New York State Bar Association

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NYSBA

February 24, 1998

VIA FEDERAL EXPRESS

The Honorable Bill Archer
Chairman
Committee on Ways and Means
House of Representatives
Washington, D.C. 20515

Re: Report on Recent Developments Regarding Worker Classification With Revised Proposals For Reform

Dear Chairman Archer:

I am pleased to submit for your consideration the enclosed report on recent developments regarding worker classification with our proposals for reform. The principal authors of this report are Sherry S. Kraus, Co-Chair of our Committee on Individuals, and Robert G. Nassau and Kenneth Bersani, members of that Committee. The report addresses the issues and complexities underlying worker classification and the difficulties of effecting reform in this area. This is a longstanding problem which is a matter of real concern to a large number of individual workers, small and large businesses and the Internal Revenue Service. Attempts to effect reform in this area have defied resolution for over two decades.

The report reviews the developments of the last two years, including the initiatives undertaken by the Internal Revenue Service and recent legislation. The report concludes that, while these efforts have addressed many difficult issues, disputes regarding the classification of workers will not be resolved until the classification of a worker becomes a tax neutral decision, i.e., classification as an independent contractor (1) affords no cost or competitive advantage to the employer, (2) does not afford the worker a greater opportunity for tax avoidance and thus (3) does not result in losses to the Internal Revenue Service because of a substantially lower compliance rate. To achieve this end, the report makes a number of recommendations intended to improve compliance for independent contractors and to equalize the administrative burdens to the employer of reporting and withholding regardless of how the worker is classified. The report also recommends removing the Section 530 moratorium so as to allow Treasury and the Internal Revenue Service an opportunity to develop more flexible and updated guidelines to determine appropriate worker classification under the common law rules. The report emphasizes the desirability of separating the solution of the tax issues from issues arising in other areas where employee status is significant, *e.g.* pension benefits.

The report analyzes proposed legislation which would introduce bright line definitional safe harbors for classification of independent contractors. Since the safe harbors under several of these Bills make classification as an independent contractor easily obtainable, the report concludes that such legislation (a) should be tied to reforms to improve independent contractor compliance in income and employment tax reporting and withholding and (b) should be limited in application to income and employment taxes only.

We emphasize that this is an area of the tax law where there are no easy, single-variable solutions and where anything short of comprehensive reform will create more problems than are cured.

We will, of course, be glad to be of further assistance in this process. If you think we can be of help, please call the undersigned or Sherry Kraus, ((716) 262-3360) the principal author of this report.

Yours very truly,

Richard O. Loengard, Jr.
Chair

Copies of the enclosed report have also been sent, under a similar cover letter, to:

The Honorable Charles B. Rangel
House Ways & Means Committee
House of Representatives

The Honorable William V. Roth, Jr.
Chairman, Committee on Finance
United States Senate

The Honorable Daniel P. Moynihan
Committee on Finance
United States Senate

The Honorable Nancy L. Johnson
Chair
Subcommittee on Oversight
House Ways & Means Committee

The Honorable William J. Coyne
Ranking Minority Member
Subcommittee on Oversight
House Ways & Means Committee

The Honorable Donald C. Lubick
Assistant Secretary (Tax Policy)
Department of the Treasury

The Honorable Charles O. Rossotti
Commissioner
Internal Revenue Service

The Honorable Stuart L. Brown
Chief Counsel
Internal Revenue Service

Lindy L. Paull
Chief of Staff
Joint Committee on Taxation

cc: Jonathan Talisman
Deputy Assistant Secretary (Tax Policy)
Department of the Treasury

James D. Clark
Majority Chief Tax Counsel
House Ways and Means Committee

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House Ways and Means Committee

Mark Prater
Majority Chief Tax Counsel
Senate Finance Committee

Nicholas Giordano
Minority Chief Tax Counsel
Senate Finance Committee

Tom Roesser
Tax Counsel
Senate Finance Committee

NEW YORK STATE BAR ASSOCIATION
TAX SECTION

REPORT ON RECENT DEVELOPMENTS REGARDING WORKER CLASSIFICATION WITH REVISED PROPOSALS FOR REFORM[1]

The purpose of this Report is to address the issues raised by three Bills, now pending in Congress, which attempt to introduce greater certainty into worker classification by setting forth objective criteria which, if met, would establish a safe harbor for characterization of a worker as either an independent contractor (two of the Bills) or as an employee (one of the Bills).

In October 1995, we prepared and submitted a report analyzing the issues and complexities underlying worker classification and proposed reforms intended to improve the administration and enforcement of worker classification for income and employment tax purposes.[2] In the two years since our 1995 Report, there have been a number of developments relating to the worker classification issue including:

- Congressional Hearings. The House Ways and Means Subcommittee on Oversight, chaired by Representative Nancy Johnson (R-CT), conducted hearings in June of 1996 on the worker classification issues.[3]

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[1]The principal authors of this Report are Sherry S. Kraus, Robert G. Nassau and Kenneth Bersani. Helpful comments were provided by Robert Wild, Arnold Kapiloff, Richard Loengard, Jr., Michael Schler, Robert Scarborough, Harold Handler, Steve Todrys and Kimberly Blanchard.

[2]New York State Bar Association Tax Section, "Report on Proposed Reforms to Administration and Enforcement of Employment Tax and Income Taxes on Individual Workers", 95 TNT 208-23 (October 17, 1995). (This Report is hereafter referred to as the "1995 Report".)

[3]By "worker classification", we mean the determination of whether a service provider is to be characterized as an "employee" or "independent contractor" for

- Internal Revenue Service Administrative Reforms. The Internal Revenue Service has initiated a number of administrative reforms to address many of the problems discussed in our 1995 Report.
- Legislative Changes. Further changes have been made to Section 530 of the Revenue Act of 1978 (hereafter "Section 530"), including (i) the addition of certain objective standards to determine if the employer has met the requirements of Section 530 and (ii) a shifting of the burden of proof in certain instances to the Internal Revenue Service. The jurisdiction of the Tax Court has been expanded to include appeals from adverse Internal Revenue Service determinations on worker classification.

We believe that the developments of the last two years (particularly the Internal Revenue Service initiatives and the legislative reform to allow appeal to the Tax Court) have gone a long way to address many of the concerns that we expressed in our 1995 Report. Accordingly, we have concluded that certain of our recommendations in the 1995 Report should be altered.

We also believe that the worker classification issue has been unnecessarily complicated by the fact that the standards for classification are being used for more than one purpose, i.e., characterization of a worker as an "employee" not only has ramifications for income and employment tax purposes, but also in determining that

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income and employment tax purposes. This determination implicates a variety of federal tax consequences. For a discussion of these consequences, see the 1995 Report.

worker's participation in an employer's pension and health insurance plans, federal and state labor law protections and other "safety net" legislation that extends only to the category of workers characterized as "employees". Each of these distinct areas raises very different policy concerns. As a consequence, the fiscal, social and political considerations involved in establishing the standards of classification may be in conflict. It is our recommendation that Congress separate each of the following distinct areas and deal with each independently. It would then be possible to determine whether the same classification standards are appropriate for each.

- Compliance. Income and employment tax reporting and withholding is a vital function in the collection of the appropriate amount of tax. We believe this to be the principal area of concern. Employers are required to report wages paid to employees, to withhold income tax and the employee's share of social security (including Medicare) tax on payments to them, and to pay the employer's share of social security tax. In contrast, payments to independent contractors are not subject to withholding of income and social security tax. The independent contractors are responsible for remitting these taxes. In addition, payments to independent contractors are subject to more limited information reporting rules than payments to employees. The policy issues in developing classification rules for reporting and withholding purposes are essentially questions of how to improve compliance without creating undue administrative burdens on taxpayers. We believe that the

best approach is to revise current law information reporting and withholding rules to improve independent contractor compliance. If a more level compliance playing field can be developed, there will be far less significance to the choice of employee or independent contractor status. Moreover, the audit, retroactive adjustments and penalty issues would take on less importance with improved independent contractor information reporting requirements.

- Qualification for Tax Deductions and Exclusions. A different set of policy questions are at stake with respect to the availability of deductions and exclusions in determining income and employment tax liability. For example, employees are subject to the "2-percent floor" imposed by Section 67 of the Code, while deductibility of work-related expenses incurred by independent contractors is not so limited. Independent contractors, but not employees, are permitted to deduct under Section 162(1) of the Code a specified percentage of their expenses for medical insurance. Employees, however, are permitted under Section 106(a) of the Code to exclude from income the value of health insurance provided by employers.

