited applicability to state and local workers covered under 218 Agreement: IRC section 3121(d)(4)**

Workers covered under a Section 218 Agreement are employees for purposes of FICA without application of the common law rules (IRC section 3121(d)(4)). This classification is not made under rules found in the IRC or the regulations thereunder. The classification is made by the Social Security Act. *See* Lesson 3. For these workers, section 530 relief for FICA taxes is inappropriate, and, therefore, unavailable, because coverage under the Section 218 Agreement is dispositive of the worker's FICA tax status.

For federal income tax withholding purposes, the status of workers covered under a Section 218 Agreement is not, however, determined by the Section 218 Agreement but under the common law standard. Section 530 relief is available, retroactively, for federal income tax liability, if the requirements of section 530 are met. The state or local government would be required to withhold federal income tax prospectively. This is because the substantive consistency requirement will fail to be met once the government begins using Form W-2 to report FICA taxes.

---

**Applies to state and local employees not covered under 218 agreement**

The common law rules are used to determine the status of a state or local government worker who is not covered under a Section 218 agreement. Relief under section 530 is available for these workers, **if** the requirements for section 530 relief are satisfied.

---

## WORKERS NOT COVERED BY SECTION 530

---

**Section 530(d)** Section 1706 of the Tax Reform Act of 1986 (1986-3, Vol. 1, C.B. 698) (TRA '86), amended section 530 of the Revenue Act of 1978 by adding subsection (d) to that section. Section 530(d) provides that relief under section 530(a) is not available in the case of a worker who, pursuant to an arrangement between the business and a client, provides services for that client as any of the following:

- engineer
- designer
- drafter
- computer programmer
- systems analyst
- other similarly skilled worker engaged in a similar line of work

---

**Applies to three-party situations**

Note that section 1706 of TRA '86 applies only to the business in a three-party situation, namely, the business providing workers to a client. Furthermore, the fact that the worker is incorporated is immaterial. The intent of Congress was to classify, under the common law rules, workers retained by businesses to provide technical services, without regard to section 530 of the Revenue Act of 1978. Section 1706 does not change anyone from independent contractor to employee. The examiner must still look at the common law rules.

Section 1706 applies to remuneration paid and services rendered after December 31, 1986.

---

## SECTION 530(d)

---

### EXAMPLE 8

You have examined the employment tax returns of Y corporation for 1992. You have determined that Y corporation provides engineers for its clients. Y corporation has taken the position that the engineers are independent contractors. Accordingly, Y corporation has not withheld income and employment taxes from their earnings. The controller of Y corporation tells you that it is a common practice in the industry to treat these workers as independent contractors. You agree that the treatment has been consistent and is a long-standing industry practice.

You should inform the controller that relief under section 530 is not available for payments received and services rendered after December 31, 1986. Section 530 of the Revenue Act of 1978 cannot be applied because the relationship between Y corporation and the engineers is of the type addressed in section 530(d).

---

**Prohibition  
against  
regulations and  
rulings lifted**

Section 1706 of TRA '86 also lifted the prohibition included in section 530 against the issuance of regulations or rulings concerning employment tax status with respect to workers to whom the amendment applies. (See Exhibit 3-1 for more information.) In response, the IRS issued Rev. Rul. 87-41, 1987-1 C.B. 296.

---

## EFFECT OF SECTION 530 RELIEF ON EMPLOYEE

---

**Status of  
employee not  
changed by  
section 530**

As noted previously, section 530 relief does not convert a worker from the status of employee to the status of independent contractor. If it has been determined that worker is an employee, the worker remains an employee for income tax purposes, such as deductions for business expenses and participation in retirement plans.

---

**Liable for  
employee share  
of FICA**

As previously stated, if the business's liability is terminated by section 530(a)(1), the worker remains liable for employee FICA tax with respect to all wages received. Rev. Proc. 85-18, section 3.08; Treas. Reg. section 31.3102(c). *See also*, Rev. Rul. 86-111, 1986-2 C.B. 176 -- The worker remains fully liable for the unwithheld employee FICA tax after the business's liability has been determined under IRC section 3509. The employee's share of FICA tax is reported on Form 4137 by substituting the word "wages" for the word "tips."

---

## SUMMARY

---

**Review of lesson** The following summarizes what we have covered in this lesson:

1. Section 530 must be considered as the first step in any worker classification case.
2. Section 530 is a relief provision that has significant impact on the administration of the employment tax laws.
3. Section 530 has been modified, amplified, and defined since 1978 through legislation, IRS revenue rulings, revenue procedures, and court cases. The basic provisions are intact but many interpretation issues remain unresolved.
4. Section 530 provides businesses with relief from federal employment tax obligations if certain requirements are met.
5. The business must meet two consistency requirements before the relief provisions of section 530 apply. For any period after December 31, 1978, the relief applies only if: <ul style="list-style-type: none"> <li>• All Forms 1099 required to be filed by the business with respect to the worker(s), for the period, are timely filed and are filed on a basis consistent with the business's treatment of the worker as an independent contractor; and</li> <li>• The treatment of the worker as an independent contractor is consistent with the treatment by the business (predecessor) of all workers holding substantially similar positions for any period beginning after December 31, 1977.</li> </ul>
6. In addition to the consistency requirements, the business must have relied on some reasonable basis, including the safe havens of a prior audit, a judicial precedent, or an industry practice.

---

## SUMMARY

---

Review of lesson,  
cont'd

7. The reasonable basis requirement, including the three safe havens, are to be liberally construed.

8. For examinations beginning before January 1, 1997, a prior audit will provide a safe haven if it is an examination of books and records by the IRS of the same entity, which is still in the same line of business and whose workers are performing substantially the same work. Examinations beginning after December 31, 1996, must have addressed the issue of the status of the class of workers at issue or of a substantially similar class of workers for employment tax purposes.

9. A judicial precedent will provide a safe haven only if the business's case is similar to the precedent. Federal employment tax cases and published rulings qualify. Technical advice memoranda or private letter rulings qualify for the business which requested them. State court decisions and rulings of agencies other than IRS do not qualify.

10. To claim a safe haven under industry practice, the business must show that it is following a long-standing recognized practice of a significant segment of its industry. Industry is the group of businesses that provide the same product or service and compete for the same customers.

11. A business that fails to meet any of the safe havens may be entitled to relief if it can be demonstrated that it relied on some other reasonable basis for not treating the worker as an employee.

---



## EXERCISES

---

**Instructions** Complete the following exercises. Be sure to explain your answers.

---

**Exercise 1** If a business is not required to file an information return because the income paid to a worker is less than \$600, could section 530 relief be available?

---

**Exercise 2** When the business has more than one class of worker involved in the independent contractor issue, and there is inconsistent treatment with respect to one of the classes of workers, would section 530 relief be denied to all classes of workers?

---

**Exercise 3** If the business filed information returns for only a portion of the workers involved in the independent contractor issue, could section 530 relief be available?

---

## EXERCISES

---

**Exercise 4** From 1980 to 1994, R, Inc. provided consultants to utility companies as independent contractors. In 1995, by agreement with one utility, R, Inc. treated its consultants as employees. It continued to treat all other similarly situated consultants as independent contractors. To which workers could section 530 relief apply?

---

**Exercise 5** A construction company that had treated its workers as employees from 1970 to 1978 began treating its workers as independent contractors in 1979. In your audit of the 1995 tax year, could section 530 treatment be awarded to the construction company?

---

**Exercise 6** If a business failed to file information returns for one year but did file the returns for the prior and subsequent years, could section 530 relief be allowed?

---

## EXERCISES

---

**Exercise 7** Does an IRS contact by correspondence constitute a past examination?

---

**Exercise 8** Q corporation has 30 workers that it treats as independent contractors. However, in a prior audit of Q corporation, the examiner did not raise the issue. The examiner requested Forms 1099 of Q corporation and found that Forms 1099 had not been filed for any of the 30 workers. The corporate officer stated that Q corporation forgot to file Forms 1099, but they were prepared and filed during the examination. Is Q corporation entitled to relief under section 530? Explain your answer.

---

## EXERCISES

---

**Exercise 9**      A, a sole proprietor, treated a number of workers as independent contractors. The IRS audited A in 1990 and raised no employment tax issues. In 1991, the proprietorship assets were transferred to A's newly organized controlled corporation, W, in a tax free transfer of assets under IRC section 351. The nature of the business remained unchanged after the incorporation, and W continued to treat the workers as independent contractors. In 1995, the IRS initiated an audit of W. Does W have a safe haven under section 530?

---

**Exercise 10**      Can a member of a related group rely on a private letter ruling or a determination letter, issued to one of the other members within the group?

---

**Exercise 11**      During the examination, you find that the business misstated the facts in the private letter ruling that it requested. Can the business have section 530 relief based on the ruling?

---

## EXERCISES

---

**Exercise 12** YZ, Inc. operates facilities where dentists conduct their practices. In 1995, you audit YZ, Inc. and question whether the dentists were properly treated as independent contractors. YZ, Inc. has requested relief under section 530 because of reasonable basis. YZ, Inc. had contacted the State Dental Board and been advised that it would be illegal under state law for it to enter into an employer-employee relationship with a dentist. Is YZ, Inc. allowed section 530 relief?

---

**Exercise 13** The N corporation is owned and operated by its two officers. The officers perform substantial services for the N corporation, and they direct and control all of the corporate operations. N corporation treats the officers as independent contractors rather than employees and pays them compensation characterized as "draws" rather than "salaries." During an examination, you question whether N should have treated these amounts as wages. N corporation has requested relief under section 530. They believe that it was reasonable for them not to pay employment taxes because the compensation was classified as "draws" and not "salaries." Would you apply section 530?

---

## CASE STUDIES

---

**Instructions**

Use the following instructions for all cases studies in this lesson:

- |   |
|---|
| 1. Read the following facts   |
| 2. List all the facts important in developing your case.  |
| 3. Pool your ideas and make a group determination whether the taxpayer is entitled to relief under section 530. |
| 4. Select a member of your group to orally present the group solution to the class.                             |
-

## CASE STUDY 1-1

---

**Facts**

P is a sole proprietor of a machine shop. P engaged eight machinists and one general custodian to work in the shop.

In 1997, you examine P's 1995 returns. For the year under examination, P's filing of Forms 941 was sporadic and inconsistent. P did not file any Forms 941 with respect to any of the workers for the first two quarters of 1995. However, for the third and fourth quarters P filed Forms 941 listing some of the workers but neglecting to list others. The working arrangement during the quarters in which Forms 941 were filed remained unchanged from the quarters in which they were not filed. P explained this inconsistency by stating that the workers were initially hired on a part-time basis as casual laborers, and that it could not afford to pay the employment taxes.

---

## CASE STUDY 1-2

---

**Facts**

You have the business's 1991 and 1992 tax years before you. The business owns and operates a trucking business that hauls bulk cement products, livestock, grains, and machinery. The business engaged several workers to drive trucks. The workers are paid a 25 percent commission on each load, and they are responsible for paying any assistants they hire to help drive or load and unload the trucks. The workers are not given any training, but they are required to have chauffeurs' licenses. The customers set the time at which the loads are to be picked up, and the business simply relay this information to the workers. The workers are not required to accept any hauling job. Log books are required if the trip is beyond 100 miles. The business provides the workers with trucks and pays all other operating expenses.

The business did not file Forms 1099 for the years 1991 and 1992. The business's 1989 tax return was examined and resulted in no employment tax liability with respect to the drivers for 1989. There were no Forms 1099 filed for the 1989 return. The business states that during the examination of the 1989 return, it was not advised of the filing requirements for Form 1099.

---



**Text of Section 530, Including Amendments**

**I. SECTION 530. CONTROVERSIES INVOLVING WHETHER INDIVIDUALS ARE EMPLOYEES FOR PURPOSES OF THE EMPLOYMENT TAXES.**

(a) **TERMINATION OF CERTAIN EMPLOYMENT TAX LIABILITY. --**

(1) **In General. -- If --**

- (A) for purposes of employment taxes, the taxpayer did not treat an individual as an employee for any period, and
- (B) in the case of periods after December 31, 1978, all Federal tax returns (including information returns) required to be filed by the taxpayer with respect to such individual for such period are filed on a basis consistent with the taxpayer's treatment of such individual as not being an employee,

then, for purposes of applying such taxes for such period with respect to the taxpayer, the individual shall be deemed not to be an employee unless the taxpayer had no reasonable basis for not treating such individual as an employee.

(2) **STATUTORY STANDARDS PROVIDING ONE METHOD OF SATISFYING THE REQUIREMENTS OF PARAGRAPH (1). --** For purposes of paragraph (1), a taxpayer shall in any case be treated as having a reasonable basis for not treating an individual as an employee for a period if the taxpayer's treatment of such individual for such period was in reasonable reliance on any of the following:

- (A) judicial precedent, published rulings, technical advice with respect to the taxpayer, or a letter ruling to the taxpayer;
- (B) a past IRS audit of the taxpayer in which there was no assessment attributable to the treatment (for employment tax purposes) of the individuals holding positions substantially similar to the position held by this individual; or
- (C) long-standing recognized practice of a significant segment of the industry in which such individual was engaged.

- (3) **CONSISTENCY REQUIRED IN THE CASE OF PRIOR TAX TREATMENT.** -- Paragraph (1) shall not apply with respect to the treatment of any individual for employment tax purposes for any period ending after December 31, 1978, if the taxpayer (or a predecessor) has treated any individual holding a substantially similar position as an employee for purposes of the employment taxes for any period beginning after December 31, 1977.
- (4) **REFUND OR CREDIT OF OVERPAYMENT.** -- If refund or credit of any overpayment of an employment tax resulting from the application of paragraph (1) is not barred on the date of the enactment of the Act by any law or rule of law, the period for filing a claim for refund or credit of such overpayment (to the extent attributable to the application of paragraph (1)) shall not expire before the date 1 year after the date of the enactment of this Act.
- (b) **PROHIBITION AGAINST REGULATIONS AND RULINGS ON EMPLOYMENT STATUS.** -- No regulation or Revenue Ruling shall be published on or after the date of the enactment of this Act and before the effective date of any law hereafter enacted clarifying the employment status of individuals for purposes of the employment tax by the Department of the Treasury (including the IRS) with respect to the employment status of any individual for purposes of the employment taxes.
- (c) **DEFINITIONS.** -- For purposes of this section --
- (1) **EMPLOYMENT TAX.** -- the term "employment tax" means any tax imposed by subtitle C of the IRC of 1954.
- (2) **EMPLOYMENT STATUS.** -- The term "employment status" means the status of an individual, under the usual common law rules applicable in determining the employer-employee relationship, as an employee or as an independent contractor (or other individual who is not an employee).
- (d) **EXCEPTION.** -- This section shall not apply in the case of an individual who, pursuant to an arrangement between the taxpayer and another person, provides services for such other person as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker engaged in a similar line of work.

