tax notes
Volume 150, Number 13 ■ March 28, 2016

Clarifying the Tax Classification of Workers

By Donald T. Williamson

Reprinted from *Tax Notes*, March 28, 2016, p. 1583

taxanalysts®

Clarifying the Tax Classification of Workers

By Donald T. Williamson


Donald T. Williamson

Donald T. Williamson is a professor of taxation and the Howard S. Dvorkin Faculty Fellow at American University, where he serves as executive director of the Kogod Tax Center, a research and advocacy institute focused on the tax issues affecting small businesses and middle-income earners.

In this article, Williamson offers several recommendations, including a bright-line test, to clarify the tax rules on the classification of workers as employees or independent contractors.

A. Statement of Issue

Misclassifying workers as independent contractors or employees can result in substantial adverse tax consequences for both workers and employers.[1] For example, Lyft Inc., a ride-hailing company based in San Francisco, recently agreed to pay $12.25 million to settle a class action lawsuit by drivers seeking recognition as employees instead of independent contractors.[2]

Generally, employers prefer to have their workers classified as independent contractors to avoid having to withhold income tax,[3] Social Security tax (FICA),[4] and federal unemployment tax (FUTA)[5] on the workers' pay. As an independent contractor, a worker is subject to self-employment tax at a rate equal to the combination of the employee and employer portions of FICA.[6] The IRS aggressively pursues employers who fail to withhold and pay over income and employment taxes on behalf of their employees.[7]

Misclassification also affects nontax issues such as workers' rights to family leave[8] or employer-provided benefits like health insurance coverage and pensions.[9] A more recently enacted example is the Affordable Care Act's requirement[10] that employers with 50 or more employees must offer healthcare coverage to their employees or face substantial penalties — stressing the need to correctly distinguish employees from independent contractors.

Surprisingly, despite the importance of proper worker classification, the issue has remained ambiguous for decades. The discussion below describes the confusion and uncertainty in the law and offers suggestions for how to clarify the standards regarding this fundamental issue.

B. Statutory Classifications

Under current law, workers are classified as employees or independent contractors either by statute or under the common law. For example, corporate officers are statutorily classified as employees for both income tax and employment tax purposes.[11] Some traveling salesmen, laundry and dry-cleaning delivery persons, and drivers engaged in the distribution of food and beverage products are classified as employees for employment tax

[1]For a general introduction to the tax treatment of employees and independent contractors, see Joint Committee on Taxation, "Present Law and Background Relating to Worker Classification for Federal Tax Purposes," JCX-26-07 (May 8, 2007).

[2]*See* Mike Isaac, "Lyft Agrees to Settle Class-Action Lawsuit With California Drivers," *The New York Times*, Jan. 27, 2016 (noting that Uber, Lyft's chief rival, remains embroiled in a similar class action lawsuit regarding employee status for drivers).

[3]Section 3401 et seq.

[4]Section 3101 et seq.

[5]Section 3301 et seq.

[6]Section 1401 et seq.

[7]In fact, specific officers and other "responsible" parties can be found personally liable for taxes not paid on behalf of the employees. *See* section 6672.

[8]*See* Government Accountability Office, "Employee Misclassification: Improved Outreach Could Help Ensure Proper Worker Classification," GAO-07-859T (May 8, 2007) (see statement of Sigurd R. Nelson). Although not a tax case, the best known misclassification class action lawsuit is *Vizcaino v. Microsoft Corp.*, 97 F.3d 1187 (9th Cir. 1996), in which "freelancers" claimed they were entitled to specific benefits provided to Microsoft employees, resulting in a settlement of approximately $100 million.

[9]For a discussion of joint initiatives and investigations by the IRS, the Labor Department, and many states to address misclassifications, see Lawrence K. Cagney et al., "Employee Classification: An Old Issue Getting Renewed Attention," *Compensation Plan. J.* (2014).

[10]P.L. 111-148; 42 U.S.C. section 18001.

[11]Sections 3121(d)(1), 3306(i), and 3401(c).

purposes but not for income tax purposes.[12] Full-time life insurance salespeople and home workers performing work according to standards set by their employer and using goods or materials furnished by the employer and that are required to be returned to the employer are classified as employees for FICA purposes.[13] Workers who otherwise would be employees for employment tax purposes under the above statutory classifications are exempt if they have a ''substantial investment in facilities used in connection with the performance of such services (other than in facilities used for transportation) or if the services are in the nature of a single transaction not part of a continuing relationship with the person for whom the services are performed.''[14]

In addition to statutory employees, there are statutory independent contractors. Section 3508 classifies ''qualified real estate agents'' and specific ''direct sellers'' as independent contractors for employment and income tax purposes. A qualified real estate agent is defined as someone licensed to sell real estate whose compensation from the activity is determined by sales volume (not hours worked) and whose services are performed under a written contract that provides that the individual is not an employee for tax purposes.[15]