- Pension and Other Employment Benefits. A third area in which the employee/independent contractor distinction is used is determining eligibility for pension benefits and legal protection extended to employees. Workers classified as employees may be eligible for

employer-provided pension plan coverage and other benefits and protection of employment law that are denied to independent contractors. The social and political considerations involved with this are totally different from those involving tax compliance.

Compliance issues of withholding and reporting are the subject matter of this Report. The other areas are beyond the scope of this Report. We recommend that these compliance matters be addressed separately from issues in these other areas. We believe it would be possible to draft rules to deal with compliance and administrative concerns which in the interest of simplification might include bright line tests to distinguish independent contractors from employees for these purposes. Since employee benefits and protection would not be jeopardized or enhanced by such an approach, the political issues arising from such bright line tests might be avoided.

Hence, we recommend decoupling reporting and withholding issues from other issues, and we recommend that the problems in each area should be analyzed separately. If the differences between the treatment of independent contractors and employees in the compliance area can be reduced, the stakes, and the significance of the distinction for compliance purposes, will diminish and, as previously indicated, the number of serious audit and penalty disputes would be substantially reduced.

Thus, our recommendations in this Report focus on ways to reduce opportunities for noncompliance by independent contractors and to make the administrative burdens of reporting and withholding more equal for employers, regardless of whether they classify their workers as independent contractors or as employees. If these goals can

be achieved, the importance of the distinction for collection of income and employment taxes will be sharply reduced, and, in addition, it may be easier to address classification issues in other areas of the law based on the different policies involved there.

This Report is divided into six parts. In Part I, we summarize the discussions and proposals presented at the 1996 hearings on this issue before the House Ways and Means Subcommittee on Oversight. In Part II, we describe the administrative reforms implemented by the Internal Revenue Service since our 1995 Report. In Part III, we summarize recent case law in this area. In Part IV, we summarize the legislative changes that have occurred since our 1995 Report. In Part V, we summarize three pieces of proposed legislation in the worker classification area. In Part VI, we analyze the developments since our 1995 Report and revise our recommendations for reform to reflect the changes that have occurred within the last two years.

We conclude with recommendations to increase the compliance and reporting requirements applicable to independent contractors and those which hire them so that the importance of the classification decision is minimized. Moreover, while we emphasize the need for changes to improve compliance in the independent contractor area, we also favor amendments to Section 530 to afford Treasury and the Internal Revenue Service an opportunity to formulate by regulation and/or revenue ruling a test to determine appropriate worker classification.

PART I. Hearings

On June 4 and June 20 of 1996, the Subcommittee on Oversight of the House of Representatives' Committee on Ways and Means conducted hearings on "current issues relating to the classification of workers as employees or independent contractors for federal tax purposes".[4] In recognition of the difficult and longstanding nature of the problem, Chairman Nancy Johnson likened the Committee's task as "going to wander into wild woods where even angels fear to tread."[5] Chairman Johnson stated that the objective of the Committee was "to identify clear, fair, objective standards to prevent the Internal Revenue Service from abusing taxpayers, while assuring fair share compliance."[6] She noted that "probably no other area of the law has remained so unclear for so long."[7]

Testimony was taken at the hearings not only on issues relating to worker classification but also on proposals currently pending before Congress. Invited to testify were Representatives John Christensen (R-NE) and Jay Kim (R-CA), who were sponsors of separate pieces of legislation intended to impose bright line safe harbor tests for independent contractor classification.

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[4]Subcommittee on Oversight, Committee on Ways and Means hearing entitled Employment Classification Issues, June 4 and June 20, 1996, Serial 104-84. (This hearing is hereafter referred to as the "1996 Hearing".)

[5]1996 Hearing at 6.

[6]Id.

[7]Id. at 101.

Summary of Treasury, IRS and GAO Testimony

Donald Lubick, Acting Assistant Secretary for Tax Policy of the United States Department of the Treasury, testified that he had been "talking about the same issue when he left the Treasury in 1980."[8] While observing that most workers clearly fit within either the employee or independent contractor category, he noted that there are inevitably many arrangements that share some of the principal characteristics of both independent contractor and employee status where the classification is less clear. Secretary Lubick noted that the characterization of a worker as an employee or an independent contractor under the common law principles will always involve inherently factual questions with an infinite variety of situations that are difficult to verbalize in mechanical terms.[9] He stated that the famous quotation by Justice Stewart about pornography is equally applicable on this issue: "I know it when I see it even though I cannot articulate how to define it."[10] He expressed his hope that everyone would agree that simply calling a worker an independent contractor by applying a label that the parties agree to is not enough to justify a different treatment for that worker from a worker in an identical factual situation who is treated as an employee and where the employer has assumed the burdens of providing employee unemployment protection, benefits and undertaken the burdens of tax compliance with respect to that worker. He stated Treasury's view that "economic realities should override attempts by any

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[8]1996 Hearing at 111.

[9]1996 Hearing at 112.

[10]Id.

individuals to opt out of the system simply by mislabeling."[11]

As developed in the Treasury, IRS and GAO testimony, government witnesses pointed out that worker classification not only affects income, social security and Medicare taxes, but also affects a host of other issues for American workers.[12] Any changes to the current worker classification rules that result in large scale shifts of workers from employee status to independent contractor status could affect not only the tax issues resulting from such a shift but could also impact the application of the body of laws that create the "safety net" of benefits and protections that extend to the sector of American workers who are treated as employees.[13] If legislation converts more and more workers from employee status to independent contractor status for all purposes, fewer workers will receive the benefits of employer-provided pension plans, lower-cost group health insurance, employer education programs, unemployment insurance, workers compensation, minimum wage and maximum hour protections, work place health and safety standards, family and medical leave protections.[14] Furthermore, workers who are classified as independent contractors have greater opportunities than employees to avoid full compliance with the tax laws.[15] Because employees are subject

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[11] Id. at 113.

[12] 1996 Hearing at 122 and 123. See also testimony of GAO representative at pages 159, 160, 164 and 166 referring to the body of laws that create a "safety net" for the American workers who are treated as employees.

[13] 1996 Hearing at 122, 123, 159 and 166.

[14] 1996 Hearing at 122 and 123.

[15] 1996 Hearing at 118 and 164.

to withholding and their wage income is reported with great precision to the Internal Revenue Service, workers who are treated as employees report almost 100% of their income. In contrast, independent contractors can more easily omit income on their tax returns without detection.[16] Based on a 1992 study by the IRS, independent contractors report 97% of their income if Forms 1099 are filed, but only 83% of their income is no Forms 1099s are filed. Misclassified independent contractors report only 62% of their income (77% if Forms 1099 are filed, 29% if Forms 1099 are not filed).[17] Furthermore, an independent contractor can incorporate and avoid information reporting on his earnings altogether under current information reporting rules.

It was also noted that even if independent contractors report 100% of their income, there are greater opportunities to overstate deductible business expenses than for employees and that many independent contractors use these opportunities with the result of significant amounts of noncompliance.[18] Treasury and IRS estimate that, based on the 1992 IRS study, approximately 2.6 billion dollars are lost each year in unpaid social security, Medicare and federal unemployment insurance taxes by reason of workers misclassified as independent contractors. The same study concluded that the income tax underpayment from misclassification of workers resulted in the loss of

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[16]1996 Hearing at 118.

[17]1996 Hearing at 139. IRS data from a 1992 study shows that reporting is lower for misclassified workers than for independent contractors in general.

[18]1996 Hearing at 118.

approximately an additional 1.6 billion dollars annually.[19]

Secretary Lubick noted that the much criticized twenty-factor test of the Internal Revenue Service (i.e., Rev. Rul. 87-41) was not intended to do the job that it has been asked to do.[20] He stated, however, that if Congress would permit the Treasury and the Internal Revenue Service to give guidance in the area by removing the Section 530 moratorium (which now prohibits the issuance by Treasury or the IRS of any further guidance on this subject) that the IRS could withdraw the twenty-factor test and develop new tests that would clarify and update the factors to be considered in deciding the appropriate classification of a worker under the common law rules.[21]

Secretary Lubick stated Treasury's opposition to any solutions in this difficult area by the use of bright line definitional safe harbors for classifying workers since such would simply "provide a road map to avoidance" because individuals can manipulate definitions to control the classification.[22] He proposed instead that the focus be shifted to introducing simpler and more expeditious methods for resolving worker classification conflicts and to introducing procedures by which the financial stakes would be lowered so that the consequences of a reclassification would not be devastating.[23]

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[19]1996 Hearing at 138 and 139.