Small Business Job Protection Act

SEC. 1122. SPECIAL RULES RELATING TO DETERMINATION WHETHER INDIVIDUALS ARE EMPLOYEES FOR PURPOSES OF EMPLOYMENT TAXES.

(a) In General.--section 530 of the Revenue Act of 1978 is amended by adding at the end the following new subsection:

"(e) Special Rules for Application of section.--

"(1) Notice of availability of section.--An officer or employee of the Internal Revenue Service shall, before or at the commencement of any audit inquiry relating to the employment status of one or more individuals who perform services for the taxpayer, provide the taxpayer with a written notice of the provisions of this section.

"(2) Rules relating to statutory standards.--For purposes of subsection (a)(2)--

"(A) a taxpayer may not rely on an audit commenced after December 31, 1996, for purposes of subparagraph (B) thereof unless such audit included an examination for employment tax purposes of whether the individual involved (or any individual holding a position substantially similar to the position held by the individual involved) should be treated as an employee of the taxpayer,

"(B) in no event shall the significant segment requirement of subparagraph (C) thereof be construed to require a reasonable showing of the practice of more than 25 percent of the industry (determined by not taking into account the taxpayer), and

"(C) in applying the long-standing recognized practice requirement of subparagraph (C) thereof--

"(i) such requirement shall not be construed as requiring the practice to have continued for more than 10 years, and

"(ii) a practice shall not fail to be treated as long-standing merely because such practice began after 1978.

"(3) Availability of safe harbors.--Nothing in this section shall be construed to provide that subsection (a) only applies where the individual involved is otherwise an employee of the taxpayer.

"(4) Burden of proof.--

"(A) In general.--If--

"(i) a taxpayer establishes a prima facie case that it was reasonable not to treat an individual as an employee for purposes of this section, and

"(ii) the taxpayer has fully cooperated with reasonable requests from the Secretary of the Treasury or his delegate,

then the burden of proof with respect to such treatment shall be on the Secretary.

"(B) Exception for other reasonable basis.--In the case of any issue involving whether the taxpayer had a reasonable basis not to treat an individual as an employee for purposes of this section, subparagraph (A) shall only apply for purposes of determining whether the taxpayer meets the requirements of subparagraph (A), (B), or (C) of subsection (a)(2).

"(5) Preservation of prior period safe harbor.--If--

"(A) an individual would (but for the treatment referred to in subparagraph (B)) be deemed not to be an employee of the taxpayer under subsection (a) for any prior period, and

"(B) such individual is treated by the taxpayer as an employee for employment tax purposes for any subsequent period,

then, for purposes of applying such taxes for such prior period with respect to the taxpayer, the individual shall be deemed not to be an employee.

"(6) Substantially similar position.--For purposes of this section, the determination as to whether an individual holds a position substantially similar to a position held by another individual shall include consideration of the relationship between the taxpayer and such individuals."

October 30, 1996

**Exhibit 1-2**  
**Page 3 of 3**

(b) Effective Dates.--

(1) In general.--The amendment made by this section shall apply to periods after December 31, 1996.

(2) Notice by Internal Revenue Service.--section 530(e)(1) of the Revenue Act of 1978 (as added by subsection (a)) shall apply to audits which commence after December 31, 1996.

(3) Burden of proof.--

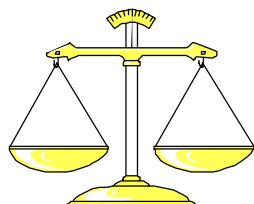
(A) In general.--section 530(e)(4) of the Revenue Act of 1978 (as added by subsection (a)) shall apply to disputes involving periods after December 31, 1996.

(B) No inference.--Nothing in the amendments made by this section shall be construed to infer the proper treatment of the burden of proof with respect to disputes involving periods before January 1, 1997.

October 30, 1996

this page left intentionally blank

# INDEPENDENT CONTRACTOR OR EMPLOYEE?



SECTION 530 PROVIDES  
BUSINESSES WITH RELIEF  
FROM FEDERAL  
EMPLOYMENT TAX  
OBLIGATIONS IF CERTAIN  
REQUIREMENTS ARE MET.

## SECTION 530 RELIEF REQUIREMENTS

**Y**our business has been selected for an employment tax examination to determine whether you correctly treated certain workers as independent contractors. However, you will not owe employment taxes for these workers, if you meet the **relief requirements** described below. If you do not meet these **relief requirements**, the IRS will need to determine whether the workers are independent contractors or employees and whether you owe employment taxes for those workers.

### Section 530 Relief Requirements:

To receive relief, you must meet all three of the following requirements:

#### I. Reasonable Basis

First, you had a reasonable basis for not treating the workers as employees. To establish that you had a reasonable basis for not treating the workers as employees, you can show that:

You reasonably relied on a court case about Federal taxes or a ruling issued to you by the IRS; or

Your business was audited by the IRS at a time when you treated similar workers as independent contractors and the IRS did not reclassify those workers as employees; or

You treated the workers as independent contractors because you knew that was how a significant segment of your industry treated similar workers; or

You relied on some other reasonable basis. For example, you relied on the advice of a business lawyer or accountant who knew the facts about your business.

If you did not have reasonable basis for treating the workers as independent contractors, you do not meet the **relief requirements**.

#### II. Substantive Consistency

In addition, you (and any predecessor business) must have treated the workers, and any similar workers, as independent contractors. If you treated similar workers as employees, this relief provision is not available.

#### III. Reporting Consistency

Finally, you must have filed Form 1099-MISC for each worker, unless the worker earned less than \$600. Relief is not available for any year you did not file the required Forms 1099-MISC. If you filed the required Forms 1099-MISC for some workers, but not for others, relief is not available for the workers for whom you did not file Forms 1099-MISC.

*The IRS examiner will answer any questions you may have about your eligibility for this relief.*

## Lesson 2

# INDEPENDENT CONTRACTOR OR EMPLOYEE: THE COMMON LAW STANDARD

## INTRODUCTION

---

**A worker is an employee if...**

IRC section 3121(d) contains four categories of employee for purposes of the FICA. A worker is an employee if he or she is one of the following:

- a common law employee
- a corporate officer
- an employee as defined by statute, commonly referred to as a "statutory employee"
- an employee covered by an agreement under Section 218 of the Social Security Act

The common law test applies also for purposes of the FUTA, federal income tax withholding, and the Railroad Retirement Tax Act.

---

**A worker is not an employee if...**

By statute, workers in three occupations are not treated as employees (commonly referred to as "statutory non-employees") for purposes of FICA, FUTA, or federal income tax withholding, provided they meet specific qualifications. (Statutory non-employees are covered in detail in Lesson 3.)

IRC Section	Class of Worker
3508	real estate agents
3508	direct sellers
3506	companion sitters

---



## INTRODUCTION

---

**In this lesson...** In this lesson, we will review three categories of evidence. Each category contains several related facts which illustrate the right to direct and control -- or its absence. All facts must be weighed to determine whether a worker is a common law employee.

---

**Objectives** At the end of this lesson, you will be able to:

1. Identify the three categories of evidence.
2. Identify facts that demonstrate the right to direct and control -- or its absence -- within the categories of evidence.
3. Properly determine if a worker is an independent contractor or a common law employee for federal employment tax purposes.

---

## COMMON LAW EMPLOYEE: CONTROL STANDARD

---

### Common law standard

In determining a worker's status, the primary inquiry is whether the worker is an independent contractor or an employee under the common law standard.

The common law, a major part of the justice system in the United States, flows chiefly from court decisions. Under the common law, the treatment of a worker as an independent contractor or an employee originates from the legal definitions developed in the law of agency -- whether one party, the principal, is legally responsible for the acts or omissions of another party, the agent -- and depends on the principal's right to direct and control the agent.

---

### The right to direct and control

Following the common law standard, the employment tax regulations provide that an employer-employee relationship exists when the business for which the services are performed has the **right** to direct and control the worker who performs the services. This control refers not only to the result to be accomplished by the work, but also the means and details by which that result is accomplished. In other words, a worker is subject to the will and control of the business not only as to **what** work shall be done but also **how** it shall be done. It is not necessary that the business actually direct or control the manner in which the services are performed; it is sufficient if the business has the **right** to do so.

---

### Control test

To determine whether the control test is satisfied in a particular case, the facts and circumstances must be examined. Questions about the relationship between the worker and the business are asked to ascertain the degree of control.

Over the years, the IRS and Social Security Administration compiled a list of 20 factors used in court decisions to determine worker status. These 20 factors were eventually published in Rev. Rul. 87-41 and are sometimes called the Twenty Factor Test. Remember, however, that this Twenty Factor Test is an analytical tool and **not** the legal test used for determining worker status. The legal test is whether there is a right to direct and control the means and details of the work.

**Exhibit 2-1** at the end of this lesson provides a list of important cases dealing with the legal standard for determining worker status.

---

## COMMON LAW EMPLOYEE: CONTROL STANDARD

---

**Control facts  
change over time**

The twenty common law factors listed in Rev. Rul. 87-41 are not the only ones that may be important. Every piece of information that helps determine the extent to which the business retains the right to control the worker is important. In addition, the relative importance and weight of the twenty common law factors can vary significantly.

Bear in mind also that information important in helping determine worker status may change over time because business relationships change over time. As a result, some of the twenty common law factors listed in Rev. Rul. 87-41 are no longer as relevant as they once were.

*See, Weber v. Commissioner*, 103 T.C. 378 (1994), *aff'd per curiam* 60 F.3d 1104 (4th Cir. 1995); *Professional and Executive Leasing, Inc. v. Commissioner*, 862 F.2d 751 (9th Cir. 1988); *Avis Rent-A-Car System, Inc. v. United States*, 503 F.2d 423 (2d Cir. 1974); *Simpson v. Commissioner*, 64 T.C. 974 (1975); *Kenney v. Commissioner*, T.C. Memo 1995-431.

---

**Understand  
business  
operations**

In determining worker classification, try to gain an understanding of the way a business operates. Focus on what the business does and how the job gets done. It is also important to understand the relationship between the business and its clients or customers.

---

## COMMON LAW EMPLOYEE: CONTROL STANDARD

---

### Examining the relationship

A correct determination can only be made by examining the relationship of the worker and the business. It is important to remember that the result can be either that the worker is an independent contractor or an employee. Normally, our audit process is designed to select returns with a high probability of error for audit. However, a case which results in a "no change" does not indicate there is a problem with the examination process. In fact, if numerous cases selected for audit result in "no change," there may be a problem with the process for selection of returns for audit, not with the examination results.

---

### Dual status/split duties

A worker may perform services for a single business in two or more separate capacities. A dual status worker performs one type of service for a business as an independent contractor, but performs a different type of service for the business as an employee. *See*, Rev. Rul. 58-505, 1958-2 C.B. 728.

---

### Developing the facts

Once you understand the work that is being performed, and the business context in which it is being performed, you need to identify and evaluate evidence. For instance, worker status cannot be determined simply by looking at job titles. Facts must be developed to make a correct determination. When you develop the facts, consider the following:

- In making a determination, you need to look at the entire relationship between a business and a worker. The relationship often has several facets, some indicating the business has control, while others indicate it does not. You will need to weigh this evidence.
  - Control is a matter of degree. In fact, even in the clearest case of an independent contractor, the worker is constrained in some way. Conversely, employees may have autonomy in some areas.
  - To make a correct determination regarding the status of the worker, you need to consider the evidence of both autonomy and the right to control. The absence of a fact that would indicate control may be as important as its presence.
-

## COMMON LAW EMPLOYEE: CONTROL STANDARD

---

**Important preliminary points**

Important preliminary points can be made:

- There is no "magic number" of relevant evidentiary facts.
  - Whatever the number of facts, **they should be used in evaluating the extent of the right to direct and control.**
  - As in any examination, **all** relevant information needs to be explored and weighed before answering the legal question of whether the right to direct and control associated with an employer-employee relationship exists.
  - The evidence that you gather **must** be factual and well-documented and must support your determination: it is not sufficient to state a legal theory.
-

## A LOOK AT THE EVIDENCE

**Categories of evidence**

Recognizing that the common law changes the relevancy and emphasis of certain facts over the years, consider types of information which are most persuasive. The following chart reflects primary categories of evidence and includes examples of key facts that illustrate the right to direct and control -- or its absence.

Behavioral Control	Facts which illustrate whether there is a right to direct or control how the worker performs the specific task for which he or she is engaged: <ul style="list-style-type: none"> <li>•instructions</li> <li>•training</li> </ul>
Financial Control	Facts which illustrate whether there is a right to direct or control how the business aspects of the worker's activities are conducted: <ul style="list-style-type: none"> <li>•significant investment</li> <li>•unreimbursed expenses</li> <li>•services available to the relevant market</li> <li>•method of payment</li> <li>•opportunity for profit or loss</li> </ul>
Relationship of the Parties	Facts which illustrate how the parties perceive their relationship: <ul style="list-style-type: none"> <li>•intent of parties/written contracts</li> <li>•employee benefits</li> <li>•discharge/termination</li> <li>•regular business activity</li> </ul>

## BEHAVIORAL CONTROL

---

### Background

In this section, we consider evidence that substantiates the right to direct or control the details and means by which the worker performs the required services. Training and instructions provided by the business are important in this context. We will also discuss such workplace developments as evaluation systems and concern for customer security in conjunction with business identification.

In considering the types of evidence discussed here, and in the remainder of this training material, remember that **ALL** relevant information must be considered and weighed to determine whether a worker is an independent contractor or an employee.

---

### Instructions

Virtually every business will impose on workers, whether independent contractors or employees, some form of instruction (for example, requiring that the job be performed within specified time frames). This fact alone is not sufficient evidence to determine the worker's status.

As with every relevant fact, the goal is to determine whether the business has retained the right to control the details of a worker's performance or instead has given up its right to control those details. Accordingly, the weight of "instructions" in any case depends on the degree to which instructions apply to **how the job gets done** rather than to the **end result**.