A direct seller is someone engaged in the trade or business of selling consumer products in the home or other non-retail establishment whose compensation is determined by sales (not hours worked) and whose services are performed under a written contract that states that the individual is not an employee for tax purposes.[16]

Finally, for FUTA purposes only, life insurance salespeople whose compensation consists entirely of commissions are classified as independent contractors under section 3306(c)(14).[17]

C. Common Law Standards

Aside from those limited statutory classifications, the code declares that a worker's status as an independent contractor or employee depends on the ''usual common law rules applicable in determining the employer-employee relationship.''[18] Under common law, an employer-employee relationship exists when the employer has the right to control the worker not only as to the result of his efforts but also regarding the means and manner of those efforts.[19]

In measuring this standard of control, the IRS has historically employed the following 20 factors (none of which is determinative) on a case-by-case basis[20]:

1. Instructions. If the employer has the right to require compliance with instructions, this indicates employee status.

2. Training. Requiring attendance at training sessions indicates that the employer wants the services performed in a particular manner, suggesting employee status.

3. Integration. Integration of the worker's services into the business operations of the employer indicates employee status.

4. Services rendered personally. Requiring workers to personally perform services indicates that the employer is interested in the methods used to accomplish the work, suggesting employee status.

5. Hiring, supervision, and paying assistants. The employer's hiring, supervising, or paying of assistants generally indicates employee status. However, the worker's hiring and supervising of others under a contract in which the worker agrees to provide materials and labor and is only responsible for the result indicates independent contractor status.

6. Continuing relationship. A continuing relationship between the worker and the employer indicates employee status.

7. Set hours of work. Establishing set hours for a worker indicates employee status.

8. Full time required. Employee status is suggested if the worker must devote substantially all of his time to the business of the employer.

9. Doing work on employer's premises. Performing work on the premises of the employer indicates employee status, especially if the work could be done elsewhere.

10. Order or sequence test. The worker's performance of services in an order or sequence prescribed by the employer indicates employee status.

---

[12]Sections 3121(d)(3)(A), (D), and 3306(i). If a worker is statutorily classified as an employee for employment tax purposes only, the individual may still deduct expenses for income tax purposes on Schedule C as a sole proprietor. Rev. Rul. 90-93, 1990-2 C.B. 33.

[13]Section 3121(d)(3)(B) and (C).

[14]Section 3121(d)(3) (flush language).

[15]Section 3508(b)(1).

[16]Section 3508(b)(2).

[17]Technically, section 3306(c)(14) excludes life insurance sales from the meaning of ''employment'' in section 3306(b), for which all remuneration is subject to FUTA.

[18]Section 3121(d)(2).

[19]Rev. Rul. 87-41, 1987-1 C.B. 296.

[20]*Id.*

11. Oral or written reports. A requirement that the worker submit regular reports indicates employee status.

12. Payment by the hour, week, or month. Payment by the hour, week, or month points to employee status. Payment by the job or commission indicates independent contractor status.

13. Payment of business and traveling expenses. Employee status is indicated if the employer pays or reimburses the worker for business expenses.

14. Furnishing tools and materials. Providing significant tools and materials to the worker indicates employee status.

15. Significant investment. Investment in facilities used by the worker indicates independent contractor status.

16. Realization of profit or loss. A worker who may realize a profit or suffer a loss as a result of the services is generally an independent contractor.

17. Working for more than one firm at a time. A worker's performance of more than de minimis services for multiple firms at the same time generally indicates independent contractor status.

18. Offering service to the general public. A worker making his services available to the public on a regular and consistent basis indicates independent contractor status.

19. Right to discharge. The right to discharge a worker indicates that the worker is an employee.

20. Right to terminate. Employee status is indicated if a worker may terminate his relationship with the employer at any time without incurring liability.

The IRS has recently revisited this 20-factor approach. It still uses the above factors but now groups them under three evidential categories: behavioral control, financial control, and the relationship between the parties.[21] The IRS offers no weighting or hierarchy in the application of the common law factors to any industry or occupation.

Because the determination of the relationship is made on a case-by-case basis, disputes are legion and offer little definitive guidance that can be applied to employment relationships in general.[22] In fact, some cases have gone beyond the 20-factor test, when the other criteria were equivocal, to consider other issues such as the good-faith belief of the parties[23] or customs in the trade or business.[24]

Compliance with federal or state regulations in other areas of the law, such as federal labor law, may constitute an additional factor in measuring an employer's control over a worker.[25] While the employer's compliance with nontax law does not determine sufficient control over the worker to make the individual an employee for tax purposes, courts may look to whether the employer standards exceed the requirements of a nontax rule. For example, while mere compliance with federal drug testing law was not evidence of employer control,[26] an employer's requirements for truck drivers that exceeded those of the Interstate Commerce Commission and the Department of Transportation were evidence of control.[27]

Ultimately, regardless of how the parties characterize the relationship or how the factors are applied,[28] a worker's status as an employee or independent contractor is a subjective case-by-case determination,[29] too often producing uncertain and even inconsistent conclusions in otherwise similar cases.