[20]1996 Hearing at 115.

[21]1996 Hearing at 115.

[22]1996 Hearing at 113.

[23]1996 Hearing at 113 and 151.

Treasury and IRS described a number of IRS initiatives that had been recently undertaken to address some of the major problems and complaints in this area. New training materials were issued in March of 1996 and released to the public for comment. The stated objective of the retraining program is to reeducate examiners on making legally correct determinations regarding whether workers are properly classified as employees or independent contractors under the common law standard with an understanding of how the twenty factors described in Rev. Rul. 87-41 may (or may not) apply to that determination. The training program is also intended to promote better consistency and uniformity in worker classification determinations to prevent widely differing determinations for workers similarly situated.[24] The examiner is also now required to consider at the outset the possibility of Section 530 safe harbor relief available to the taxpayer even if the issue is not raised by the taxpayer.[25]

To address the issue of potentially devastating assessments upon retroactive reclassification of workers, Treasury and the IRS described a two year pilot program initiated by the Internal Revenue Service in March of 1996 called the "Classification Settlement Program" (hereafter alternatively referred to as "CSP"). For employers who have complied with the Form 1099 information return laws, the examiner will offer a settlement at the examination level based on a series of graduated settlement offers

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[24]1996 Hearing at 120 and 121.

[25]1996 Hearing at 120 and 121. Even in cases where, under common law rules, the worker should have been classified as an employee rather than as an independent contractor, the employer is protected against retroactive and prospective reclassification of the worker if the employer satisfies the three tests for Section 530 relief. For a more detailed description of the Section 530 tests, see Part II, Infra.

which will limit any deficiency assessment resulting from the misclassification to one year so long as the employer agrees to reclassify the workers prospectively.[26]

In March of 1996, the IRS also initiated a one year pilot program to allow immediate severance and appeal to the IRS Appeals Office of any employment tax issue arising on audit.

In lieu of the current legislative attempts to address the problems of worker classification by imposing a bright line definitional safe harbor test for classification as an independent contractor, Treasury made the following proposals:

a. Modify Section 530 to allow the Internal Revenue Service to waive past deficiencies for misclassification of workers if the employer (i) complies with Form 1099 filing requirements; (ii) can demonstrate a reasonable basis for meeting the requirements of Section 530 and (iii) agrees to prospective reclassification of its workers as employees. This legislation would have the effect of extending relief from retroactive assessments to taxpayers who fall just short of meeting the Section 530 requirements so long as they agree to come into compliance in their classification of workers for the future.[27]

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[26]1996 Hearing at 121 and 122.

[27]1996 Hearing at 125. Under current Section 530, the employer would not be entitled to any waiver of past deficiency assessments for improper classification of a worker as an independent contractor unless all three tests of Section 530 are met. The recommended legislative change would broaden and complement the relief now offered under the CSP at the IRS.

b. Enlarge the jurisdiction of the United States Tax Court to cover worker classification determinations for employment tax purposes. Access to the Tax Court would permit disputes to be resolved more quickly and at a lower cost than in Federal District Court or the Court of Claims. Simplified procedures should be made available for small business cases so that the issues could be resolved without requiring the business to retain counsel.[28]

c. Repeal the Section 530 moratorium that prohibits Treasury and the Service from issuing any further guidance on common law classification of workers. An improved understanding of the appropriate common law classification can be provided administratively by revenue ruling or other administrative guidance. Such guidance would allow future fine tuning of the classification criteria to reflect ongoing changes in the workplace and, thereby, be preferable to a "one-size fits all" legislative definition of independent contractor which may be appropriate in certain contexts but inappropriate in others .[29]

d. Stiffen the laws that currently contribute to a lower level of compliance for independent contractors by improving the information reporting system (Forms 1099). (The recommendations of our 1995 Bar Association

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[28]1996 Hearing at 125. This legislative change has been made since the hearing. (See Part IV),

[29]1996 Hearing at 124 to 126.

Report were noted.) Increase the penalty of $50 for failure to file an information return (which was last increased in 1982) to the greater of $50 per return or 5% of the total amount required to be reported. The strengthening of this penalty will provide stronger incentives to employers to comply with the information reporting rules. IRS studies conclude that the filing of Forms 1099 with respect to payments to independent contractors is the single most effective tool for enforcing proper reporting of income by independent contractors.

e. Modify the law to require information return reporting for payments made to a corporation for services provided (with appropriate exceptions to be prescribed in regulations). The purpose of this modification would be to eliminate easy avoidance of the information return filing rules for workers who incorporate.[30]

The GAO recommended study of the use of withholding taxes from payments made to independent contractors as a mechanism for significantly improving compliance with the income tax laws.[31] GAO conceded that the most important consideration in any withholding system of this type is that the tax withheld approximate the tax due for the year. GAO acknowledged the difficulties of imposing a withholding system on independent contractors who have widely varying annual net income. In addition to the problem of potential overwithholding, GAO noted that withholding taxes

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[30]1996 Hearing at 126.

[31]1996 Hearing at 170.

can also adversely affect cash flow. To address these issues, GAO suggested either a graduated withholding system to account for differences in expenses (presumably among occupation groups) or simply a very low flat rate of withholding (e.g., 5%) for all payments. Regardless of the amount withheld, the benefit from withholding would be to bring the worker into the system which, in itself, will substantially improve compliance. GAO also recommended that the laws on withholding be modified so that an independent contractor not be able to circumvent withholding by incorporating. Because any withholding system would likely need to exempt certain independent contractors, the withholding system must be complemented by an effective information reporting system.[32]

PART II. IRS REFORMS

As noted in the Treasury and Internal Revenue Service testimony described in Part I, the Internal Revenue Service has initiated a number of administrative reforms intended to address many of the concerns arising from the worker classification audit program.

a. Classification Settlement Program (CSP). This new settlement program was commenced in March of 1996 for a two year test period and is intended (i) to insure that examiners properly review taxpayer relief options under Section 530 even if not initiated by the taxpayer and (ii) to make a number of settlement offers available at the examination level which would normally not be available unless the taxpayer

[32] 1996 Hearing at 170.

exercised the right to appeal to IRS Appeals or to the courts. The settlement offer uses a standard closing agreement developed at the IRS National Office for settling Section 530 cases on the basis of hazards of litigation.[33]

Under the CSP, where it appears that a business erroneously treated a worker as an independent contractor rather than as an employee, the examiner is required to review whether the business might be eligible for relief under Section 530. If, after reviewing the facts and circumstances of the case, and after consulting with the group manager, the examiner concludes that the business is eligible for the CSP, a series of graduated settlement offers will be made available to the taxpayer. If the business meets the Section 530 reporting consistency requirement (i.e., complies with the Form 1099 reporting rules), but does not meet the Section 530 substantitive consistency requirement or the Section 530 reasonable basis test, the offer will be in the amount of a full employment tax assessment for only the one taxable year under examination computed under the provisions of IRC Section 3509, if applicable. If the business meets the reporting consistency requirement and has a colorable argument

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[33]To qualify for Section 530 relief, the business must meet three tests: (1) Reporting Consistency: All federal tax returns (including information returns) required to be filed by the taxpayer with respect to the individual for the period, must have been filed by the business on a basis consistent with the business's treatment of the individual as not being an employee; (2) Substantive Consistency: The business must have consistently treated similarly situated worked as independent contractors; and (3) Reasonable Basis: The business must have had some reasonable basis for not treating the worker as an employee. This may consist of reasonable reliance on: a judicial precedent, published ruling, a private letter ruling or technical advice memorandum issued to the taxpayer, the results of a past audit of the taxpayer's or a longstanding recognized practice of a significant segment of the industry. Any other reasonable basis will also suffice.

that it meets the substantive consistency requirement and the reasonable basis test, the offer will be an assessment equal to 25% of the employment tax liability for the audit year, computed using Section 3509, if applicable. In either form of settlement, the business must agree to properly classify its workers prospectively, thus ensuring future compliance. If it is determined that the business clearly meets all three requirements of Section 530, no assessment will be made and the business will be allowed to continue treating its workers as independent contractors if it chooses. However, if a business elects to convert its workers to the appropriate classification of employees prospectively, the business may enter into a closing agreement and, by doing so, will not give up its claim to Section 530 relief for prior years.[34]

Taxpayer participation in the Classification Settlement Program is voluntary and the CSP settlement offer may be accepted at any time during the examination process. A taxpayer's decline of the settlement offer will not affect appeal rights to IRS Appeals or rights to judicial review of the issue. However, if the business rejects the offer, the examiner may continue with traditional examination procedures and expand the audit to other open years. In cases where the taxpayer is not, under current law, required to issue information returns (e.g., reporting payments to a corporation or payments of less than $600), the taxpayer will still be eligible for the CSP.