---

## BEHAVIORAL CONTROL

---

**Types of instructions**

Instructions about how to do the work may cover a wide range of topics, for example:

- when to do the work
- where to do the work
- what tools or equipment to use
- what workers to hire to assist with the work
- where to purchase supplies or services
- what work must be performed by a specified individual (including ability to hire assistants)
- what routines or patterns must be used
- what order or sequence to follow

---

**Prior approval**

The requirement that a worker obtain approval before taking certain actions is an example of instructions.

---

**EXAMPLE 1**

L was hired by manufacturing company X as a management consultant for their sales department. According to X, L's responsibilities are:

- to ensure that the sales department is fully staffed
- to ensure that all materials used by the sales agents are stocked and available
- to review all sales contracts

While developing the facts listed above, you discover that X requires L to secure prior approval:

- to hire and/or fire within the sales department
- to purchase additional materials, as needed by the sales agents
- to accept any sales contract prepared by the sales department

X's requirement that L secure prior approval is evidence of control over L's behavior in the performance of L's services.

---



## BEHAVIORAL CONTROL

---

### EXAMPLE 2

L was hired by manufacturing company X as a management consultant for its sales department. According to X, L's responsibilities are:

- to ensure that the sales department is fully staffed
- to ensure that all materials used by the sales agents are stocked and available
- to review all sales contracts

While developing the facts listed above, you discover that X does not require L to secure prior approval:

- to hire or fire personnel in the sales department
- to purchase additional materials as needed by sales agents
- to accept a sales contract prepared by the sales department

Rather, X allows L to take whatever actions L deems necessary, in L's discretion, to achieve the goals listed as L's responsibility.

The absence of detailed instructions as to how L will perform the job function is evidence of L's autonomy in work performance.

### Degree of instruction

The degree of instruction depends on the scope of instructions, the extent to which the business retains the right to control the worker's compliance with the instructions, and the effect on the worker in the event of noncompliance. All these provide useful clues for identifying whether the business keeps control over the manner and means of work performance (leaning toward employee status), or only over a particular product or service (leaning toward independent contractor status).

The more detailed the instructions are that the worker is required to follow, the more control the business exercises over the worker, and the more likely the business retains the right to control the methods by which the worker performs the work. Absence of detail in instructions reflects less control.

## BEHAVIORAL CONTROL

---

**EXAMPLE 3**

J is an independent truck driver. J received a call from manufacturing company Y to make a delivery run from the Gulf Coast to the Texas Panhandle. J accepts the job and agrees to pick up the cargo the next morning. Upon arriving at the warehouse, J is given an address to which to deliver the cargo and is advised that the delivery must be completed within two days. This is direction of **what** is to be done rather than **how** it is to be done and is consistent with independent contractor status.

**EXAMPLE 4**

T is also a truck driver but does local deliveries for manufacturing company Z. T reports to the warehouse every morning. The warehouse manager tells T what deliveries have to be made, how to load the cargo in the truck, what route to take, and the order in which various elements of the cargo are to be delivered. This is instruction on **how** the work is to be performed and is consistent with employee status.

**Presence of instructions or rules mandated by governmental agencies or industry governing bodies**

Although the presence and extent of instructions is important in reaching a conclusion as to whether a business retains the right to direct and control the methods by which a worker performs a job, it is also important to consider the weight to be given those instructions if they are imposed by the business only in compliance with governmental or governing body regulations. If a business requires its workers to comply with rules established by a third party (for example, municipal building codes related to construction), the fact that such rules are imposed by the business should be given little weight in determining the worker's status. However, if the business develops more stringent guidelines for a worker in addition to those imposed by a third party, more weight should be given to these instructions in determining whether the business has retained the right to control the worker.

## BEHAVIORAL CONTROL

---

**Instructions by customer**

You may find that the customer tells the business that engages the worker **how** work is to be done. This type of evidence must be evaluated with great care.

If the business passes on the customer's instructions about **how** to do work as its own, the business has, in essence, adopted the customer's standards as its own. You should not disregard the instructions and standards merely because they originated with the customer.

---

**Suggestions v. instructions**

In some cases, a business will state that it does not instruct workers, but merely provides suggestions about how work is to be performed. A **suggestion** does not constitute the right to direct and control. For example, a dispatcher may suggest avoiding Highway X because of traffic congestion. However, if compliance with the **suggestions** is mandatory, then the **suggestions** are, in fact, **instructions**.

---

## BEHAVIORAL CONTROL

---

### **Business identification as instructions**

In the past, a requirement that a worker wear a uniform or put a business logo on a vehicle had typically been viewed as the type of instruction consistent with employee status. However, in view of increasing concerns about safety, many businesses now provide customers with some reassurance about the identification of those people gaining access to their homes or workplaces.

As a result, the fact that a worker is required to wear a business uniform or other identification, or is required to place the business's name on the worker's vehicle, does not necessarily indicate that the worker is an employee of the business. If the nature of the worker's occupation is such that the worker must be identified with the business for security purposes, wearing a uniform or placing the business's name on a vehicle is a neutral fact in analyzing whether an employment relationship exists.

---

### **Nature of occupation for instructions**

The nature of a worker's occupation also affects the degree of direction and control necessary to determine worker status. Highly trained professionals such as doctors, accountants, lawyers, engineers, or computer specialists may require very little, if any, training and/or instruction on how to perform their services. In fact, it may be impossible for the business to instruct the worker on how to perform the services because it may lack the essential knowledge and skills to do so. Generally, such professional workers who are engaged in the pursuit of an independent trade, business, or profession in which they offer their services to the public are independent contractors and not employees. *See*, Treas. Reg. section 31.3121(d)-1(c)(2). Nevertheless, an employer-employee relationship can exist between a business and workers in these occupations. *See, James v. Commissioner*, 25 T.C. 1296 (1956).

In analyzing the status of professional workers, evidence of control or autonomy with respect to the financial details of how the task is performed tends to be especially important, as does evidence concerning the relationship of the parties.

---

## BEHAVIORAL CONTROL

---

### Nature of work for instructions

An employment relationship may also exist when the work can be done with a minimal amount of direction and control, such as work done by a stockperson, store clerk, or gas station attendant. The absence of **need** to control should not be confused with the absence of **right** to control. The right to control contemplated by Treas. Reg. section 31.3121(d)-1(c)(2) and the common law as an incident of employment requires **only such supervision as the nature of the work requires**. The key fact to consider is whether the business retains the **right** to direct and control the worker, regardless of whether the business actually exercises that right.

---

### Evaluation systems

Like instructions, evaluation systems are used by virtually all businesses to monitor the quality of work performed by workers, whether independent contractors or employees. Thus, in analyzing whether a business's evaluation system provides evidence of the right to control work performance or the absence of such a right, you should look for evidence of how the evaluation system may influence the worker's behavior in performing the details of the job.

If an evaluation system measures compliance with performance standards concerning the **details** of **how** the work is to be performed, the system and its enforcement are evidence of control over the worker's behavior. However, not all businesses have developed formal performance standards or evaluation systems. This is especially true of smaller businesses. The lack of a formal evaluation system is a neutral fact.

---

## BEHAVIORAL CONTROL

---

### Training

Training is a classic means of explaining detailed methods and procedures to be used in performing a task. Periodic or on-going training provided by a business about procedures to be followed and methods to be used indicates that the business wants the services performed in a particular manner. This type of training is strong evidence of an employer-employee relationship.

However, not all training rises to this level. The following types of training, which might be provided to either independent contractors or employees, should be disregarded:

- orientation or information sessions about the business's policies, new product line, or applicable statutes or government regulations
  - programs that are voluntary and are attended by a worker without compensation
-

## FINANCIAL CONTROL

---

### Economic aspects of relationship

In this section, we consider evidence of whether the business has the right to direct or control the economic aspects of the worker's activities. Economic aspects of the relationship between the parties are frequently analyzed in determining worker status. These illustrate who has financial control of the activities undertaken. The items that usually need to be explored are:

- significant investment
- unreimbursed expenses
- services available to the relevant market
- method of payment
- opportunity for profit or loss

All of these can be thought of as bearing on the issue of whether the recipient has the right to direct and control the means and details of the **business** aspects of how the worker performs services. The first four items are important in their own right, but also affect whether there is an opportunity for the realization of profit or loss.

---

### Economic dependence

Although economic aspects of the relationship between a worker and a business are significant in determining worker status, it is equally important to understand that some features of the economic relationship are **not** relevant. 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 services are performed. This analysis has been rejected by Congress and the Supreme Court as a basis for determining worker classification. *Nationwide Mutual Insurance Co. v. Darden*, 503 U.S. 318 (1992). As a result, the worker's economic status is inappropriate for use in analyzing worker status.**

---

### Significant investment

A significant investment is evidence that an independent contractor relationship may exist. It should be stressed, however, that a significant investment is **not** necessary for independent contractor status. Some types of work simply do not require large expenditures. Further, even if large expenditures (such as costly equipment) are required, an independent contractor may rent the equipment needed at fair rental value.

---

## FINANCIAL CONTROL

---

**No dollar  
limitation on  
investment**

There are no precise dollar limits that must be met in order to have a significant investment. However, you must be sure that the investment has substance. Further, as long as the worker pays fair market or fair rental value, the worker's relationship to the seller or lessor is irrelevant. The size of the worker's investment and the risk borne by the worker are not diminished merely because the seller or lessor receives the benefit of the worker's services.

---

**EXAMPLE 5**

C is a backhoe operator for Y distributing company. Y company treats C as an independent contractor. Y company claims that C has a significant investment in the \$75,000 backhoe that C uses. Further investigation finds that C leases the backhoe at less than fair rental value and can turn it in at any time without liability for further payments. Y company pays for liability insurance and regular maintenance on the backhoe. C has expenses for the backhoe rental but, based on these facts, evidence of a significant investment has not been established.

---



## FINANCIAL CONTROL

---

### Business expenses

The extent to which a worker chooses to incur expenses and bear their costs impacts the worker's opportunity for profit or loss. This constitutes evidence that the **worker** has the right to direct and control the financial aspects of the business operations. Although not every independent contractor need make a significant investment, almost every independent contractor will incur an array of business expenses either in the form of direct expenditures or in the form of fees for pro rata portions of one or several expenses. These may include:

- rent and utilities
- tools and equipment
- training
- advertising
- payments to business managers and agents
- wages or salaries of assistants
- licensing/certification/professional dues
- insurance
- postage and delivery
- repairs and maintenance
- supplies
- travel
- leasing of equipment
- depreciation
- inventory/cost of goods sold

---

### Reimbursed expenses

Businesses often pay business or travel expenses for their employees. However, independent contractors' expenses may also be reimbursed. Independent contractors may contract for direct reimbursement of certain expenses or may seek to establish contract prices that will reimburse them for these expenses. You should, therefore, focus on **unreimbursed** expenses, which better distinguish independent contractors and employees, inasmuch as independent contractors are more likely to have unreimbursed expenses.

---

## FINANCIAL CONTROL

---

### Unreimbursed expenses

If expenses are unreimbursed, then the opportunity for profit or loss exists. Fixed ongoing costs that are incurred regardless of whether work is currently being performed are especially important. However, employees may also incur unreimbursed expenses in connection with the services they perform for their businesses. Thus, relatively minor expenses incurred by a worker, or more significant expenses that are customarily borne by an employee in a particular line of business, such as an auto mechanic's tools, would generally **not** indicate an independent contractor relationship.

---

### Services available

An independent contractor is generally free to seek out business opportunities. Indeed, the independent contractor's economic prosperity depends on doing so successfully. As a result, independent contractors often advertise, maintain a visible business location, and are available to work for the relevant market.

Of course, these activities are not essential for independent contractor status. An independent contractor with special skills may be contacted by word of mouth without the need for advertising. An independent contractor who has negotiated a long-term contract may find advertising equally unnecessary and may be unavailable to work for others for the duration of the contract. Further, other independent contractors may find that a visible business location does not generate sufficient business to justify the expense. Therefore, the absence of these activities is a neutral fact.

---

### EXAMPLE 6

U company engaged C to perform landscaping services on its grounds. Such services consist of weekly lawnmowing and the annual trimming of hedges. C advertises these services in the Yellow Pages. The fact that C advertises would indicate that C is available to perform services for the relevant market. Consider, however, that C negotiates a long-term contract with U company to maintain all of U company's business locations. C decides not to continue advertising, yet C is still available to perform services for the relevant market.

---

## FINANCIAL CONTROL

---

**Method of payment** The method of payment may be helpful in determining whether the worker has the opportunity for profit or loss.

---

**Salary or hourly wage** A worker who is compensated on an hourly, daily, weekly, or similar basis is guaranteed a return for labor. This is generally evidence of an employer-employee relationship, even when the wage or salary is accompanied by a commission. However, in some lines of business, such as law, it is typical to pay independent contractors on an hourly basis.

---

**Flat fee** Performance of a task for a flat fee is generally evidence of an independent contractor relationship, especially if the worker incurs the expenses of performing the services. When payments are made (daily, weekly, or monthly) is not relevant.

---

**Commissions** A commission-based worker may be either an independent contractor or employee. The worker's status may depend on the worker's ability to realize a profit or incur a loss as a result of services rendered.

---

## FINANCIAL CONTROL

---

### Realization of profit and loss

The ability to realize a profit or incur a loss is probably the strongest evidence that a worker controls the business aspects of services rendered. The facts already considered -- significant investment, unreimbursed expenses, making services available, and method of payment -- are all relevant in this regard.

As part of this review, you should also consider whether the worker is free to make business decisions which affect the worker's profit or loss. If the worker is making decisions which affect his or her bottom line, the worker likely has the ability to realize profit or loss. Examples include decisions regarding the types and quantities of inventory to acquire, the type and amount of monetary or capital investment, and whether to purchase or lease premises or equipment. Remember that employees can also make these decisions, but they do not usually affect the employee's bottom line.

It is sometimes asserted that because a worker can receive more money by working longer hours or receive less money by working less, the worker has the ability to incur a profit or loss. This type of income variation, however, is also consistent with employee status and does not distinguish employees from independent contractors.

---

### Not all facts required

Note that **not all** financial control facts need be present in order for the worker to have the ability to realize profit or loss. For example, a worker who is paid on a straight commission basis, makes business decisions, and has unreimbursed business expenses likely would have the ability to realize profit or loss -- even if the worker does not have a significant investment and does not market services.

---

## RELATIONSHIP OF THE PARTIES

---

### Relationship of business and worker

In this section, we describe other facts that recent court decisions consider relevant in determining worker status. Most of these facts reflect how the worker and the business perceive their relationship to each other. It is much harder to link the facts in this category directly to the right to direct and control **how** work is to be performed than the categories previously discussed. However, the relationship of the parties is important because it reflects the parties' **intent** concerning control.

