INDEPENDENT CONTRACTOR DETERMINATIONS

STATUS

Representative Jim McDermott (D-WA) and Senator John Kerry (D-MA) have introduced identical bills, H.R. 6128 and S. 3786, the Fair Playing Field Act.

President Obama included language in his Fiscal Year 2011 proposed budget that is similar to the approach of the legislative proposals.

The Internal Revenue Service (IRS) has ramped up its enforcement activities. Separately, the first two thousand letters out of an eventual total of six thousand over three years will be sent to some very unfortunate small businesses by the IRS. The reason businesses will be getting these letters is because their business rhymes with "random." The IRS is conducting what it calls a National Research Program (NRP). The purpose is to determine whether businesses are properly classifying individuals as employees or independent contractors. This is supposedly a scientific sample. Businesses are not selected based on the likelihood of having an issue with classifications but because they are unlucky. Every business that gets the letter will be put through an audit, regardless. In addition to the classification issue the examiners will also be looking at executive and officer compensation whether fringe benefits are being properly reported as taxable or nontaxable income. (The IRS has a publication at www.irs.gov that is a pretty good primer on fringe benefits, Publication 15-B, Employer's Tax Guide to Fringe Benefits.)

BACKGROUND

As long as there have been employment taxes, tax administrators and taxpayers have been engaged in a dialogue to answer the question "Who is an employee?"

The Internal Revenue Code (IRC) and Treasury Regulations (limitations on the ability of the latter to address the subject will be discussed later) provide only basic guidance on the question of "who is an employee?" IRC Section 3121, for example, defines an employee as "any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee."

Treasury Regulation 31.3401 defines the employment relationship as: "Generally the relationship of employer and employee exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so."

The IRS, faced with the responsibility to make determinations of the status of individuals, uses a "facts and circumstances" approach appropriate with its statutory authority. Thus it has largely

fallen to the courts to determine whether various facts and factors are relevant to the determination of "who is an employee." Over time, that body of cases and rulings under our system of jurisprudence is what is referred to as the "common law."

In 1987, in Revenue Ruling 87-41, the IRS distilled the "common law" into 20 factors.

The modern day context for the application of the common law test is often framed around whether the individual is an employee or an independent contractor. At issue are not only the various employment tax obligations, but income tax and employee benefit ramifications.

Other Statutory Influences

Section 530 of the Revenue Act of 1978 was the vehicle for one of the most significant changes in the common law-based process of determining the classification of an individual as employee or independent contractor. Originally, it was meant to be a temporary provision to provide Congress more time to sort through the options for the appropriate rules regarding classification. The section was made permanent in 1982. It was modified in 1986, 1996, and 2006.

Certain types of business activity were specifically designated as not employees such as direct sellers and real estate agents. For other industries, Section 530 provided a "safe harbor" which is generally stated in the negative: "Section 530 allows a taxpayer to treat a worker as not being an employee for employment tax purposes (but not income tax purposes), regardless of the worker's actual status under the common law test, unless the taxpayer has no reasonable basis for such treatment or fails to meet certain requirements."

One of the "reasonable bases" is a long-standing recognized practice in the industry. Some of the major changes to Section 530 made by the Small Business Job Protection Act of 1996 focused on that basis.

The 1986 and 2006 changes addressed specific activities and services and whether Section 530 relief was available. Section 1706 of the Tax Reform Act provides that Section 530 does not apply to a person who provides services as an engineer, designer, drafter, computer programmer, a systems analyst, or similar skilled worker. Section 864 of the Pension Protection Act of 2006 provides the similar worker consistency requirement of Section 530 does not apply to an individual who provides services as a test proctor or room supervisor by assisting in the administration of college entrance or placement examinations, provided the service recipient is a 501 (c) organization.

An important provision of Section 530 that has had an influence on the determination process over the last 30 years states, "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 taxes by the Department of the Treasury (including the IRS) with respect to the employment status of any individual for purposes of the employment taxes."

While the small business community has staunchly defended the continued need for the prohibition until there is a consensus regarding the appropriate objective standard for determinations (the very debate that led to Section 530), for the purposes of tax administration and compliance the regulation prohibition provision has relevance for understanding how outreach, education, compliance, and enforcement has been and can be shaped.

Finally, when the common law test is not met, other statutory provisions may provide for a more specific determination.

As noted, the regulation prohibition provision of Section 530 has had a significant influence on the tools available to tax administrators, practitioners, and taxpayers to understand their responsibilities and rights in the determination process.

Most determinations are made on the basis of the completion of Form SS-8 by the individual performing the services and the service recipient. For many years the Form SS-8 tracked what had come to be known as the traditional 20 point common law test. Form SS-8 was recently revised to conform to another document.

In 1996, mindful of the regulation prohibition, the IRS published a training manual for examiners, entitled "Independent Contractor or Employee? Training Materials." The manual grouped the common factors in three categories: (1) behavioral control; (2) financial control, and (3) relationship of the parties. The manual also "updated" commentary on the relevance of some of the traditional common law factors in the economy as it was in the 1990s. The current Form SS-8 tracks the three "basket" concept of the Training Manual.

LEGISLATION

The Fair Playing Field Act of 2010 ends the moratorium on IRS guidance addressing worker classification

The Section 530 will be repealed. The section 530 safe harbor will continue to be available to employers with respect to the treatment of an individual for Federal employment tax purposes *only* until the individual has a reclassification date.

Under the Fair Playing Field Act of 2010, an individual's "reclassification date" is the earlier of the following two dates: (1) the first day of the first calendar quarter beginning more than 180 days after the date of an "employee classification determination" with respect to such individual; or (2) the effective date of the "first application final regulation" issued by the Secretary of the Treasury with respect to such individual (or if later, the first day of the first calendar quarter beginning more than 180 days after such regulation is issued). The "first applicable final regulation" is the first final regulation or other guidance of general applicability which sets forth the factors for determining the employment status of a class of individuals holding positions similar to the position held by such individual. An "employee classification determination" with respect to an individual is a determination by the Secretary of the Treasury, in connection with an audit of the taxpayer that begins after the date that is one year after the date of enactment, that

a class of individuals holding positions with the taxpayer that are substantially similar to the position held by the individual are employees.

The legislation amends the provisions of the Code that provide for reduced penalties for failure to deduct and withhold income taxes and the employee's share of FICA taxes to provide that the reduced penalties are not available in cases where there is noncompliance with guidance issued by the Secretary of the Treasury without a reasonable basis for treating an individual as an independent contractor.

The legislation requires persons who contract independent contractors on a regular and ongoing basis to provide a written statement to each independent contractor of the Federal tax obligations of independent contractors, the labor and employment law protections that do not apply to independent contractors, and the right of the independent contractor to seek a status determination from the IRS. Taxpayers who fail to provide such a statement in a timely manner or who provide an incorrect/incomplete statement will be subject to the penalties imposed by the Code for failures to meet certain information reporting requirements.

OUTLOOK

When he was Senator Obama, the President had a bill that was similar to the one introduced by Representative McDermott and Senator Kerry.

With the IRS' own interest in this issue at an all time high, the possibility of passage is also at an all time high