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[34]This protection against loss of Section 530 relief upon change of workers to employee status was codified in the Small Business Job Protection Act of 1996. (See discussion infra)

In summary, the program is intended to provide an avenue for early resolution of disputed worker classification issues and to mitigate the consequences of retroactive assessments in cases where all of the criteria of Section 530 are not met so long as the taxpayer agrees to future compliance in the classification of the workers. This is accomplished by limiting the deficiency adjustment to only one year and by allowing the use of a standardized closing agreement at the examination level on settlement terms that would not normally be available at that level.[35]

b. Early Referral of Employment Tax Issues. A one year test program was begun in March of 1996 to introduce a procedure for early referral of employment tax issues to IRS Appeals. Where an unagreed employment tax issue arises at the exam level, the classification issue can be separated and sent to IRS appeals for quicker resolution of the entire case.[36]

c. Coordination of All Large Worker Classification Projects. All large worker classification projects will now require the approval of the National Office in Washington. This includes projects where the issue is not only the existence of an employer-employee relationship but also where the issue is the identity of the employer, e.g., employee leasing. The object is to promote uniform treatment of all affected taxpayers in an industry.[37]

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[35]Classification Settlement Program Fact Sheet Release, News Release 3/5/96, IR-96-7.

[36]IRS News Release, 3/5/96, IR-96-7.

[37]1996 Hearing at 138.

d. Updated Training Materials. The IRS has conducted a review of its existing employment tax compliance programs. The training materials for IRS examiners that handle worker classification issues have been revised. For the first time ever, the IRS requested comments on the training materials from the public. The stated intention of the training materials is to ensure that IRS examiners properly classify workers in a manner that is impartial and reflective of current law. Examiners are required to actively consider the application of the Section 530 safe harbor to the taxpayer's situation. When applying the common law standards for determining appropriate worker classification, the training materials emphasize that the relevant evidence to be considered may change over time because of changing business relationships in the work environment. Examiners are cautioned against a mechanical application of the twenty factor test and are directed instead to emphasize the statutory common law test of right to control. Examiners are advised that the use of independent contractors can be a legitimate business practice that will not be challenged by the Internal Revenue Service.

PART III. JUDICIAL DEVELOPMENTS

Although there continues to be a steady volume of reported cases in the worker classification area, there have been no cases that have "made law". This is necessarily the case in an area that is so fact-sensitive.

One recent case that has received a lot of publicity is Vizcaino v. Microsoft

Corp.[38] However, this was not a worker classification tax case. Microsoft had been audited nearly ten years ago regarding the characterization of its freelance workers, and had agreed with the Internal Revenue Service that those workers were employees for withholding and employment tax purposes. The dispute in Vizcaino involved the eligibility of freelance workers to participate in certain of Microsoft's qualified pension plans. This case points up the importance of worker classification beyond simply income and employment taxes. As we noted in our 1995 Report, the issue is no longer a matter of concern only to small businesses.[39]

PART IV. RECENT LEGISLATION

Both 1996 and 1997 saw statutory developments in the area of worker classification.

a. Changes to Section 530

As part of the Small Business Job Protection Act of 1996, Congress added a new subsection to Section 530 of the Revenue Act of 1978.[40]

Section 530 was originally enacted to protect employers from the potentially devastating consequences of a worker classification audit. Under Section

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[38]97 F.3d 1187 (9th Cir. 1997).

[39]The IRS is in the process of developing a CSP for pension reclassification issues. 15 Tax Mgmt. Weekly Rep. 1512 (Oct. 14, 1996).

[40]See Section 1122 of the Small Business Job Protection Act of 1996 (P.L. 104-188), which added new subsection 530(e) to Section 530 of the Revenue Act of 1978 (P.L. 95-600), effective for periods after December 31, 1996.

530, prior to its amendment by the Small Business Job Protection Act, an employer could avoid liability for having characterized a worker as an independent contractor (rather than as an employee) if the employer (1) always treated the worker as an independent contractor; (2) filed all returns (including information returns) required for the worker, and all the returns were consistent with independent contractor status; and (3) had a reasonable basis for treating the worker as an independent contractor. For purposes of this third condition, an employer was treated as having a reasonable basis for treating a worker as an independent contractor if such treatment was in reasonable reliance on (1) judicial precedent, published rulings, or technical advice or letter ruling to the employer; (2) a past Internal Revenue Service audit in which no assessment was made on account of improper treatment of the worker; or (3) a longstanding recognized practice of a significant segment of the industry in which the individual worked.

The Small Business Job Protection Act made several changes to these rules:

(1) The Internal Revenue Service must now provide the taxpayer with written notice of the provisions of Section 530 at the commencement of an audit involving worker classification issues.

(2) The "prior audits" safe harbor rule has been modified so that taxpayers may not rely on an audit unless the audit included an examination for employment tax purposes of whether the worker involved (or any worker holding a position substantially similar to the position held by the worker involved) should be treated as an

employee of the taxpayer.

(3) A worker does not have to otherwise be classified as an employee in order for Section 530 to apply. This reverses the IRS position that there must first be a determination that the worker is an employee under the common-law standards before relief can be available under Section 530.

(4) The industry practice safe harbor provisions have been altered to provide that the safe harbor does not require a showing of the practice of more than 25% of an industry (determined without taking into account the taxpayer). Because this is a safe harbor percentage, a lower percentage may still constitute a "significant segment of the industry" based on the particular facts and circumstances.

(5) A practice need not have continued for more than ten years in order for the industry practice to be considered longstanding. Since this is intended as a safe harbor, an industry practice in existence for a shorter period of time may still be considered "longstanding" based on the particular facts and circumstances.

(6) An industry practice may be treated as longstanding even if such practice commenced after 1978 (i.e., the enactment year of Section 530).

(7) The fact that a taxpayer changes its treatment of workers from independent contractor status to employee status for employment tax purposes will not affect the applicability of Section 530 for prior periods.

(8) The burden of proof in Section 530 has been modified to provide that if an employer establishes a prima facie case that it was reasonable not to treat a worker as an employee for purposes of Section 530, the burden of proof shifts to the Internal Revenue Service with respect to such treatment.

- In order for a shift in the burden of proof to occur, the taxpayer must fully cooperate with reasonable requests by the Service for information relevant to the taxpayer's treatment of the worker as an independent contractor.

b. Tax Court Review of Worker Classification

If an employer is denied independent contractor status for a worker, the employer now has the option of appealing to Tax Court to resolve the dispute concerning employment status. If it is determined by the Internal Revenue Service that (i) one or more of the taxpayer's workers are employees, or (ii) that the taxpayer is not entitled to relief under the safe harbor provisions of Section 530, the Tax Court has jurisdiction to determine whether the Internal Revenue Service is correct in its determination. The Tax Court review is de novo. A small case procedure is available where the amount of employment taxes in dispute is $10,000 or less for each calendar

quarter involved. New IRC Section 7436.

Previously, in employment tax cases, the Tax Court was not an available forum to litigate worker status or the amount of employment taxes owed. The only way an employer could contest the Internal Revenue Service's position was to meet the procedural requirements of a refund suit and sue either in the United State Court of Federal Claims or in Federal District Court. Generally, this would be done by paying the disputed employment taxes in connection with one employee for each quarter included in the assessment and then filing a refund claim.