---

### Intent of parties/written contract

Courts often look at the **intent** of the parties. This is most often embodied in their contractual relationship. Thus, a written agreement describing the worker as an independent contractor is viewed as evidence of the parties' intent that a worker is an independent contractor.

A contractual designation, in and of itself, is not sufficient evidence for determining worker status. The facts and circumstances under which a worker performs services are determinative of the worker's status. Treas. Reg. section 31.3121(d)-1(a)(3) provides that the designation or description of the parties is immaterial. This means that the **substance** of the relationship, **not the label**, governs the worker's status. The contract may, however, be relevant in ascertaining methods of compensation, expenses that will be incurred, and the rights and obligations of each party with respect to **how** work is to be performed.

In addition, if it is difficult, if not impossible, to decide whether a worker is an independent contractor or an employee, the **intent** of the parties, as reflected in the contractual designation, is an effective way to resolve the issue. The contractual designation of the worker is "very significant in close cases." *See, Illinois Tri-Seal Prods., Inc. v. United States*, 353 F.2d 216, 218 (Ct. Cl. 1965).

---

### Forms W-2

Filing a Form W-2 usually indicates the parties' belief that the worker is an employee. However, workers have succeeded in obtaining independent contractor status even when Forms W-2 were filed. *See, e.g., Butts v. Commissioner*, T.C. Memo 1993-478, *aff'd per curiam* 49 F.3d 713 (11th Cir. 1995).

---

## RELATIONSHIP OF THE PARTIES

---

### **Incorporation**

Questions sometimes arise concerning whether a worker who creates a corporation through which to perform services can be an employee of a business that engages the corporation. Provided that the corporate formalities are properly followed and at least one non-tax business purpose exists, the corporate form is generally recognized for both state law and federal law, including federal tax, purposes. Disregarding the corporate entity is generally an extraordinary remedy, applied by most courts only in cases of clear abuse. Thus, the worker will usually not be treated as an employee of the business, but as an employee of the corporation.

However, the fact that a worker receives payment for services from a business through the worker's corporation does not automatically require a finding of independent contractor status with respect to those services. For example, a professional athlete who attempted to assign a salary received from the team to a wholly-owned professional corporation was nevertheless held by the Tax Court to be a common law employee of the team, rather than the professional corporation. *Sargent v. Commissioner*, 93 T.C. 572 (1989), *rev'd* 929 F.2d 1252 (8th Cir. 1991). *Sargent's* reversal by the Eighth Circuit illustrates courts' reluctance to disregard the corporate entity. *See, Leavell v. Commissioner*, 104 T.C. 140 (January 30, 1995).

---

### **Employee benefits**

Providing a worker with employee benefits traditionally associated with employee status has been an important fact in several recent court decisions. *See, Weber v. Commissioner, supra; Lewis v. Commissioner*, T.C. Memo 1993-635. If a worker receives employee benefits, such as paid vacation days, paid sick days, health insurance, life or disability insurance, or a pension, this constitutes some evidence of employee status. The evidence is strongest if the worker is provided with employee benefits under a tax-qualified retirement plan, IRC section 403(b) annuity, or cafeteria plan, for, by statute, these employee benefits can **ONLY** be provided to employees. Some decisions, however, have ascribed less weight to the fact that employee benefits were provided. *See, e.g., Butts v. Commissioner, supra.*

---

## RELATIONSHIP OF THE PARTIES

---

### Employee benefits, cont'd

If a worker is excluded from a benefit plan because the worker is not considered an employee by the business, this is relevant (though not conclusive) in determining the worker's status as an independent contractor. In contrast, if the worker is excluded on some other grounds (*e.g.*, the worker's work location or business unit), the exclusion is irrelevant in determining whether the worker is an independent contractor or an employee. This is because none of these employee benefits is required to be provided to employees. Many workers whose status as bona fide employees is unquestioned receive no employee benefits. This pattern is possible even if **some** workers in a business receive employee benefits, for there is no requirement that **all** workers be covered.

---

### State law characterization

State laws, or determinations of state or federal agencies, may characterize a worker as an employee for purposes of various benefits. Characterizations based on these laws or determinations should be disregarded, because the laws or regulations involved may use different definitions of employee or be interpreted to achieve particular policy objectives.

For example, state laws determine whether workers are employees for purposes of workers' compensation and unemployment insurance. Because the definition of "employee" for these purposes is often broader than under the common law rules, eligibility for these benefits should be disregarded in determining worker status.

---

### Discharge/termination

The circumstances under which a business or a worker can terminate their relationship have traditionally been considered useful evidence bearing on the status the parties intended the worker to have.

Some recent court decisions continue to explore such evidence. However, in order to determine whether the facts before you are relevant to the worker's status, you will need to consider the impact of modern business practices and legal standards governing worker termination.

---

## RELATIONSHIP OF THE PARTIES

---

**Discharge/  
termination --  
traditional  
analysis**

Under a traditional analysis, a business's ability to terminate the work relationship at will, without penalty, provided a highly effective method to control the details of how work was performed and, therefore, tended to indicate employee status. Conversely, in the traditional independent contractor relationship, the business could terminate the relationship only if the worker failed to provide the intended product or service, thus indicating the parties' intent that the business not have the right to control how the work was performed.

---

**Limits on ability  
to discharge  
worker**

In practice, however, businesses rarely have complete flexibility in discharging an employee. The business may be liable for pay in lieu of notice, severance pay, "golden parachutes," or other forms of compensation when it discharges an employee. In addition, the reasons for which a business can terminate an employee may be limited -- whether by law, by contract, or by its own practices. As a result, inability to freely discharge a worker, by itself, no longer constitutes persuasive evidence that the worker is an independent contractor.

---

**Limits on  
worker's ability  
to quit**

Looking at the issue from the other angle, a worker's ability to terminate work at will was traditionally considered to illustrate that the worker merely provided labor and tended to indicate an employer-employee relationship. In contrast, if the worker terminated work, and the business could refuse payment or sue for nonperformance, this indicated the business's interest in receipt of the product or service for which the parties had contracted and tended to indicate an independent contractor relationship.

---

**Termination of  
contracts**

In practice, however, independent contractors may enter into short-term contracts for which nonperformance remedies are inappropriate or may negotiate limits on their liability for nonperformance. For example, professionals, such as doctors and attorneys, are typically able to terminate their contractual relationship without penalty.

---



## RELATIONSHIP OF THE PARTIES

---

**Nonperformance  
by employee**

At the same time, businesses may successfully sue employees for substantial damages resulting from their failure to perform the services for which they were engaged. As a result, the presence or absence of limits on a worker's ability to terminate the relationship, by themselves, no longer constitutes useful evidence in determining worker status. On the other hand, a business's ability to refuse payment for unsatisfactory work continues to be characteristic of an independent contractor relationship.

---

**Discharge/  
termination --  
limited  
usefulness**

Because the significance of facts bearing on the right to discharge/terminate is so often unclear and depends primarily on contract and labor law, this type of evidence should be used with great caution.

---

## RELATIONSHIP OF THE PARTIES

---

**Permanency** Courts have considered the existence of a permanent relationship between the worker and the business as relevant evidence in determining whether there is an employer-employee relationship.

---

**Indefinite relationship** If a business engages a worker with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is generally considered evidence of their intent to create an employment relationship.

---

**Long-term relationship** However, a relationship that is created with the expectation that it will be indefinite should not be confused with a long-term relationship. A long-term relationship may exist between a business and either an independent contractor or an employee.

The relationship between the business and an independent contractor may be long-term for several reasons:

- the contract may be a long-term contract
- contracts may be renewed regularly due to superior service, competitive costs, or lack of alternative service providers

A business may also have a relationship with an employee that is long-term, but not indefinite. This could occur if temporary employment contracts are renewed or if a long-term, but not indefinite, employment contract is entered into. As a result, a relationship that is long-term, but not indefinite, is a neutral fact that should be disregarded.

---

## RELATIONSHIP OF THE PARTIES

---

**Temporary relationship**

A temporary relationship is also a neutral fact that should be weighed carefully. An independent contractor will typically have a temporary relationship with a business, but so too will employees engaged on a seasonal, project, or "as needed" basis.

---

**Regular business activity**

The courts have looked at the services performed by the worker and the extent to which those services are a key aspect of the regular business of the company.

In considering this evidentiary fact, you should remember that the mere fact that a service is desirable, necessary, or even essential to a business does not mean that the service provider is an employee. An appliance store needs workers to install electricity and plumbing in the store building. However, this work can be done equally well by independent contractors or employees. In this case, you can avoid confusion by focusing on the fact that the work the electricians and plumbers perform in the store is not the store's regular business.

In contrast, the work of an attorney or paralegal is part of the regular business of a law firm. If a law firm hires an attorney or paralegal, it is likely that it will present their work as its own. As a result, there is an increased probability that the law firm will direct or control their activities. However, you need to examine further facts to see whether there is evidence of the right to direct or control before you conclude that these workers are employees. It is possible that the work performed is part of the principal business of the law firm, yet it has hired workers who are outside specialists and may be independent contractors.

---

## FACTS OF LESSER IMPORTANCE

---

**Introduction** This section discusses facts that will typically provide less useful evidence of whether a worker is an independent contractor or an employee. In past decades, these facts were probably more important. However, recent court decisions give them little independent weight. To the extent these facts continue to have relevance, they are generally already reflected in the types of evidence described previously.

---

**Part-time or full-time work** The fact that a worker performed services on a part-time basis or worked for more than one person or business was once thought to be significant evidence indicating that the worker was an independent contractor. However, in today's economy, whether a worker performs services on a full-time or part-time basis is a neutral fact. There are several reasons for this change.

With cutbacks and downsizing in business and industry, many companies hire workers on a part-time basis. These workers may be either independent contractors or employees.

Similarly, working full-time for one business is also consistent with either independent contractor or employee status. An independent contractor may work full-time for one business either because other contracts are lacking, because the contract by its terms requires a full-time, exclusive effort, or because the independent contractor chooses to devote full-time to a particular project.

Finally, many employees "moonlight" by working for a second employer. As a result, whether services are performed for one business is no longer useful evidence.

---

**Place of work** Whether work is performed on the business's premises or at a location selected by the business often has no bearing on worker status. Even when it is relevant evidence, it will be relevant because it illustrates the business's right to direct and control how the work is performed and will have been considered in connection with instructions.

---

## FACTS OF LESSER IMPORTANCE

---

**One location** In many cases, services can be provided at only one location. For example, repairing a leaky pipe requires a plumber to visit the premises where the pipe is located. Similarly, a camera operator must shoot a commercial at the same location as the director and actors. These requirements are inherent in the result to be achieved and are not evidence of the right to direct and control how the work is performed.

---

**Different locations** In other cases, work can be performed at many different locations. Modern technology has developed tools that greatly expand the scope of the workplace, such as cellular phones, modems, and computer networks. Allowing work offsite can be attractive to businesses due to lowering costs, improving morale, and helping to retain valued workers. In today's world, off-site work is consistent with either an independent contractor or employer-employee relationship.

The place where work is performed is most likely to be relevant evidence in cases in which the worker has an office or other business location. However, you will have already considered this evidence in evaluating significant investment, unreimbursed expenses, and opportunity for profit or loss.

---

**Hours of work** You can easily apply the same reasoning that we used in connection with place of work to understand why hours of work is also a fact that, if relevant, has already been considered in connection with instructions.

Some work must, by its nature, be performed at a specific time. Again, our camera operator must be ready to provide photography services when the director and actors are on hand. This relates to the result to be achieved, not how the work is performed.

Modern communications have increased the ease of performing work outside normal business hours, while flexibility in setting hours may improve morale and retain valued workers. In today's world, flexible hours are consistent with either independent contractor or employee status.

---

## WEIGHING THE EVIDENCE

**Control and autonomy both present**

---

When you have explored the relevant evidence, you will probably find some facts that support independent contractor status and other facts that support employee status. This is because independent contractors are rarely totally unconstrained in the performance of their contracts, while employees almost always have some degree of autonomy.

---

**Which predominates?**

You will, therefore, need to weigh the evidence before you in order to determine whether, looking at the relationship as a whole, evidence of control or autonomy predominates. You may, for example, find that the business requires the worker to be on site during normal business hours, but has no right to control other aspects of how the work is to be performed; that the worker has a substantial investment and unreimbursed expenses combined with a flat fee payment; and that contractual provisions clearly show the parties' intent that the worker be an independent contractor. In this case, you would logically conclude that the worker was an independent contractor despite the instructions about the hours and place of work.

---

### EXAMPLE 7

Dr. B owns and operates Z medical center, which provides a variety of medical services. To better serve his patients, Dr. B purchased an x-ray machine and hired Dr. C to read the x-rays. Dr. C is a highly skilled and highly trained professional in the field of radiology.

Even though Dr. B does not instruct Dr. C on how to take and read x-rays, other evidence, such as financial control or the contractual relationship of the parties, may indicate a right to direct and control Dr. C to an extent consistent with employee status. On the other hand, a lack of financial control by Dr. B over such details of Dr. C's radiology practice as fees, billings, and collections, may indicate Dr. C's autonomy to an extent consistent with independent contractor status, notwithstanding Dr. C's use of Dr. B's equipment. This is especially true if their contract evidences intent to create an independent contractor relationship.

---

## SUMMARY

---

**Review of lesson** The following summarizes what we have covered in this lesson:

1.	In determining a worker's status, you should gain an understanding of the way a business operates and the relationship between the business and the worker.
2.	Areas to consider while developing your case are: <ul style="list-style-type: none"><li>• What the business does and how the job gets done.</li><li>• The relationship between the business and its clients or customers.</li><li>• Facts that indicate whether the business has the right to control <b>how</b> work is done.</li></ul>
3.	Evidence that may be the most persuasive can be identified within three specific categories. <ul style="list-style-type: none"><li>• Behavioral control.</li><li>• Financial control.</li><li>• Relationship of the parties.</li></ul>
4.	Behavioral control focuses on whether there is a right to direct or control <b>how</b> the work is done. The presence or absence of instructions and training on how work is to be done are especially relevant.

---

## SUMMARY

---

**Review of lesson,  
cont'd**

5.	Financial control focuses on whether there is a right to direct or control how the <b>business</b> aspects of the worker's activities are conducted. Significant investment, unreimbursed expenses, services available to the relevant market, method of payment, and opportunity for profit or loss are facts relevant to financial control.
6.	Relationship of the parties focuses on how the parties perceive their relationship. Intent of parties/written contract, employee benefits, discharge/termination, permanency, and regular business activity are relevant to how the parties perceive their relationship.
7.	Relevant evidence in all three categories must be weighed to determine the worker's status.

---



## CASE STUDIES

---

**Instructions**

Use the following instructions for all cases in this lesson:

1.	Read the following facts.
2.	List all the facts that illustrate the business's <b>right</b> to control how work is performed.
3.	List all the facts that illustrate the worker's <b>autonomy</b> with respect to how the work is performed.
4.	List all the facts that are equally consistent with independent contractor or employee status and that should, therefore, be disregarded.
5.	Weigh the facts that point toward independent contractor or employee status, then outline your arguments as to whether the workers in question are independent contractors or employees.
6.	Identify any additional facts that should be developed.
7.	Pool your ideas and develop a group answer.
8.	Select a member of your group to orally present the group solution to the class.

---

## CASE STUDY 2-1

---

**Facts**

An attorney is a sole practitioner who rents office space and pays for the following items: telephone, computer, on-line legal research linkup, fax machine, and photocopier. The attorney buys office supplies and pays bar dues and membership dues for three other professional organizations. The attorney has a part-time receptionist who also does the bookkeeping. The attorney pays the receptionist, withholds and pays federal and state employment taxes, and files a Form W-2 each year. For the past two years, the attorney has had only one client, a corporation with which there has been a long-standing relationship. The attorney charges the corporation an hourly rate for services and sends monthly bills detailing the work performed for the prior month. The bills include charges for long distance calls, on-line research time, fax charges, photocopies, mailing costs, and travel costs for which the corporation has agreed to reimburse.

---

## CASE STUDY 2-2

---

**Facts**

A manufacturer's representative (rep) is the sole proprietor of a building supplies business and has an exclusive contract with a building supplies manufacturer. The rep has the sole right to the territory covered, sells only that manufacturer's products, but did not pay anything for the right to the territory. The rep has a bachelor's degree in civil engineering and belongs to several professional associations, paying membership dues. The rep has an office and a secretary, but the manufacturer does not reimburse for these expenses. The rep's name appears in the yellow page advertisements under both the rep's sole proprietorship name and the name of the manufacturer represented. The rep is required to provide regular trip reports to the manufacturer and attend sales meetings and trade shows conducted in the rep's territory.

The rep bids on portions of major commercial construction contracts. These jobs require engineering skills and design work to adapt the building materials to the project plans. All bids are subject to the manufacturer's post-review. Upon winning a bid, the rep engages and pays the workers who will install the building materials, providing the necessary construction bonds. The rep submits invoices to the general contractor for payment directly to the rep on forms prescribed by the manufacturer. If the general contractor fails to pay, the rep is responsible for collecting and is liable to the manufacturer for payment.

---

## CASE STUDY 2-3

---

**Facts**

A computer programmer is laid off when Company X downsizes. Company X agrees to pay the programmer \$10,000 to complete a one-time project to create a certain product. It is not clear how long it will take to complete the project, and the programmer is not guaranteed any minimum payment for the hours spent on the project. The programmer does the work on a new high-end computer, which cost the programmer \$5,000. The programmer works at home and is not expected or allowed to attend meetings of the software development group. Company X provides the programmer with no instructions beyond the specifications for the product itself. The programmer and Company X have a written contract, which provides that the programmer is considered to be an independent contractor, is required to pay federal and state taxes, and receives no employee benefits from Company X. Company X will file a Form 1099.

---

**SELECTED CASES**

*United States v. Silk*, 331 U.S. 704 (1947)

In this case, the Supreme Court applied the common law standard in concluding that the coal unloaders at issue were employees, whereas the coal truck and moving van drivers were independent contractors. However, the Court also suggested that the meaning of the term "employee" should be given a broader meaning in order to carry out the purpose of social security legislation. For history of repudiation of this broader meaning, *see, Illinois Tri-Seal* below.

*Bartels v. Birmingham*, 332 U.S. 126 (1947)

The Supreme Court applied the common law standard in determining that band members were employees of the bandleader, rather than of dance hall operators. However, the Court also suggested that an "economic reality" test should be used for purposes of interpreting the social security legislation. For history of the repudiation of the "economic reality" test, *see, Illinois Tri-Seal* below.

*Illinois Tri-Seal Products v. United States*, 353 F.2d 216 (Ct. Cl. 1965)

An excellent history of the Congressional repudiation of the *Silk/Bartels* "economic reality" approach can be found in this case holding window installers to be independent contractors. The case also illustrates the intrinsically factual nature of independent contractor/employee determinations. It also contains helpful discussions of the distinction between instructions and suggestions and of the significance of the parties' view of their relationship in close cases.

*McGuire v. United States*, 349 F.2d 644 (9th Cir. 1965)

This case, holding "swampers" who unloaded produce trucks to be employees, distinguishes between the right to control and the need to control in the context of workers requiring little supervision.

*Avis Rent-A-Car System, Inc. v. United States*, 503 F.2d 423 (2d Cir. 1974)

The importance of avoiding single fact analysis is stressed in this case holding car shuttlers to be employees. Facts considered relevant include the right to control the manner in which work is performed, substantial investment, expenses, ability to profit, special skills, permanence, and whether work is part of the principal's regular business.

*Simpson v. Commissioner*, 64 T.C. 974 (1975)

The IRS successfully argued in this case that an insurance agent was an independent contractor. Relevant facts were: 1) degree of control over details; 2) investment in facilities; 3) opportunity for profit or loss; 4) right to discharge; 5) whether work is part of principal's regular business; 6) permanency; and 7) the relationship the parties believed they were creating.

*Professional and Executive Leasing, Inc. v. Commissioner*, 862 F.2d 751 (9th Cir. 1988).  
*James v. Commissioner*, 25 T.C. 1296 (1956)

Both cases focus on the right to control the manner in which the work of highly skilled professionals is performed.

*Nationwide Mutual Insurance Co. v. Darden*, 503 U.S. 318 (1992)

In this case under Title I of the Employee Retirement Income Security Act of 1974 (ERISA), the Supreme Court held that traditional common law concepts should be used to interpret the term "employee" absent legislative direction to the contrary. The decision contains the Supreme Court's repudiation of the "economic reality" dicta in *Silk*.

*Weber v. Commissioner*, 103 T.C. 378 (1994), *aff'd per curiam* 60 F.3d 1104 (4th Cir. 1995).  
*Shelley v. Commissioner*, T.C. Memo 1994-432.

The importance of small factual differences is apparent in these two cases. In *Weber*, a Methodist minister was held to be an employee, while in *Shelley*, a clergyman in another denomination was held to be an independent contractor.

## Lesson 3

# STATUTORY EMPLOYEES, STATUTORY NON-EMPLOYEES, AND OTHER CLASSES OF WORKERS

## INTRODUCTION

---

**In this lesson**

In the previous lesson, you studied what constitutes a common law employee where the business is liable for FICA, FUTA, and federal income tax withholding. In this lesson, you will study corporate officers and certain workers that are defined by statute as employees, commonly referred to as "statutory employees." You will also study workers in three occupations where, by statute, the worker performing the services is specifically not treated as an employee (commonly referred to as "statutory non-employee"). In cases of a statutory non-employee, the business for which the services are performed is not treated as an employer, and, therefore, is not liable for any of these taxes.

IRC section 3121(d) contains four categories of employees for FICA tax purposes:

- common law employees (discussed in Lesson 2)
- corporate officers
- statutory employees
- employees covered by an agreement under section 218 of the Social Security Act

IRC section 3508 contains tests for the treatment of real estate agents and direct sellers as statutory non-employees. IRC section 3506 provides the requirements for treating companion sitters as statutory non-employees.

---

**Objectives**

At the end of this lesson, you will be able to:

1. Determine whether a corporate officer is an employee for purposes of FICA and FUTA taxes and federal income tax withholding.
  2. Identify statutory employees for purposes of FICA and FUTA taxes.
  3. Identify statutory non-employees.
- 

## CORPORATE OFFICERS

---

**Exception**

Officers are specifically included within the definition of employee for purposes of FICA, FUTA, and federal income tax withholding. See IRC sections 3121(d)(1), 3306(i), and 3401(c). The common law standard is not applicable. The regulations provide that generally an officer of a corporation is an employee of the corporation. However, an officer is not considered to be an employee of the corporation if two requirements are met: (1) the officer does not perform any services or performs only minor services; **and** (2) the officer is not entitled to receive, directly or indirectly, any remuneration. Treas. Reg. section 31.3121(d)-1(b).

The officer must meet **both** requirements to be excepted from employee status. In determining whether services performed by a corporate officer are considered minor or nominal, examine the character of the service, the frequency and duration of performance, and the actual or potential importance or necessity of the services in relation to the conduct of the corporation's business.

A director of a corporation, acting in the capacity of a director, is not an employee of the corporation for those services, even if that worker also serves as an employee or officer of the corporation for other services. Therefore, part of the compensation paid this worker can be for services rendered as an independent contractor (director) and part of the payments can be for services rendered as an employee. Rev. Rul. 58-505.

---



## CORPORATE OFFICERS

---

### EXAMPLE 1

Various officers of five related operating corporations performed only minor ministerial functions entailing a few hours work a year for the corporations. The officers also received no remuneration for the services they performed for these five corporations. Because the officers satisfied both requirements for the exception from employee status (*i.e.*, they performed only minor services for the corporations and received no remuneration), the officers were not employees of the operating corporations. Rev. Rul. 74-390, 1974-2 C.B. 331.

However, the sole shareholder of a closely held corporation performing services as a corporate officer, who either performs more than minor services or receives compensation for the services, is an employee even though the services performed and the amount of compensation for them are under the sole shareholder officer's complete control. Rev. Rul. 71-86, 1971-1 C.B. 285.

---

### Payments to officers

You should closely examine all payments to the officer, such as amounts labeled as draws, loans, dividends, or other distributions, to determine whether the payments are in fact wages for FICA, FUTA, and federal income tax withholding purposes.

For example, in Rev. Rul. 74-44, 1974-1 C.B. 287, the two shareholders of an S corporation received no compensation for services they performed for the corporation. Instead, they arranged to receive "dividends" from the corporation. The ruling concluded that the dividends were in fact compensation for services and were wages for purposes of FICA, FUTA, and federal income tax withholding.

---

## STATUTORY EMPLOYEES

---

**Statutory  
employee**

If a worker is not an employee under the usual common law rules or a corporate officer, the worker and the business may nevertheless still be subject to employment taxes. IRC section 3121(d)(3) lists workers in four occupational groups who, under certain circumstances, are considered employees for FICA tax, and, in some instances, FUTA tax, but not for federal income tax withholding. These groups include:

- agent-drivers or commission-drivers
- full-time life insurance salespersons
- home workers
- traveling or city salespersons

These workers are referred to as "statutory employees." Workers in these four occupational groups are employees for FICA tax purposes. By definition, a worker cannot be a statutory employee under IRC section 3121(d)(3) if that worker is a common law employee. *See Lickiss v. Commissioner*, T.C. Memo 1994-103.

---

## STATUTORY EMPLOYEES

---

### **General requirements**

In order for IRC section 3121(d)(3) to apply when a worker performs services for remuneration for a business, there are three general requirements. They are:

1. The contract of service contemplates that the worker will personally perform substantially all the work.
  2. The worker has no substantial investment in facilities other than transportation facilities used in performing the work.
  3. There is a continuing work relationship with the business for which the services are performed.
- 

### **Work performed personally**

The term "contract of service" means an arrangement oral or written, under which the particular services are performed. The term "personally perform" means it is contemplated that the worker will do substantially all the work personally. Therefore, if the arrangement contemplates that the worker would be free to delegate as much of the work as he or she desires, then the worker could not be a statutory employee under this section.

---

### **No substantial investment**

The term "substantial investment" is not defined in the regulations. All of the facts for each case must be considered to determine whether the facilities furnished by the worker are substantial. Several factors listed below should be considered:

1.	What is the value of the worker's investment compared to the total investment?
2.	Are the facilities furnished essential to perform the work or for the personal convenience of the worker?
3.	Are the facilities being purchased or leased at fair market or fair rental value?
4.	Are the facilities furnished by the worker considerably more extensive than those usually furnished by workers performing comparable services?

---

## STATUTORY EMPLOYEES

---

**Continuing  
relationship**

Work is considered to be of a continuing nature if it is regular or frequently recurring. Regular part-time and regular seasonal work are considered continuing. A single job transaction is not generally a continuing relationship.

---

## CATEGORIES OF STATUTORY EMPLOYEES

---

### Agent drivers or commission drivers

The statute limits agent drivers or commission drivers to workers who distribute meat or meat products, vegetables or vegetable products, fruit or fruit products, bakery products, beverages (other than milk), or laundry or dry-cleaning services for a business. The distribution of other services or products will not disqualify the worker from this category of statutory employee if handling the additional products or services is incidental to handling the specified items.

The agent or commission drivers may sell at retail or wholesale. They may operate from their own trucks or from trucks belonging to the business for which they work. The drivers may serve customers designated by the business as well as those they solicit. Their compensation may be based on commission, or the difference between the price charged to the customer and the price paid by the driver to the business for the product or service.

---

### EXAMPLE 2

B is engaged on a continuing basis in distributing meat products to retail stores for the Z company. B is not a common law employee of the Z company. The contract of service with the Z company specifies that substantially all of the services are to be performed personally by B who has no investment in facilities other than a delivery truck and that B is paid on a commission basis. B is a statutory employee of the Z company. However, if B expands the distribution business, hires other workers, and no longer personally performs the deliveries, B is not a statutory employee of the Z company.

### Full-time life insurance salespersons

This group includes salespersons whose full-time occupation is soliciting life insurance or annuity contracts or both, primarily for one life insurance business.

---

## CATEGORIES OF STATUTORY EMPLOYEES

---

**Full-time life insurance salespersons, cont'd**

Generally, the contract of employment reflects the intent of the worker and the business in determining whether the worker is a full-time or part-time salesperson. The actual time devoted to the work is not determinative. A worker may work regularly only a few hours each day and still qualify as a full-time life insurance salesperson.