PART V. PROPOSED LEGISLATION

In this part we will summarize three legislative proposals intended to introduce objective safe harbor tests in the classification of workers.

a. The Christensen Bill. The Independent Contractor Tax Simplification Act of 1995 (H.R. 1972; hereafter the "Christensen Bill") was introduced by Representative Jon L. Christensen (R-NE) on June 30, 1995, and ultimately enjoyed the co-sponsorship of 203 Congressmen (20 Democrats and 183 Republicans). The Christensen Bill was so popular that it was included, substantially verbatim, as Section 934 of the Revenue Reconciliation Bill of 1997 (subsequently renamed the Taxpayer Relief Bill of 1997 (H.R. 2014)), which Bill was reported by the House Ways and Means Committee on June 13, 1997, and was passed by the House of Representative on June 26, 1997.

The Senate's version of the Revenue Reconciliation Bill of 1997 (S. 949), which was reported by the Senate Finance Committee on June 20, 1997, and was passed by the Senate on June 27, 1997, did not contain any global provision regarding worker classification. Notwithstanding active negotiations up to the final moments, the Conference Report on the Taxpayer Relief Bill of 1997, reported by the Conference Committee, and enacted by Congress on July 31, 1997, did not include the Christensen Bill.[41]

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[41]Although the Taxpayer Relief Act of 1997 did not contain the Christensen Bill, there is evidence that a toned-down version of that Bill nearly made it into the Act. During the Conference Committee's negotiations, Representative Christensen was working with Representative Bill Archer (R-TX) and other members of the Conference Committee to revise his proposal in order to add anti-abuse provisions that would have prevented wholesale reclassification of workers as independent contractors. (In this regard, our 1995 Report noted this very flaw as one of the deficiencies of the Christensen Bill.) Although it is unclear whether Representative Christensen's new proposal was ever reduced to legislative language, the proposal was reported to consist of three changes: (1) prohibiting businesses from engaging former employees as independent contractors in the year after the employee had been on the payroll, if the basis for reclassification is that the former employee is now an incorporated independent contractor; however, employers could reclassify the greater of 3% of their work force or 10 such individuals before the prohibition is triggered; (2) making clear that independent contractors who incorporate must file the appropriate tax forms like any other incorporated business; and (3) requiring that the written agreement between the parties make clear the tax obligations assumed by the independent contractor. See Worker Classification Compromise May Face Procedural Problems on Senate Floor, 1997 DIR 137 (July 17, 19978), and Tax Conferees Continue Work on Reconciliation Package, 16 Tax Mgmt. Weekly Rep. 1099 (July 21, 1997) for reports of Representative Christensen's efforts. It was subsequently reported that the Republican members of the Conference Committee had accepted the Christensen Bill. However, it was obvious throughout the Conference Committee's negotiations that President Clinton (in part responding to intense objections by organized labor) was strongly opposed to the Christensen Bill in any guise. See Intensive Round of Talks Follows GOP Agreement on Some Tax Issues, 16 Tax Mgmt. Weekly Rep. 1,131 (July 28, 1997). As noted above and in the text, in the end the Christensen Bill was not included as part of the Taxpayer Relief Act of 1997.

The Christensen Bill sets forth objective criteria that must be met in order for a worker to be classified as an independent contractor. Specifically, the worker must satisfy three separate tests:

Under the first test, the worker must either: (1) have a significant investment in assets or training; (2) incur significant unreimbursed expenses; (3) agree to perform his services for a particular amount of time or to complete a specific result and be liable for damages for early termination without cause; (4) be paid primarily on a commission basis; or (5) purchase products for resale.

Under the second test, the worker must either: (1) have a principal place of business; (2) not primarily provide the service at the employer's place of business; or (3) pay fair market rent for use of the employer's premises. If none of these conditions is met, then the worker must either: (1) not be required to perform services exclusively for the employer in the current, preceding or subsequent year, and have performed a significant amount of services for other employers; (2) have offered to perform services for others; or (3) provide services under a registered business name.

Under the third test, the worker and employer must enter an agreement that provides that the worker will not be treated as an employee.

b. The Bond/Nickles Bill. The Independent Contractor Tax Reform Act of 1997 (S. 473; hereafter the "Bond/Nickles Bill") was introduced by Senator Christopher (Kit) Bond (R-MO) on March 19, 1997, with co-sponsorship by Senator Don Nickles (R-OK). Although the Bond/Nickles Bill was not included as part of the Senate's version of the Revenue Reconciliation Bill of 1997, it continues to be the subject of legislative

attention.

The Bond/Nickles Bill sets forth two safe harbors pursuant to which a worker will be classified as an independent contractor. If the worker does not satisfy either of those safe harbors, then all other present laws rules -- including Section 530 of the Revenue Act of 1978, and the common law test for worker classification -- will be applied.

Under the first Bond/Nickles Bill safe harbor, to avoid employee status the worker must: (1) have the ability to realize a profit or loss; (2) incur unreimbursed expenses that are ordinary and necessary to the worker's industry and which represent an amount at least equal to two percent of the worker's adjusted gross income attributable to services performed pursuant to one or more contracts with the employer; and (3) agree to provide services for a particular amount of time, or to complete a specific result or task. Under this safe harbor, the worker must also: (1) have a principal place of business; (2) not primarily provide the service at a single employer's facility; (3) pay a fair market rent for use of the employer's facility; or (4) operate primarily with equipment that is not supplied by the employer. Furthermore, the services must be performed pursuant to a written contract between the worker and the employer, and the contract must expressly provide that the worker will not be treated as an employee for federal tax purposes.

Under the second Bond/Nickles Bill safe harbor, a worker will be classified as an independent contractor if: (1) there is a written contract between the worker and the employer and the contract expressly provides that the worker will not be

treated as an employee for federal tax purposes (the same requirement as under the first safe harbor); (2) the worker conducts business as a properly constituted corporation or limited liability company under applicable state law; and (3) the worker does not receive from the employer any benefits that are provided to the employer's employees.

Neither Bond/Nickles Bill safe harbor will apply unless the employer satisfies its information reporting (i.e., Form 1099) obligations.

The Bond/Nickles Bill also repeals the safe harbor of Section 530 of the Revenue Act of 1978 and substitutes a new safe harbor that protects the employer and the worker against retroactive recharacterization of workers. Subsection (g) of the Bill precludes the Internal Revenue Service from assessing employment taxes for a worker who has been incorrectly characterized as an independent contractor so long as (1) the worker and the employer have a written contract meeting the requirements of subsection (d) described above; (2) both the worker and the employer have reported the payments for tax purposes consistent with independent contractor status; and (3) there is a reasonable basis for treating the worker as an employee. The safe harbor can be satisfied even if the employer and/or the worker did not satisfy the tax reporting requirement so long as there is "reasonable cause and not willful neglect" in the failure to report. No guidance is given regarding what would constitute "reasonable cause" for failure to report. If the requirements of subsection (g) are met, the Internal Revenue Service is precluded from assessing any deficiency for unpaid employment taxes against either the worker or the employer for a period earlier than 30 days after the

issuance of the "30 day letter" of proposed deficiency or the "90 day letter" (i.e., deficiency notice under Section 6212 of the Code).

c. The Visclosky Bill. Most recently, on October 8, 1997, Representative Peter Visclosky (D-IN) introduced a bill that would enumerate eight objective criteria to be used in determining the appropriate classification of a worker.[42] Specifically, under the Visclosky Bill, a worker would be presumed to be an employee unless all of the following eight requirements were met:

(1) the worker makes comparable services available to the general public on a regular and consistent basis and represents himself as an independent contractor with respect to those services;

(2) the worker has performed, or is available to perform, services for more than one employer at a time;

(3) the employer does not have the right (and does not attempt) to control the manner or means of the worker's performance of such services;

(4) the worker controls the means of performing the services, including setting the sequence and hours of work;

(5) the worker operates under contracts to perform specific services for specific amounts of money, the rate of which is negotiated for every service performed;

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[42]H.R. 2642 is co-sponsored by four other Democratic representatives.

(6) the worker may realize a profit or suffer a loss under contracts to perform services;

(7) the worker is responsible for the satisfactory completion of the work that the individual contracts to perform, and is liable for a failure to complete the work; and

(8) the worker incurs significant unreimbursed capital expenses (not typically incurred by employees) in carrying on the business activity in which such services are performed.

PART VI. ANALYSIS AND RECOMMENDATIONS FOR REFORM

Summary of 1995 Recommendations

Since we drafted our report in 1995, enormous attention has been focused on the difficult issues of worker classification and the need for reform. In our 1995 Report, we made fifteen specific recommendations that we believed would improve the administration and enforcement of the federal income and employment taxes as applied to workers and their employers. Many of those recommendations did not relate to the precise issue of worker classification but rather related to ancillary compliance issues such as information reporting.