The salesperson's efforts must be devoted primarily to soliciting life insurance or annuity contracts. Occasional or incidental sales of other types of insurance for the business, or the occasional placing of surplus-line insurance, will not affect this requirement. However, the salesperson who devotes substantial efforts to selling applications for insurance contracts other than life insurance and annuity contracts (for example, health and accident, fire, automobile, etc.) does not meet the requirement.

---

**Home workers**

The term "home worker" can encompass workers who perform a wide range of duties. Traditionally, this group would have included, but was not limited to, workers who would make such things as clothing, bedding, needlecraft products, or similar products. In addition, it can also include workers who provide typing or transcribing services. *See* Rev. Rul. 64-280, 1964-2 C.B. 384 and Rev. Rul. 70-340, 1970-1 C.B. 202. The work is done away from the business's place of business, usually in the worker's own home, the home of another, or a home workshop.

---

**Specific requirements for home workers**

To qualify as a statutory employee, the worker must meet, in addition to the three general requirements previously listed, the following requirements:

- |   |
|---|
| 1. The work must be done in accordance with the specifications given by the business (generally, simple and consisting of such things as patterns or samples).          |
| 2. The material or goods on which the work is done must be furnished by the business.   |
| 3. The finished product must be returned to the business or to another designation. It is immaterial whether the business picks up the work, or the worker delivers it. |
- 

## CATEGORIES OF STATUTORY EMPLOYEES

---

**\$100 rule for  
home workers**

\$100 Rule - IRC section 3121(a)(10) provides that the pay which the home worker receives for such work is not subject to FICA tax unless \$100 or more of cash (checks, money orders, or cashiers checks) is received during any calendar year from one business. A home worker may be employed by several businesses.

If the \$100 cash pay test is met, all non-cash payments (clothes, merchandise, transportation passes, etc.) from the same business are also included as wages.

---

**Traveling or city  
salesperson**

This category includes workers who operate away from the business's premises. Their full-time business activity is selling merchandise for a business. The test of full-time relates to an exclusive or principal business activity for a single business and not to the time spent on a job. Sideline sales activities for some other business, however, do not exclude these workers from coverage.

---

## CATEGORIES OF STATUTORY EMPLOYEES

---

**Specific requirements for traveling or city salespersons**

In order for traveling or city salespersons to fall within the statutory test, they must meet, in addition to the three general requirements previously listed, the following requirements:

- |    |   |
|----|---|
| 1. | Their entire or principal business activity must be devoted to soliciting and transmitting orders for merchandise of a single business.     |
| 2. | The orders must be obtained from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments. |
| 3. | The merchandise sold must be bought for resale or must be supplied for use in the purchaser's business operations.                          |

---

**Principal business activity defined for traveling or city salespersons**

The definition of an entire or principal business activity is discussed in Rev. Rul. 55-31, 1955-1 C.B. 476. Generally, the test is met if 80 percent of the activity is for one business.

---



## CATEGORIES OF STATUTORY EMPLOYEES

### Types of purchasers for traveling or city salespersons

Workers must sell principally to the classes of purchasers described in IRC section 3121(d)(3)(D) to be considered statutory employees. They may also sell incidentally to others. These classes are shown in the table below.

CLASS OF PURCHASER	DESCRIPTION
Wholesaler	A wholesaler buys merchandise in large quantities and usually sells in small quantities to jobbers or to retail dealers but not to the ultimate consumer. The wholesaler does not process the merchandise in any way to cause it to lose or change its identity.
Retailer	A retailer buys merchandise in small quantities and then sells it in smaller quantities usually to the ultimate consumer.  Retail establishments may perform service functions or processing or manufacturing operations with respect to the items they sell without losing their character as retail establishments. For example, a store which sells drapery and slip cover material, and also makes draperies and slip covers for the consumer, is a retail establishment and not a manufacturer. A neighborhood bakery is essentially a retail store, even though it changes the form of the raw material to the final prepared material.
Contractor	Contractors include such service organizations as contractors for window washing, wall cleaning, construction, and other services.
Hotels, Restaurants, or Other Similar Establishments	The phrase "other similar establishments" refers solely to establishments similar to hotels and restaurants whose primary function is the furnishing of food or lodging.

## CATEGORIES OF STATUTORY EMPLOYEES

---

**Classes of purchasers not included for traveling or city salespersons**

Manufacturers, schools, hospitals, churches, municipalities, and state and federal governments are not within the included classes of purchasers. A manufacturer produces articles for use from raw or prepared materials by giving them new forms, qualities, and properties, or combinations of these items.

Sales made to a unit of an organization not within the included classes of purchasers may meet the requirements regarding "classes of purchasers" provided the unit carries on a separate and clearly identifiable business with a type of purchaser described in IRC section 3121(d)(3)(D). For example, sales made to an unincorporated university bookstore, owned and operated by the university, are sales made to a purchaser included in the statutory definition of "traveling or city salesperson."

---

**Resale or use for traveling or city salespersons**

Merchandise must be for resale or for use in the business operation of the purchaser. The phrase "merchandise for resale" includes only tangibles which do not lose their identity as they pass through the hands of the purchaser. The phrase "supplies for use in the business operation" means principally supplies used in conducting the purchaser's business. This includes all tangible merchandise not considered "merchandise for resale." Services, such as radio time and advertising space, are intangible and outside the definition. However, items such as advertising novelties and calendars constitute supplies within the definition.

---

**EXAMPLE 3**

J performs sales services for a company which publishes catalogs and plans for home designs. J solicits orders for the catalogs exclusively from lumber dealers, who purchase them either for resale or for free distribution to their customers. The lumber dealers are wholesalers or retailers. The catalogs for resale constitute "merchandise for resale," and those purchased for free distribution constitute supplies for use in the purchaser's business operation. Therefore, J meets the statutory test and is an employee of the publishing company. If, however, J only sells advertising space in the catalogs, J is not an employee of the publishing company.

---

## CATEGORIES OF STATUTORY EMPLOYEES

---

**Service may be part of the sale for traveling or city salespersons**

If workers perform substantial work in servicing the articles they sell, they may still meet the requirements of IRC section 3121(d)(3)(D). For example, a worker who spends a day selling a machine and a day supervising its installation and training the purchaser's personnel in its use may still have performed services as a full-time salesperson.

Furnishing such services may be a necessary part of the inducement for the buyer to purchase. The question, therefore, is whether the total activity is essentially a selling activity. If so, the services related to the sale, even though substantial, are an integral part of the sale.

---

**Statutory employees' expenses**

Statutory employees under IRC section 3121(d)(3) are not employees for the purpose of deducting trade or business expenses. Therefore, they may deduct their expenses on Schedule C rather than as miscellaneous itemized deductions. Rev. Rul. 90-93, 1990-2 C.B. 33.

Statutory employees receive a Form W-2. A check is made in Box 15 to indicate that the worker is a statutory employee. Federal income tax withholding does not apply to statutory employees.

If statutory employees also have earnings from self-employment, they may not use expenses from services as a statutory employee to reduce net earnings from self-employment for purposes of SECA, IRC section 1402(a). This is because services as a statutory employee do not constitute the carrying on of a trade or business for purposes of SECA. Statutory employees are required to file a Schedule C for services performed as a statutory employee separate from a Schedule C that reports net earnings from self-employment.

---

## CATEGORIES OF STATUTORY EMPLOYEES

---

**Statutory  
employee  
treatment**

Recently, workers who were otherwise common law employees have claimed to be statutory employees to be eligible for the treatment of Rev. Rul. 90-93. The issue in Rev. Rul. 90-93 was whether a full-time life insurance salesperson who was treated as an employee for FICA purposes under IRC section 3121(d)(3) was also an employee for purposes of IRC sections 62 (relating to above the line deductions) and 67 (relating to two percent floor on miscellaneous itemized deductions). The holding was that a full-time life insurance salesperson described in IRC section 3121(d)(3) is not an employee for purposes of sections 62 and 67. Rev. Rul. 90-93 also applied to all other statutory employees described in IRC section 3121(d)(3) in connection with expenses they incur in the conduct of their trades or businesses.

If a worker's return appears to take inconsistent positions, further evaluation is appropriate. For example, if a worker's return includes a W-2 indicating employee status yet claims deductions related to this income on Schedule C, you should ask the worker for an explanation of the potentially inconsistent positions. If the worker is not a statutory employee, the appropriate adjustment should be made.

Remember, the worker can be a statutory employee only if the worker is an independent contractor under the common law standard.

---

## CATEGORIES OF STATUTORY EMPLOYEES

---

**Statutory  
employee benefit  
plans**

Except for full-time life insurance salespersons, statutory employees under IRC section 3121(d)(3) remain independent contractors for employee benefit purposes. Thus, they are not eligible to participate in the employee benefit plans sponsored by the business for employees and cannot enjoy the exclusions from income for amounts paid under accident and health insurance arrangements under IRC sections 104, 105, and 106 to the extent that those income tax exclusions apply only to employees. However, statutory employees can establish and maintain their own self-employed retirement plans.

Full-time life insurance salespersons are an exception. They are treated as employees not only for FICA tax purposes, but also for certain employee benefit programs maintained by the business. IRC section 7701(a)(20). Thus, they may participate as employees under the business's group term life insurance program under IRC section 79, apply the exclusions available to employees participating in the business's accident and health plans under IRC sections 104, 105, and 106, apply the exclusion from income under IRC section 101(b) for employer provided death benefits, and participate as an employee in the business's qualified deferred compensation or retirement plans under IRC section 401(a) and the business's cafeteria plan under IRC section 125. On the other hand, a full-time life insurance salesperson may not base contributions to a self-employed retirement plan (commonly called a Keogh plan) on the compensation received from the insurance business.

---

## STATE AND LOCAL GOVERNMENT EMPLOYEES

---

### **218 Agreement**

IRC section 3121(d)(4) provides that workers for state and local governments are employees for FICA purposes if the governmental unit has entered into an agreement with the Social Security Administration to provide FICA coverage pursuant to Section 218 of the Social Security Act. These agreements may be broad or may deal with very specific worker groups. Since April 20, 1983, coverage under a 218 agreement cannot be terminated.

---

### **Can be employees for FICA purposes under common law**

As a result of legislative changes since 1986, workers for state and local governments can also be employees for FICA purposes if they are employees under the common law rules, even though the worker's services are not covered under a Section 218 Agreement.

In analyzing how workers who are not covered under a Section 218 Agreement are treated, it is helpful to keep in mind that FICA taxes consist of two components, Old Age, Survivors, and Disability Insurance (OASDI) and Hospital Insurance (Medicare).

For services performed after July 1, 1991, both the OASDI and the Medicare components of FICA apply to state and local government common law employees, unless the employee is covered by a public retirement system. As most of these governments have broad coverage in their public retirement systems, relatively few state and local government employees are covered by this rule.

The Medicare portion of FICA taxes applies to wages of state and local government common law employees hired after March 31, 1986, unless the employee meets the continuing employment exception of IRC section 3121(u)(2)(C).

---

## STATUTORY NON-EMPLOYEES

---

**Introduction**

Workers in three occupations will not be treated as employees for FICA, FUTA, or federal income tax withholding purposes provided they meet certain qualifications. These workers are referred to as "statutory non-employees." IRC section 3508 provides that, for all IRC purposes, qualified real estate agents and direct sellers are statutory non-employees. IRC section 3506 provides that, for purposes of subtitle C of the IRC relating to employment tax, (FICA and FUTA taxes, and federal income tax withholding), qualifying companion sitters are statutory non-employees.

---

**Qualified real estate agents**

IRC section 3508 provides that a worker is a qualified real estate agent if the following requirements are met:

1.	The worker is a licensed real estate agent.
2.	Substantially all of such worker's remuneration for services is directly related to sales or other output rather than to the number of hours worked.
3.	A written contract exists between the worker and the business for which services are being performed that provides that the worker will not be treated as an employee for federal tax purposes.

Proposed Treas. Reg. section 31.3508-1(b)(2) defines services performed as a real estate agent and provides examples. Services do not include management of property.

---

**Direct sellers**

IRC section 3508 provides that a worker is a direct seller if the following qualifications are met:

1.	The worker is engaged in the sale of consumer products in the home or in other than a permanent retail establishment.
2.	Substantially all of such worker's remuneration for services is directly related to sales or other output rather than the number of hours worked.
3.	A written contract exists between the worker and the business for which the services are being performed that provides that the worker will not be treated as an employee for federal tax purposes.

---

## STATUTORY NON-EMPLOYEES

---

### Direct sellers, cont'd

The proposed regulations drafted for IRC section 3508 include detailed explanations of the terms used to define "direct seller." Since their publication in 1986, the regulations have come under increasing criticism. One area that has been attacked concerns the definition of "consumer products." Proposed Treas. Reg. section 31.3508-1(g)(3) defines "consumer products" as tangible personal property used for personal, family, or household purposes, including property intended to be attached to, or installed in any real property.

---

### Litigation of definition of consumer products

The definition of "consumer products" was litigated in *Cleveland Institute of Electronics, Inc.*, 787 F.Supp. 741 (DC. ND. Ohio 1992). In this case, the products being sold were home study educational courses. The Service deemed these courses to be intangible in nature and consequently held that they did not meet the proposed regulations' definition of "consumer products." The District Court's consideration of this matter resulted in the conclusion that the proposed regulations' definition of "consumer products" was unnecessarily restrictive. In deciding that the workers selling these courses were independent contractors, the court expanded the definition to include not only tangible consumer goods, but also intangible consumer services such as the courses at issue.

---

### Consumer products- definition expanded

This expanded definition of "consumer products" was subsequently cited in *The R Corporation*, 94-2 USTC par. 50,380 (DC. M.D. FL (1994)) where sellers of TV cable services were involved. In ruling that the sellers of cable service were direct sellers under IRC section 3508, the court concluded that the cable service being sold was an intangible consumer product.

Based upon the litigation cited above, and pending finalization of the regulations and further consideration of this issue in that context, cases should not be developed based on a distinction between tangible and intangible products; *i.e.*, both types of products will qualify. In your consideration of direct seller cases, care should be taken, therefore, to ensure that your research is current.

---



## STATUTORY NON-EMPLOYEES

---

**Newspaper carriers and distributors**

The Small Business Job Protection Act added qualifying newspaper distributors and carriers as direct sellers. Under the amendment, a person engaged in the trade or business of the delivery or distribution of newspapers or shopping news qualifies as a direct seller provided all remuneration is directly related to sales or output, rather than hours worked. Also, the services must be performed pursuant to a written contract that provides the person will not be treated as an employee for Federal tax purposes. The provision is effective with respect to services performed after December 31, 1995.

---

**Companion sitters**

IRC section 3506 provides that a companion sitter will not be an employee of a companion sitting placement service if the companion sitting placement service neither pays nor receives the salary or wages of the sitter. The placement service may be compensated on a fee basis by either the sitter or the person or business for which the sitting is performed.

The companion sitter is deemed to be self-employed unless considered to be a statutory or common law employee of the person or business for which the services are performed. Treas. Reg. section 31-3506-1(c) and (d).

---

**Quick reference**

**Exhibit 3-1** at the end of this lesson was prepared to provide you with a quick reference regarding the tax treatment by the business of FICA, FUTA, and federal income tax withholding of wages earned by the various types of workers discussed in this lesson and Lesson 2.

---

## SUMMARY

---

**Review of lesson** The following summarizes what we have covered in this lesson:

- |    |  |
|----|--|
| 1. | Officers of corporations are employees for purposes of FICA, FUTA, and federal income tax withholding unless the services rendered are minor or nominal, and they neither receive nor are entitled to receive any compensation.  |
| 2. | Certain classes of workers who do not meet the common law rules of determining employer-employee relationships are still employees for FICA tax purposes. These statutory employees are: <ul style="list-style-type: none"><li>• Agent or commission drivers.</li><li>• Full-time life insurance salespersons.</li><li>• Home workers.</li><li>• Traveling or city salespersons.</li></ul>       |
| 3. | Before a worker in one of these four categories is considered a statutory employee, three general requirements must be met: <ul style="list-style-type: none"><li>• Contract of service states that the work will be performed personally.</li><li>• Worker has no substantial investment in facilities.</li><li>• Continuing relationship exists between the worker and the business.</li></ul> |
-

## SUMMARY

---

**Review of lesson  
cont'd**

- |   |
|---|
| <p>4. In determining whether a worker is an employee, first apply the common law rules. If the facts do not support a position that a worker is a common law employee, then apply a test to determine if the worker is a statutory employee. If you determine that a statutory employee situation exists, the business is liable for FICA tax. The business may also be liable for FUTA tax. Remember, the determination that a worker is a statutory employee is made for employment tax purposes. Thus, the worker is not subject to federal income tax withholding and is not eligible for voluntary federal income tax withholding because the common law status is that of independent contractor, not employee.</p> |
| <p>5. Qualified real estate agents, direct sellers, including newspaper carriers and distributors, and companion sitters are statutory non-employees and are not treated as employees for purposes of FICA, FUTA, and federal income tax withholding if they meet certain IRC requirements.</p>   |
-

## EXERCISES

---

**Instructions** Complete the exercises below. Be sure to explain your answers.

---

**Exercise 1** A company is a wholesale distributor of automobile parts and rubberseal compounds to be inserted in automobile or truck tire tubes. Salespersons spend all their working time soliciting orders for the distributor's products from retail automobile dealers, gasoline service stations, repair shops which also sell at retail, truck fleet owners who contract with merchants to deliver packages, and owners of taxicabs and limousines used for transporting passengers. Twenty percent of the working time is spent selling to owners of taxicabs and limousines. Is the worker a statutory employee?

---

**Exercise 2** An insurance salesperson is engaged full-time in soliciting life insurance and annuity contracts for four different businesses. This salesperson maintains an office in the home and spends approximately an equal amount of time selling for each business.

- a. Is the salesperson a statutory employee of any of the businesses? Why or why not?
  
  
  
  
  
  
  
  
  
  
  - b. Would there be any difference if the salesperson worked for only two businesses, assuming equal time was spent between each business?
-

## EXERCISES

---

Exercise 2,  
cont'd

- c. Would your answer change if 80 percent of the working time was devoted to one business?

---

Exercise 3

G is a transcriber for the N company, a court reporting business. G is engaged more or less regularly by the N company. G furnishes all supplies and equipment, performs the services at home under no direct supervision, and is not an employee under the common law rules. Even though G is not a common law employee, is G subject to FICA? FUTA? federal income tax withholding? Cite your authority.

---

Exercise 4

Certain drivers who work for a local bakery are not considered by the bakery to be its employees. A written contract provides that the drivers furnish their own trucks and pay all their own expenses. The drivers have no other substantial investment in facilities. The bakery goods are purchased from the bakery which has no control over the prices at which the goods are resold. The drivers are not permitted to return unsold goods. It is further agreed that the drivers are to perform the delivery services personally, except in case of illness, when they may hire a substitute. Would you consider these drivers statutory employees?

---

## CASE STUDIES

---

**Instructions**

Use the following instructions for all cases in this lesson:

1.	Read the following facts.
2.	List all the facts that illustrate whether the workers in question are common law employees, statutory employees, or independent contractors.
3.	Identify any additional facts that should be developed.
4.	Pool your ideas and develop a group answer.
5.	Select a member of your group to orally present the group solution to the class.

---

## CASE STUDY 3-1

---

**Introduction**

Below is information regarding a contract agreement required to be signed by salespersons for a real estate business.

---

**Contract agreement - salespersons**

Salespersons agree to:

1.	Work diligently in conducting their business and increase the goodwill and reputation of the business.
2.	Provide their own license, which is required by state law, pay their own dues for membership in the local real estate exchange, and provide their own transportation.
3.	Report to the office daily and attend weekly sales meetings. These, however, are not mandatory.
4.	Take turns keeping the office open on Saturday afternoon and Sunday.
5.	Refrain from selling real estate for other businesses and from making sales in their own name and on their own behalf.
6.	Solicit new listings and customers.
7.	Pay all of their own expenses.

---

**Contract agreement-business**

The business agrees to:

1.	Make available to the salespersons all current listings and facilities of the business's office which include clerical help and office expenses.
2.	Assist the salespersons in their work by providing advice, instructions, and cooperation.
3.	Furnish necessary business cards, forms, and stationery.

---

## CASE STUDY 3-1

---

**Additional  
information**

The following information was provided:

1.	Each salesperson is provided with a manual which explains the business's operating policies in detail.
2.	All sales are closed in the name of the business.
3.	Commissions are paid to the business and are divided monthly between the salesperson and the business according to a fixed schedule.
4.	The contract provides that the salesperson will be an independent contractor and responsible for all federal taxes.

---



## CASE STUDY 3-2

---

**Facts provided**

The following are facts provided by the taxpayer:

- An owner-operator of a truck established a pick-up and delivery laundry and dry cleaning service route through door-to-door solicitation. The owner-operator entered into an oral special rate agreement with a laundry whereby customers' articles of clothing were taken to the laundry for processing.
  - The driver has solicited laundry business for a number of years. Prior to the oral agreement with the present laundry, customer articles were taken to other laundries for processing.
  - The driver has no defined territory. The customers may call the owner-operator at home for pickup. The customer list is not provided to the laundry and the route may be sold or transferred without the laundry's approval.
  - The laundry's name is not on the driver's truck. The laundry refers most requests for service to their salaried drivers who perform the same services but do not own their trucks.
  - The owner-operator driver retains a percentage of the retail price charged to customers and turns over the balance to the laundry company for its services. The driver handles the accounts, makes collections, bears all truck expenses, has no supervision from the laundry, and has no investment in the laundry facilities.
-

October 30, 1996

this page left intentionally blank

<b>TREATMENT BY BUSINESS UNDER DIFFERENT EMPLOYMENT TAXES</b>			
<b>Type of Worker</b>	<b>Income Tax Withholding</b>	<b>Social Security</b>	<b>Federal Unemployment</b>
Common Law Employee	Withhold	Taxable	Taxable
Corporate Officer	Withhold	Taxable	Taxable
Statutory Employees			
Agent and commission driver	No Withholding	Taxable	Taxable
Full-time life insurance salesperson	No Withholding	Taxable	Exempt
Full-time traveling or city salesperson	No Withholding	Taxable	Taxable
Home worker	No Withholding	Taxable if paid \$100 or more in cash during the calendar year	Exempt
218 Employee	Withhold	Taxable	Exempt
Statutory Non-Employees			
Qualified real estate agent - IRC section 3508(b)(1)	No Withholding	Exempt*	Exempt
Direct seller - IRC section 3508(b)(2)	No Withholding	Exempt*	Exempt
Companion sitter - IRC section 3506	No Withholding	Exempt*	Exempt
Section 530 Employee (See Chapter 3)	No Withholding	Exempt**	Exempt

\* However, statutory non-employees are subject to SECA.

\*\* Employees owe employee share of FICA.

## ANSWERS TO EXERCISES

### LESSON 1

---

**Exercise 1** If a business is not required to file an information return because the income paid to a worker is less than \$600, could section 530 relief be available?

**Answer**

Yes. Only required returns need to be filed.

---

**Exercise 2** When the business has more than one class of worker involved in the independent contractor issue, and there is inconsistent treatment with respect to one of the classes of workers, would section 530 relief be denied to all classes of workers?

**Answer**

No. Section 530 relief would be denied for all workers in the class in which there was inconsistent treatment. The other classes would be allowed the relief.

---

**Exercise 3** If the business filed information returns for only a portion of the workers involved in the independent contractor issue, could section 530 relief be available?

**Answer**

Section 530 relief would be allowed only for the individuals and periods for whom information returns were filed.

---

---

**Exercise 4**

From 1980 to 1994, R, Inc. provided consultants to utility companies as independent contractors. In 1995, by agreement with one utility, R treated its consultants as employees. It continued to treat all other similarly situated consultants as independent contractors. To which workers could section 530 relief apply?

**Answer**

No safe haven for employment tax treatment of any worker would apply if the business treated any worker holding a substantially similar position as an employee for employment tax purposes (*Institute for Resource Management Inc. v. U.S.*, 22 Cl. Ct. (1990)).

---

**Exercise 5**

A construction company that had treated its workers as employees from 1970 to 1978 began treating its workers as independent contractors in 1979. In your audit of the 1992 tax year, could section 530 treatment be awarded to the construction company?

**Answer**

Section 530 relief is unavailable because the employer had treated drivers as employees for "any period beginning after December 31, 1977" (section 530(a)(1)(A) and Rev. Rul. 84-161, 1984-2 C.B. 202)).

---

**Exercise 6**

If a business failed to file information returns for one year but did file the returns for the prior and subsequent years, could section 530 relief be allowed?

**Answer**

Section 530 relief would be allowed for all years **except** the year the business failed to file information returns.

---

---

**Exercise 7**

Does an IRS contact by correspondence constitute a past examination?

**Answer**

If the correspondence contact was made to verify a discrepancy disclosed by an information matching program (for example, an IRP, self-employment tax, and similar service center programs), such contacts do not constitute a past examination. They are referred to as "adjustments."

If correspondence contact entailed the examination or inspection of the business's records to determine the accuracy of the deductions claimed on a return, such contacts constitute an examination.

---

**Exercise 8**

Q corporation has 30 workers that it treats as independent contractors. However, in a prior audit of Q corporation, the examiner did not raise the issue. The examiner requested Forms 1099 of the Q corporation and found that Forms 1099 had not been filed for any of the 30 workers. The corporate officer stated that the corporation forgot to file Forms 1099, but they were prepared and filed during the examination. Is the corporation entitled to relief under section 530? Explain your answer.

**Answer**

No. The failure to supply Forms 1099 to the IRS, before the due date of February 28, is a failure to meet the "all required returns" consistency test and, thus, eliminates Section 530 relief.

---

---

**Exercise 9**

A, a sole proprietor, treated a number of workers as independent contractors. The IRS audited A in 1990 and raised no employment tax issues. In 1991, the proprietorship assets were transferred to A's newly organized controlled corporation, W, in a tax free transfer of assets under IRC section 351. The nature of the business remained unchanged after the incorporation, and W continued to treat the workers as independent contractors. In 1995, the IRS initiated an audit of W. Does W have a safe haven under section 530?

**Answer**

W had not met the audit safe haven because it was A, not W, who was audited. However, under the "other reasonable basis" test, W may rely on the previous audit of A, in which the IRS did not challenge the employment tax treatment of the individuals, because W is a continuation of A's proprietorship in corporate form. W has continued to treat the individuals in the same manner as A. Rev. Rul. 83-152, 1982 C.B. 172

---

**Exercise 10**

Can a member of a related group rely on a private letter ruling, a determination letter, issued to one of the other members within the group?

**Answer**

No. Each member of a related group is considered to be a separate employer. Therefore, only the member receiving the determination letter can rely on it under the judicial precedent safe haven. However, if the facts are the same, the business may have "other reasonable basis."

---

**Exercise 11**

During the examination, you find that the business misstated the facts in the private letter ruling that it requested. Can the business have section 530 relief based on the ruling?

**Answer**

If the facts are misstated, if significant facts were omitted, or if there has been a substantial change in the facts since issuance, the business may not rely on a Private Letter Ruling or determination letter (IRC section 6110(j)(3)).

---

---

**Exercise 12**

YZ, Inc. operates facilities where dentists conduct their practices. In 1995, you audit YZ, Inc. and question whether the dentists were properly treated as independent contractors. YZ, Inc. has requested relief under section 530 because of reasonable basis. YZ, Inc. had contacted the State Dental Board and been advised that it would be illegal under state law for it to enter into an employer-employee relationship with a dentist. Is YZ, Inc. allowed section 530 relief?

**Answer**

Yes. YZ's reliance on the Dental Board's advice was a reasonable basis under Section 530 for treating the dentists as independent contractors (*Queensgate Dental Family Practice, Inc.*).

---

**Exercise 13**

The N corporation is owned and operated by its two officers. The officers perform substantial services for N corporation, and they direct and control all of the corporate operations. N corporation treats the officers as independent contractors rather than employees and pays them compensation characterized as "draws" rather than "salaries." During an examination, you question whether N should have treated these amounts as wages. N corporation has requested relief under section 530. They believe that it was reasonable for them not to pay employment taxes because the compensation was classified as "draws" and not "salaries." Would you apply section 530?

**Answer**

No. Since the officers are performing substantial services typical of officers and are paid for those services, they are employees of the corporation for purposes of federal tax law. Even though the corporation calls the officer's pay "draws" rather than "salaries," there is no reasonable basis for treating the officers as other than employees, even under a liberal application of the reasonable basis rule of section 530 Rev. Rul. 82-83, 1982-1 C.B. 151.

---



## ANSWER TO CASE STUDY 1-1

---

**Facts**                    P is a sole proprietor of a machine shop. P engaged eight machinists and one general custodian to work in the shop.