Our major concerns at that time were (a) the devastating effect of unlimited retroactive assessments upon IRS reclassification of a worker from independent contractor to employee status; (b) the Internal Revenue Service's overly restrictive interpretation of the Section 530 safe harbor and (c) the IRS's rigid application of its "twenty factor" test under Rev. Rul. 87-41 with a resulting strong bias toward finding

employee classification. At that time, we favored legislation that set forth objective criteria for safe harbor classification of workers as independent contractors and as employees. As to those workers who did not fall clearly within either safe harbor category, we favored removal of the Section 530 moratorium so that Treasury could develop additional guidance to determine the appropriate worker classification under the common law tests. We also recommended the creation of a new information reporting form that could be submitted by employers who desired to trigger the start of the statute of limitations, thereby limiting their exposure to no more than three years of retroactive reclassification in cases where the safe harbor provisions of Section 530 would not prevent a deficiency assessment for past years. We noted that the greatest impetus for reform in this area has been the potentially devastating deficiency assessments that a retroactive worker reclassification can create. The Report observed that at least one court has upheld the Service's position that the filing of a Form 1099-MISC by an employer for workers classified as independent contractors does not trigger the start of the statute of limitations. Accordingly, the Service is free to challenge an employer's classification of its workers as independent contractors many years after the fact unless retroactive reclassification is protected under the safe harbor provisions of Section 530.

In that Report, we also discussed some of the problems with the continued reliance on Section 530 to prevent IRS reclassifications of workers for prior periods. At that time, Section 530 discouraged employers from reclassifying their workers to employee status, even if such was the correct or desired classification, since such

could result in their losing Section 530 protection. Section 530 also results in revenue losses for each protected, but incorrectly classified, worker since the employer's one-half of social security and Medicare taxes is never paid by anyone. (The worker, as an employee, would only be required to pay the employee one-half of social security and Medicare taxes; the employer would not have to pay the employer one-half of social security and Medicare taxes because Section 530 allows the employer to continue treating the worker as an independent contractor.) Section 530 also can result in unfair competitive advantages to employers who fall within its safe harbor over employers who bear the costs and administrative burdens of correctly treating their workers as employees.

Comment on Changes Since 1995. The initiatives implemented by the Internal Revenue Service in its revised training program and classification settlement program have gone a long way to address the concerns that we raised in our 1995 Report. Evident in those initiatives is a radical change in IRS philosophy toward application of the Section 530 safe harbor and toward mitigating the financially devastating consequences of retroactive deficiency assessments. In our view, the Classification Settlement Program is achieving its objective of providing an early, fair and non-litigious resolution of disputed worker classification issues on terms that, in many cases, are more favorable (and, certainly, more certain) than the taxpayer could obtain at IRS Appeals or in court. The program also has the salutary effect of promoting corrected future reclassification of workers -- a result that is not accomplished through Section 530 which allows continued treatment of workers as independent contractors

even though that would not be the correct classification under common law rules.

Under the CSP, an employer who does nothing more than file a Form 1099 with respect to a worker will be offered a settlement that limits the employer's exposure to past deficiency assessments to the one taxable year under examination so long as the employer agrees prospectively to reclassify the worker to an employee. In addition, if the employer demonstrates any "colorable argument" of meeting the "substantive consistency" test and the "reasonable basis" test of Section 530, the deficiency assessment is reduced to only 25% of the employment tax liability for the one year under examination so long as the workers are prospectively reclassified as employees.

In our view, the CSP has the dual benefit of achieving future corrected reclassification of workers without the financially devastating consequences of a multiple year retroactive deficiency assessment.

We also believe that in its retraining program, the IRS is (a) acknowledging the legitimate role of independent contractors in the modern day work place; (b) educating its auditors on the appropriate standards for applying the Section 530 safe harbor and (c) recognizing that a mechanical application of the twenty factor test is ill conceived and improper. Reforms have also been implemented at the IRS to ensure greater uniformity in the outcome of worker classification audits. This is particularly important when competitors in the same industry group are being audited.

In the legislative arena, we believe that the expansion of Tax Court jurisdiction to include review of worker classification issues has been an enormous step in the right

direction in resolving the concerns of worker classification. A small business employer can now have an independent review of a disputed worker classification case on a more expedited and less expensive basis than had been previously available. Contributing to the high level of frustration with former IRS policy was the absence to the small business employer of affordable and expedited judicial review of the IRS determination. The costs of (i) paying a portion of the deficiency assessment; (ii) going through the refund claim process and (iii) appealing the matter to Federal District Court or the Court of Claims, often made the judicial appeal process out of reach of many taxpayers even in circumstances where the taxpayer likely would have prevailed on the merits. The ability to obtain Tax Court review of a disputed classification, along with a small case procedure for reviewing disputed employment taxes of $10,000 or less for each calendar quarter involved, now provides a long needed forum for independent review.

The recent statutory changes to Section 530 have both good and bad features. The change which requires the Internal Revenue Service to provide the taxpayer with written notice of the provisions of Section 530 at the commencement of an audit involving worker classification issues is commendable. We also agree with the change that narrows the overly broad "prior audits safe harbor rule" and extends this safe harbor protection only to cases where the audit includes an examination for employment tax purposes of whether the worker involved (or any worker holding a position substantially similar to the position of the worker involved) should be treated as an employee of the taxpayer.

We also agree with the change to Section 530 that allows an employer to prospectively change its treatment of workers from independent contractor status to employee status without relinquishing the protection of the Section 530 safe harbor for deficiency assessments against prior periods. This change addresses one of the major drawbacks of relief under Section 530, i.e., that it perpetuates the continued improper treatment of a worker as an independent contractor even though that worker, under common law rules, should be classified as an employee. However, we are concerned with recent changes, such as the shifting of burden of proof to the IRS, that make Section 530 easier to satisfy at a time when reform should be focused on encouraging employers to classify their workers correctly for the future while offering relief from retroactive assessments in appropriate cases.

As to the legislative proposals which would introduce bright line objective safe harbor tests for classification of workers, we continue to be of the view that any legislative effort to provide a broad safe harbor definition for independent contractors must be tied to legislative changes which improve tax compliance by independent contractors. This is particularly important in the case of two of the Bills, which impose easily satisfied criteria for classification as an independent contractor.

In our view, the objective criteria set forth in the Christensen Bill and the Bond/Nickles Bill for classification of a worker as an independent contractor could be so easily satisfied in the employer/worker relationship that there is a significant risk of undermining treatment of workers as employees, especially given the current cost incentives to employers to classify their workers as independent contractors. Our 1995

Report analyzed the Christensen Bill and noted that any well trained worker with a "dba" and a written agreement with his employer could be classified as an independent contractor under the objective criteria stated because the worker would satisfy the requirements of (1) having a significant investment in training; (2) providing services under a business name; and (3) entering into a written agreement with his employer stating that the worker would be treated as an independent contractor.

Under the Bond/Nickles Bill, a worker would only need (1) to incorporate (which can be accomplished for several hundred dollars in most states) and (2) have a written contract with the employer agreeing that the worker would not be treated as an employee for federal tax purposes, in order to be properly classified as an independent contractor. (A worker will not be treated as an employee if the worker meets the requirements of subsections (d) and (e) of the Act.) Furthermore, by having the worker incorporate, the employer also becomes exempt from meeting any Form 1099 payment reporting requirements under current law with respect to the worker,[43] thus further diminishing the Internal Revenue Service's ability to enforce compliance in the underreporting of income by self-employed workers. Even in cases where the worker is not incorporated and must meet the criteria of subsections (b), (c) and (d) of the Bond/Nickles Bill, the factors chosen are, in our view, not adequate to ensure that the worker should be eligible for "safe harbor" classification as an independent contractor.[44]

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[43]Internal Revenue Code Section 6041(a), Section 6041A.

[44]Under subdivision (b), the worker must have the ability to realize a profit or

Because of the relative ease by which workers can be classified as independent contractors under either Bill, the proposals have, in our view, been accurately described as introducing "check-the-box" worker classification rules.