In 1997, you examine P's 1995 returns. For the year under examination, P's filing of Forms 941 was sporadic and inconsistent. P did not file any Forms 941 with respect to any of the workers for the first two quarters of 1995. However, for the third and fourth quarters P filed Forms 941 listing some of the workers but neglecting to list others. The working arrangement during the quarters in which Forms 941 were filed remained unchanged from the quarters in which they were not filed. P explained this inconsistency by stating that the workers were initially hired on a part-time basis as casual laborers, and that it could not afford to pay the employment taxes.

---

**Rationale**                The working arrangement during the quarters in which the workers were not treated as employees remained unchanged from the quarters in which the same workers were treated as employees. In addition, the workers who were not treated as employees throughout the year performed services similar to those performed by the workers who were treated as employees part of the year. This is inconsistent treatment.

---

**Conclusion**              The business is not entitled to section 530 relief.

---

## ANSWER TO CASE STUDY 1-2

---

**Facts**

You have the business's 1991 and 1992 tax years before you. The business owns and operates a trucking business that hauls bulk cement products, livestock, grains, and machinery. The business engaged several workers to drive trucks. The workers are paid a 25 percent commission on each load, and they are responsible for paying any assistants they hire to help drive or load and unload the trucks. The workers are not given any training, but they are required to have chauffeurs' licenses. The customers set the time at which the loads are to be picked up, and the business simply relay this information to the workers. The workers are not required to accept any hauling job. Log books are required if the trip is beyond 100 miles. The business provides the workers with trucks and pays all other operating expenses.

The business did not file Forms 1099 for the years 1991 and 1992. The business's 1989 tax return was examined and resulted in no employment tax liability with respect to the drivers for 1989. There were no Forms 1099 filed for the 1989 return. The business states that during the examination of the 1989 return, it was not advised of the filing requirements for Form 1099.

---

**Conclusion**

The prior audit can be a safe haven, but the business did not file Forms 1099; therefore, "failure to file all returns" eliminates section 530 relief for 1991 and 1992. However, section 530 relief may be available for subsequent years if forms 1099 are filed.

---

## LESSON 2

### ANSWER TO CASE STUDY 2-1

**Facts**

An attorney is a sole practitioner who rents office space and pays for the following items: telephone, computer, on-line legal research linkup, fax machine, and photocopier. The attorney buys office supplies and pays bar dues and membership dues for three other professional organizations. The attorney has a part-time receptionist who also does the bookkeeping. The attorney pays the receptionist, withholds and pays federal and state employment taxes, and files a Form W-2 each year. For the past two years, the attorney has had only one client, a corporation with which there has been a long-standing relationship. The attorney charges the corporation an hourly rate for services and sends monthly bills detailing the work performed for the prior month. The bills include charges for long distance calls, on-line research time, fax charges, photocopies, mailing costs, and travel costs for which the corporation has agreed to reimburse.

**Conclusion**

This list is not all-inclusive.

Employee	Neutral Value	Independent Contractor
Single client	Paid by the hour	Hired secretary
	reimbursed for expenses	No financial control
	Payment of bar dues	Opportunity for profit or loss
	Direction	economic independence

The attorney could be an independent contractor even though at the beginning independent contractor status is clear but at the end it is less clear. It is not clear that the attorney is an employee even with the addition of the last fact.

## ANSWER TO CASE STUDY 2-2

---

### Facts

A manufacturer's representative (rep) is the sole proprietor of a building supplies business and has an exclusive contract with a building supplies manufacturer. The rep has the sole right to the territory covered, sells only that manufacturer's products, but did not pay anything for the right to the territory. The rep has a bachelor's degree in civil engineering and belongs to several professional associations, paying membership dues. The rep has an office and a secretary, but the manufacturer does not reimburse for these expenses. The rep's name appears in the yellow page advertisements under both the rep's sole proprietorship name and the name of the manufacturer represented. The rep is required to provide regular trip reports to the manufacturer and attend sales meetings and trade shows conducted in the rep's territory.

The rep bids on portions of major commercial construction contracts. These jobs require engineering skills and design work to adapt the building materials to the project plans. All bids are subject to the manufacturer's post-review. Upon winning a bid, the rep engages and pays the workers who will install the building materials, providing the necessary construction bonds. The rep submits invoices to the general contractor for payment directly to the rep on forms prescribed by the manufacturer. If the general contractor fails to pay, the rep is responsible for collecting and is liable to the manufacturer for payment.

---

## ANSWER TO CASE STUDY 2-2, CONT'D

**Conclusion**

This list is not all-inclusive.

Employee	Neutral	Independent Contractor
one party (exclusive contract)	Bachelor's degree	own expenses
subject to management post review	professional organizations	advertised
attend meetings & submit report		liable for payment to manufacturer
used manufacturer's forms		hired workers for installation
		submit invoice to G.C. for payment
		has to pay bills

It should be clear that the rep is an independent contractor. Although the manufacturer post-reviews the rep's paperwork and bids and imposes meeting requirements, these facts are outweighed by the rep's potential to experience profit or loss and the ability to direct and control the work.

## ANSWER TO CASE STUDY 2-3

---

**Facts**

A computer programmer is laid off when Company X downsizes. Company X agrees to pay the programmer \$10,000 to complete a one-time project to create a certain product. It is not clear how long it will take to complete the project, and the programmer is not guaranteed any minimum payment for the hours spent on the project. The programmer does the work on a new high-end computer, which cost the programmer \$5,000. The programmer works at home and is not expected or allowed to attend meetings of the software development group. Company X provides the programmer with no instructions beyond the specifications for the product itself. The programmer and Company X have a written contract, which provides that the programmer is considered to be an independent contractor, is required to pay federal and state taxes, and receives no employee benefits from Company X. Company X will file a Form 1099.

---

**ANSWER TO CASE STUDY 2-3, CONT'D**

**Conclusion**

This list is not all-inclusive.

Employee	Neutral	Independent Contractor
Laid off: hired back for the same kind of job	Cost of equipment	One time job
	Work at home	No minimum payment
	Length of time for "job"	Not expected or allowed to go to meetings
	no benefits	written contract
		F1099 (intent)
		pays taxes
		no benefits
		no instructions - only specifications

The computer programmer is an independent contractor with respect to the services provided to Company X.

## LESSON 3

---

### Exercise 1

A company is a wholesale distributor of automobile parts and rubberseal compounds to be inserted in automobile or truck tire tubes. Salespersons spend all their working time soliciting orders for the distributor's products from retail automobile dealers, gasoline service stations, repair shops which also sell at retail, truck fleet owners who contract with merchants to deliver packages, and owners of taxicabs and limousines used for transporting passengers. Twenty percent of the working time is spent selling to owners of taxicabs and limousines. Is the individual a statutory employee?

### Answer

The customers to whom sales are made all qualify as contractors or retailers, etc., except the owners of taxicabs and limousines. Thus, 80% of the working time is spent soliciting orders from customers of the types specified in IRC section 3121(d)(3)(D). Under Rev. Rul. 55-31, 1955-1 C.B. 475, 80% of working time satisfied the "principal business activity" test that was the predecessor of the "full-time" test. Regs. section 31.3121(d)-1(d)(3)(iv)(b) continues the "principal business activity" standard. In this case, the principal business activity is soliciting orders for one principal and selling to the requisite types of customers. This meets the regulatory test, so the individual is an employee of the distributor for FICA and FUTA purposes.

---

### Exercise 2

An insurance salesperson is engaged full-time in soliciting life insurance and annuity contracts for four different companies. This salesperson maintains an office in the home and spends approximately an equal amount of time selling for each company.

- a. Is the salesperson a statutory employee of any of the companies? Why or why not?

### Answer

The individual is not an employee of any of the companies, as the "primarily for one life insurance company" rule is not met.

---

### Exercise 2, cont'd

- b. Would there be any difference if the salesperson worked for only two businesses, assuming equal time was spent between each company?



**Answer**

No. Same as a.

- c. Would your answer change if 80 percent of the working time was devoted to one business?

**Answer**

If 80% of the individual's working time were devoted to one business, then the agent would probably meet all three specific requirements for being a statutory employee. 80% would satisfy the requirement in the Regulations section 31.3121(d)-1(d)(3)(ii) that the salesperson must sell "primarily" for one business.

---

**Exercise 3**

G is a transcriber for the N company, a court reporting business. G is engaged more or less regularly by the N company. G furnishes all supplies and equipment, performs the services at home under no direct supervision, and is not an employee under the common law rules. Even though G is not a common law employee, is G subject to FICA? FUTA? WT? Cite your authority.

**Answer**

G, who is not an employee under the usual common law rules, is nevertheless an employee for FICA purposes because G is a home worker under the provisions of IRC section 3121(d)(3)(C). The pivotal question is whether the worker has a substantial investment in facilities used in connection with their work. Rev. Rul. 70-340, 1970-1 C.B. 202, holds that the transcriber's investment in a typewriter and a transcriber is not substantial. This conclusion is reached by taking into account the character and volume of work being done, the useful life of the equipment, and the amount of income generated by its use. G's compensation is not subject to FUTA and WT.

---

*Continued on next page*

---

**Exercise 4**

Certain drivers who work for a local bakery are not considered by the bakery to be its employees. A written contract provides that the drivers furnish their own trucks and pay all their own expenses. The bakery goods are purchased from the bakery which has no control over the prices at which the goods are resold. The drivers are not permitted to return unsold goods. It is further agreed that the drivers are to perform the delivery services personally, except in case of illness, when they may hire a substitute. Would you consider these drivers statutory employees?

**Answer**

The drivers are statutory employees for FICA and FUTA purposes. All general requirements and the specific requirements have been met.

Stress the fact that the investment in a vehicle is not considered in determining whether an individual is a statutory employee. Note that owner-drivers are the only statutory employees whose compensation is subject to FUTA. See section 3306(i).

---

## ANSWER TO CASE STUDY 3-1

**Introduction**

Below is information regarding a contract agreement required to be signed by salespersons for a real estate business.

**Contract agreement - salespersons**

Salespersons agree to:

1.	Work diligently and conduct their business and to increase the goodwill and reputation of the business.
2.	Provide their own license, which is required by state law, pay their own dues for membership in the local real estate exchange and provide their own transportation.
3.	Report to the office daily and attend weekly sales meetings. These, however, are not mandatory.
4.	Take turns keeping the office open on Saturday afternoon and Sunday.
5.	Refrain from selling real estate for other brokers and from making sales in their own name and on their own behalf.
6.	Solicit new listings and customers.
7.	Pay all of their own expenses.

**Contract agreement-firm**

The business agrees to:

1.	Make available to the salespersons all current listings and facilities of the business's office which include office help and office expenses.
2.	Assist the salespersons in their work by providing advice, instructions, and cooperation.
3.	Furnish necessary business cards, forms and stationery.

## ANSWER TO CASE STUDY 3-1,CONT'D

**Additional  
information**

---

The following information was provided:

1.	Each salesperson is provided with a manual which explains the business's operating policies in detail.
2.	All sales are closed in the name of the business.
3.	Commissions are paid to the business and are divided monthly between the salesperson and the business according to a fixed schedule.
4.	The contract provides that the salesperson will be an independent contractor and responsible for all federal taxes.

---

## ANSWER TO CASE STUDY 3-1, CONT'D

---

**Solution** If it is the intent of the business that an employer-employee relationship is not to exist, then the business must not retain the right to control the manner and means whereby the salespersons perform their work. The business may set the tasks, define the objectives, and specify the results to be achieved. The mode and manner of accomplishment must, however, be left to the salesperson.

---

**Conclusion** The salespersons in this case are determined to be independent contractors (self-employed persons). Some of the factors present in the relationship would tend to lead you to the conclusion that the relationship is that of employer and employee.

1. The salespersons are to work diligently for the business.
2. They have agreed to report to the office daily and attend weekly sales meetings.
3. They take their turns in keeping the office open.
4. They may not sell in their own name nor for other brokers.

On the other hand, they:

1. Pay their own expenses;
2. Provide their own licenses;
3. Furnish their own transportation;
4. Are not required to report to the office or attend sales meetings;
5. Are compensated only by commissions they earn.

They would not be employees even if the business exercised greater control because they meet the qualifications of IRC section 3508(b)(1).

---

See also

- 
- Rev. Rul. 76-138, 1976-1 C.B. 315.
  - *Dimmitt-Rickhoff-Bayer Real Estate Co. v. Finnegan*, 179 F.2d 882, (8th Cir. 1950).
  - IRC section 3508.
-

## ANSWER TO CASE STUDY 3-2

---

**Facts provided**

The following are facts provided by the taxpayer:

- An owner-operator of a truck established a pick-up and delivery laundry and dry cleaning service route through door-to-door solicitation. The owner-operator entered into an oral special rate agreement with a laundry whereby customers' articles of clothing were taken to the laundry for processing.
  - The driver has solicited laundry business for a number of years. Prior to the oral agreement with the present laundry, customer articles were taken to other laundries for processing.
  - The driver has no defined territory. The customers may call the owner-operator at home for pickup. The customer list is not provided to the laundry and the route may be sold or transferred without laundry's approval.
  - The laundry's name is not on the driver's truck. The laundry refers most requests for service to their salaried drivers who perform the same services but do not own their trucks.
  - The owner-operator driver retains a percentage of the retail price charged to customers and turns over the balance to the laundry business for its services. The driver handles the accounts, makes collections, bears all truck expenses, has no supervision from the laundry, and has no investment in the laundry facilities.
-

## ANSWER TO CASE STUDY 3-2, CONT'D

---

**Solution**

The driver is an independent contractor.

1. In an employer-employee relationship, the employer has the right to direct and control the manner in which the services are performed. A person who is subject to the control and direction merely as to the **result** to be accomplished by the work and not the means and methods to be used is an independent contractor.
2. The laundry neither exercises nor has the right to exercise control over the owner-operator driver in the performance of services.
3. The agent-driver or commission driver who is not an employee under the usual common law rules may still be considered an employee of the principal for limited purposes if the driver meets certain tests. One test which must be met is that the driver serves customers designated by the person for whom services are performed as well as the driver's own customers. In this situation there is no contract of service and no principal as those terms are defined in Treas. Reg. sections 31.3121(d)-1(3)(i) and 31.3121(d)-1(4)(ii). Consequently, there can be no statutory employee finding.
4. The owner-operator driver is engaged in a trade or business and is self-employed. The owner-operator is responsible for paying self-employment tax under SECA. The laundry business is not liable for any employment taxes related to this owner-operator driver.

This case is based on Rev. Rul. 54-555, 1954-2 C.B. 339.

---