In contrast, the Visclosky Bill imposes a set of objective tests that must be met if the worker is not to be presumed to be an employee. However, if the worker meets these criteria, it does not appear that a presumption of independent contractor status is necessarily the result. In contrast to the Christensen Bill and the Bond/Nickles Bill, this legislation would clearly swing the pendulum more to the side of employee characterization.

In light of the significant reforms implemented by the Internal Revenue Service on this issue and the expansion of the Tax Court jurisdiction to allow for review of disputed worker classification cases, we are no longer in favor at this time of use of legislative definitional safe harbors to define either independent contractors or employees. As we encountered in our 1995 efforts to craft a safe harbor definition for independent contractors and employees, this is an extremely difficult undertaking and can never fully take into account the rapidly changing work place and the countless variety of employer/worker relationships. We agree with Secretary Lubick's

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loss, incur unreimbursed expenses which are ordinary and necessary and which represent at least 2% of the worker's adjusted gross income attributable to his services as an independent contractor and must agree to perform services for a particular amount of time or to complete a specific result or task. Under subdivision (c), the worker must have a principal place of business, not primarily provide the service at a single recipient's facilities, pay a fair market rent for the use of the employer's facilities or operate primarily with equipment not supplied by the employer. Under subdivision (d), the worker must be providing services under a written contract which provides that the worker will not be treated as an employee for federal tax purposes.

observations at the hearings in 1996:

> "The attempt to define [independent contractor or employee] provides simply a road map to avoidance because individuals who want to classify in one direction or another are able to manipulate the definitions to throw the classification on one side or another. In effect, the use of definitive factors, for the most part, seem to shift the fight over uncertainties simply to a different terrain. If definitional factors are applied in a very mechanical way, they are easily manipulable." 1996 Hearing at 113.

Ideally, the classification of a worker as an employee or as an independent contractor would be a tax neutral decision. Classification as an independent contractor would not, on the one hand, afford the worker a greater opportunity for tax avoidance and, on the other hand, result in the worker suffering the loss of important benefits such as unemployment insurance, health insurance, worker's compensation and retirement plans.

Under present rules, however, there is a tremendous disparity in treatment depending upon the worker's classification. We believe that this is the driving force behind many of the disputes between business and the Internal Revenue Service over whether a particular worker is an employee or independent contractor. If the worker is classified as an independent contractor, the employer will have no obligation to withhold either income or social security taxes and no obligation to pay the employer's portion of social security taxes. An independent contractor also will generally not qualify for participation in the employer's benefit programs. The savings to the employer in direct and indirect costs are very substantial. On the other hand, because independent contractors have a substantially lower compliance rate than employers, the Internal Revenue Service faces the fact that it can lose money any time a worker is

classified as an independent contractor. We believe that these disparities have led employers to search for justification to treat workers as independent contractors and has led the Service, in the past, to search for a mechanism which will ensure the treatment of workers as employees.

While reforms can be implemented to ameliorate some of the worst excesses on both sides of the issue and while definitional safe harbors can be created to establish greater certainty in the characterization of a worker, we firmly believe that the issue will never be resolved until the basic disparity in cost to the employer and in compliance levels with the Service are eliminated.

An analogy exists in the Service's efforts to control "abusive" tax shelters during the 1980's. The Service's initial efforts, which it pursued for more than ten years, was to distinguish between "allowable" shelters, whose benefits were properly realized, and "abusive" shelters, whose purported benefits would be disallowed in full. To this end, it adopted remedial regulations, promulgated positions with respect to many kinds of shelters in revenue rulings and other technical publications, and instituted nationally coordinated audit programs. All this activity resulted in an enormous number of disputed cases, many of which were devastating for individual taxpayers because of their retroactive nature and threatened to congest the Tax Court to the point of making it ineffective. These remedial measures were not effective because, despite them, the tax benefits of participating in an allowable shelter were so great that large numbers of taxpayers continued to become involved in all kinds of shelters. Unfortunately, many such taxpayers had no way of determining in advance which shelter would be allowable

or abusive, and promoters had substantial economic incentive to promote the bad along with the good.

The tax shelter problem was not resolved until 1986 when Congress enacted legislation which did away with almost all of the benefits which had been sought by both allowable and abusive shelters. The result was that the problem disappeared virtually overnight. In the same way, we believe that remedial measures aimed at making individual disputes easier to settle will never fully resolve the underlying employer - contractor issue. That will be done only when an employer seeking to negotiate either employee or independent contractor status with a worker will do so knowing that his tax burden will be essentially the same whichever status he negotiates. For the Service, the resolution will come when it knows that whether an employer classifies a worker as an employee or independent contractor, the compliance rate will be essentially the same. When those results are achieved, then the classification of workers will take place on an appropriate and neutral basis.

As we have indicated in this Report, substantial progress has already been made in developing and placing into effect provisions which would ameliorate the effects of individual disputes. We believe that we should now address proposals which resolve the heart of the matter. In our opinion, the matter will not be fully resolved until there is instituted, by legislation:

1. A reporting system for independent contractors as detailed and accurate as that which now exists in connection with wage and salary reporting for employees; and

2. After further study by the Treasury, some form of a tax withholding system which requires withholding by the payor and which, as nearly as possible, fully pays an independent contractor's income and self-employment tax liabilities prior to the filing of that contractor's income tax return.[45]

Our recommendations with respect to improving the information reporting system as to independent contractors are set forth below as recommendations (1) through (5) of this Report. Our recommendation with respect to withholding (recommendation 6) is supportive of the proposal of the General Accounting Office at the 1996 hearings that a withholding system be established on payments to independent contractors. We agree with the General Accounting Office that, even if a relatively nominal amount were withheld on gross payments (e.g., 1% to 5%), the distinctions between employee status and independent contractor status in terms of opportunity for tax avoidance would be significantly reduced. Furthermore, since the administrative burdens to the employer of reporting, withholding and paying over would be essentially the same whether the worker is an employee or an independent contractor, this factor would be eliminated in the employer's decision on classification of a worker.

However, under present law, classification of a worker as an employee or independent contractor not only affects income and employment taxes, but also affects the worker's eligibility for unemployment insurance, minimum wage protection, workers

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[45] We recognize that a study is needed to determine whether all independent contractors would be subject to this regime and whether there should be a de minimis exception to limit the paper work burden, especially with respect to small enterprises which render services to many customers.

compensation, participation in employer provided pension and health insurance plans and a host of other federal and state "safety net" protections. So long as these benefits and protections extend to the category of workers treated as "employees" under the tax law, any legislative change that alters the definition of independent contractor (and, thus, employees) will impact far beyond the income and employment tax laws. For this reason, we recommend that if safe harbor legislation is enacted to introduce greater certainty in the classification of independent contractors, such definitions should be applicable only for income and employment tax purposes.[46] Otherwise, the implications of such changes will be complicated by the fiscal, social and policy concerns that arise from the loss of "safety net" protections to workers who were previously classified as employees but are reclassified as independent contractors.

While this type of decoupling leads to additional complexity, it has precedent. The Section 530 safe harbor prevents the Internal Revenue Service from reclassifying workers from independent contractors to employees only for employment tax purposes. For all other purposes, including participation in employer provided pension plans, the worker is classified as an employee.

Unless the definitional safe harbors set forth in the Christensen Bill and the Bond/Nickles Bill are (1) decoupled from application to any area other than income and employment taxes and (2) tied to significant reform in income and employment tax compliance for independent contractors, such legislation could easily create more

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46 The same type of limitation should apply to any regulatory safe harbor applicable to income and employment taxes.

problems than it cures. Our proposed approach to reform focuses instead on improving compliance in income and employment tax reporting and withholding.

Recommendations:

(1) Increase penalties for failure to file information returns. We reiterate our recommendation in our 1995 Report to increase the penalty for an employer's failure to file information returns with respect to independent contractors from $50 a return to the greater of $50 or 5% of the amount required to have been reported correctly but not so reported. We also recommend raising the cap on the penalty from its current $250,000 level to a substantially higher amount. A higher penalty is necessary to provide greater incentive for employers to file the necessary information returns with respect to their independent contractor workers. If independent contractor status ceases to provide its current level of opportunity for tax avoidance, the decision of whether to be classified as an independent contractor or as an employee from the worker's perspective would be a more tax neutral decision.

(2) Lower the $600 reporting threshold for payment to independent contractors. This recommendation was also made in our 1995 Report to reduce the gap in the filing of information returns so as to improve compliance and remove the disparities that make independent contractor status an easier avenue for tax avoidance than employee status. For further discussion of this recommendation, see our 1995 Report.

(3) Require information reporting for payments to incorporated independent contractors. As we recommended in our 1995 Report, unless this loophole is closed,

independent contractors will continue to incorporate to shield income from tax reporting and employers will insist that their independent contractors incorporate to avoid the penalty for not filing information returns. Without this change, any increase in the penalty for failure to file Form 1099 information returns will be easily avoided by having the worker incorporate.

(4) Establish a quick check system for verifying TINs. As recommended in our 1995 Report, such a change would discourage workers from deliberately falsifying TINs. For further discussion of this recommendation, see our 1995 Report.

(5) Other compliance recommendations. As more fully discussed in our 1995 Report, we continue to recommend the following: (a) require businesses to separately report on their tax returns the total amount of payments to independent contractors; (b) require businesses to provide independent contractors with a written explanation of their tax obligations and rights as self-employed workers; (c) require attachment of the Form 1099-MISC to the worker's income tax return; and (d) reduce or eliminate the low volume filer exception for magnetic media filing of Form 1099-MISC.

(6) Withholding. Direct Treasury to study the possibilities of implementing a withholding system for payments made to independent contractors. As discussed in the General Accounting Office testimony at the 1996 hearings, even a nominal withholding on payments to independent contractors (1% to 5%) would go a long way in closing the compliance gap for independent contractors since, just as with Form 1099 filings, withholding would have the beneficial effect of bringing many more independent contractors into the system. We believe that if the withheld amount were sufficiently

small (e.g., 1% to 5%) so as to avoid the potential for overwithholding and were backed up by an effective Form 1099 reporting system, the distinctions between employee status and independent contractor status in terms of opportunity for tax avoidance would be significantly reduced. Furthermore, since the administrative burdens to the employer of reporting, withholding and paying over would be essentially the same whether the worker is an employee or an independent contractor, this factor would be eliminated in the employer's decision on classification of a worker.

(7) Three year statute of limitations. We recommend a legislative change to impose a statute of limitations period of three years for retroactive deficiency assessments against an employer who can demonstrate compliance with the Form 1099 information reporting requirements with respect to the worker and can demonstrate a reasonable basis for having treated the worker as an independent contractor. This would address the situation where there has been a misclassification of the worker by the employer, but the employer cannot establish the grounds for protection under Section 530. While the current IRS Classification Settlement Program would still be available to this employer to limit the assessment to at most a one year deficiency adjustment in return for prospective reclassification, there inevitably will be cases either that slip through the Classification Settlement Program or where the taxpayer rejects the CSP offer and loses his appeal. We believe that in cases where the taxpayer has complied with the informational reporting requirements and can establish a reasonable basis for the classification (falling short, however, of justifying classification of the worker as an independent contractor under common law rules), that

a three year statute of limitations for past deficiency assessments should be the maximum allowed. This change will codify the Service's stated policy regarding past deficiency adjustments.[47]

(8) Remove Section 530 moratorium prohibiting Treasury and the IRS from issuing guidance in this area. Treasury and the IRS should be allowed an opportunity to provide clearer, fairer and more easily administrable rules, regarding classification for purposes of reporting and withholding requirements, applicable to workers who are tested under the common law rules.[48] Treasury should be granted a two year period in which to issue guidance in this area.

(9) Continue CSP Program. We encourage the Internal Revenue Service to continue the classification settlement program beyond the two year trial period that ends in March of 1998. We believe that this program is an excellent example of what the Internal Revenue Service can do administratively to address the problems in this area without the need for statutory intervention. The administrative decision to "diffuse the conflict" by foregoing past deficiency assessments in return for prospective compliance represents not only a sound business decision by the IRS, but also demonstrates that the IRS can address the concerns of rigidity, abuse and overly harsh results that previously were associated with worker classification audits. For employers

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[47] As noted in our 1995 Report, there was anecdotal evidence at that time of IRS adjustments that go back beyond three years.

[48] For example, such guidance might take the form of a Revenue Procedure setting forth conditions under which a worker's classification as an independent contractor would be accepted solely for these purposes.

who have complied with the informational reporting rules and who can show as little as a "colorable argument" for relief under Section 530, the deficiency assessment imposed under the current CSP is only 25% of the deficiency that which would otherwise be due for the one year audit period. For employers who cannot meet the "colorable argument" test, the CSP offers a one year deficiency adjustment in return for prospective compliance so long as the employer has complied with the information reporting requirements. We believe that the CSP offers a fair option to any taxpayer who has a worker classification dispute with the IRS.

(10) Hold on future Section 530 legislation. We recommend that no further legislation be enacted at this time to ease taxpayer requirements for relief under the Section 530 safe harbor. The recent statutory changes in the Small Business Job Protection Act which shift the burden of proof to the Internal Revenue Service after the employer has made a prima facie case, is an example of the type of legislation which we would no longer favor. Another example are the proposed changes in the Bond/Nickles Bill which would grant broad protections to employers against retroactive deficiencies even in cases where the information reporting requirements have not been met.[49] Since relief under Section 530 allows employers to continue classifying their workers as independent contractors even if the worker should be treated as an

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[49]Workers and employers would be granted wholesale protection against retroactive reclassification of workers by virtue of a written contract and the demonstration that there was "a reasonable basis" for such characterization "made in good faith" even in the absence of either the worker and/or the employer having met the applicable tax reporting requirements so long as "reasonable cause" for the failure can be shown.

employee under common law tests, we prefer to encourage employers to avail themselves of the IRS Classification Settlement Program so that more worker classification disputes can be resolved with corrected classification of the worker for the future.

We do not recommend at this time any broader legislative or administrative waivers of past deficiency assessments in the misclassification area (other than as recommended in this report) since such could undermine compliance. The Internal Revenue Service must continue to have available to it the power to make full deficiency assessments for all open years in appropriate cases to give incentives to employers to comply with the information reporting laws and to properly classify their workers, albeit with relief in appropriate cases from the devastating effect of retroactive deficiency assessments. If all of the sting is taken out of the consequences of misclassification, the objective of achieving proper classification of workers could be underminded. For employers who do not comply with the informational reporting requirements or who knowingly or, without basis, misclassify their workers, the Internal Revenue Service should continue to have the full deficiency assessment procedure available.

It is for this reason that we do not favor the recommendation by Treasury in the 1996 hearings of a further amendment to Section 530 that would waive all past period deficiency assessments against employers with respect to workers who are misclassified as independent contractors if the employer (a) can demonstrate compliance with the information reporting rules (i.e., Form 1099); (b) can demonstrate a

reasonable basis for believing that the classification as an independent contract qualified under Section 530 and (c) agrees to prospective reclassification of the workers in dispute. We are concerned that the magnitude of this waiver could be counterproductive by undermining compliance.

While we continue to be concerned with some of the more undesirable features of Section 530 insofar as the safe harbor promotes continued future misclassification of workers and can create unfair competitive advantages, we are not at this time in favor of a full repeal of the Section 530 safe harbor. We believe that Section 530 safe harbor relief should continue to be available to employers in cases where the employer meets the statutory tests and has concluded that the "carrot" of waiver of past deficiencies is not worth the "stick" of prospective compliance that would be available under the Classification Settlement Program. We do believe, however, that if programs such as the CSP are continued at the IRS, that more and more employers will opt for resolution of their worker classification disputes under this option, even at the cost of future reclassification of workers, rather than pursue through administrative and judicial appeal the benefits of Section 530 safe harbor relief, especially since such would require a higher level of proof and additional legal costs.

(11) Safe harbor legislation. We do not at this time favor introduction of bright line objective tests, such as are contained in the Christensen and Bond/Nickles Bills, for determining independent contractor status. We favor instead affording Treasury and the Internal Revenue Service an opportunity to develop more flexible and updated guidelines to determine appropriate worker classification under the common law rules.

The initiatives of the past two years at the Internal Revenue Service give us encouragement that any definitional reforms can be fairly and clearly implemented at the administrative level if the moratorium on guidance from the Treasury and the Internal Revenue Service is lifted.

However, if bright line definitions, such as are contained in the Christensen and Bond/Nickles Bills are enacted to give greater certainty in the classification of a worker, such legislation should (a) be tied to needed reforms to improve independent contractor compliance in income and employment tax reporting and withholding and (b) be limited in application to income and employment taxes only.