D. Section 530 Relief

In an effort to alleviate the uncertainty in the common law, Congress enacted section 530 of the Revenue Act of 1978[30] to provide a safe harbor for

---

[21]IRS Publication 15-A, *Employer's Supplemental Tax Guide (Supplement to Pub. 15, Employer's Tax Guide)* (Dec. 23, 2015). *See, e.g.*, LTR 200119035 (noting the employer's lack of financial or behavioral control over a part-time, as-needed worker, the IRS found the relationship to be one of independent contract).

[22]*See* Helen E. Marmoll, "Employment Status — Employee v. Independent Contractor," Tax Management Portfolio No. 391-4th (1993) (citing hundreds of rulings and court decisions determining the employment status of no less than 374 different occupations).

[23]*See, e.g., Harris v. Commissioner*, T.C. Memo. 1977-358.

[24]*See Ewing v. Vaughan*, 169 F.2d 837 (4th Cir. 1948) (noting that floor salesmen are commonly understood to be employees); *Bonney Motor Express Inc. v. United States*, 206 F. Supp. 22 (E.D. Va. 1962) (specific "gypsy chasers" used by trucking companies for loading and unloading cargo are commonly understood in the industry not to be employees).

[25]For example, in determining whether a worker is an employee for purposes of minimum wage, overtime pay, child labor law, etc., the Labor Department looks to the "economic realities" of the relationship and whether the worker is "economically dependent" on the employer. *See* Fair Labor Standards Act, 29 U.S.C. section 201.

[26]*K&D Auto Body Inc. v. Division of Employment Security*, 171 S.W.3d 100 (Mo. Ct. App. 2005).

[27]*National Labor Relations Board v. Deaton Inc.*, 502 F.2d 1221 (5th Cir. 1974).

[28]Reg. section 31.3401(c)-1(e).

[29]Reg. section 31.3401(c)-1(d).

[30]P.L. 95-600 (Nov. 1978). Section 530 has been amended by section 9(d)(1) and (2) of P.L. 96-167 (Dec. 1979); section 1(a) and (b) of P.L. 96-541 (Dec. 1980); section 269(c)(1) and (2) of P.L. 97-248, the Tax Equity and Fiscal Responsibility Act of 1982

(Footnote continued on next page.)

finding specific workers to be independent contractors without reference to the common law factors. Under section 530, a worker may be treated as an independent contractor for employment tax purposes if the employer filed all tax returns (including information returns such as Form 1099-MISC) consistently treating the worker as an independent contractor and if the employer had no reasonable basis for treating the worker as an employee.[31] For this purpose, the employer is deemed to have a reasonable basis for not treating a worker as an employee if there is:

- a previous IRS audit of the taxpayer (or other ruling issued to the taxpayer) in which there was no assessment of employment tax for individuals holding positions substantially similar to the position held by the worker in question;[32]
- a published IRS ruling, judicial case, or ruling issued to the taxpayer finding the parties' relationship to be one of independent contract;[33] or
- a long-standing recognized practice of a significant segment of the industry in which the taxpayer is a member.[34]

Even when the taxpayer does not meet one of the above conditions, the safe harbor of section 530 may still apply when the taxpayer establishes some other ''reasonable basis'' for treating the relationship as one of independent contract. In determining what is ''reasonable'' for this purpose, both the Joint Committee on Taxation[35] and the legislative history to the 1978 Revenue Act[36] state that the provision should be ''construed liberally in favor of taxpayers.''

Significantly, section 530 prohibits the IRS from promulgating any regulation or revenue ruling clarifying the definition of the employment status of individuals for employment tax purposes.[37] However, a taxpayer may obtain an IRS determination letter regarding the employment status of a particular worker for purposes of employment taxes and income tax withholding, but these letters will not be issued for prospective new hires.[38]

To address the uncertainty in this area, the IRS established a voluntary classification settlement program (VCSP) allowing an employer who reclassifies employees for future tax years to pay a fraction of the payroll tax liability for the prior misclassified years.[39] However, like section 530, the VCSP is available only if the employer had consistently treated the workers as independent contractors, filing Forms 1099-MISC for the previous three years.[40]

While intended to alleviate the assessment of taxes and penalties on employers who in good faith misclassified employees as independent contractors, neither the VCSP nor section 530 can provide general guidance — each case must still be independently and inefficiently measured using an inscrutable list of classification factors. Because it is not directly part of the tax code, section 530 is merely a patch for avoiding the perceived inequity of assessing substantial tax and penalties on employers who acted in good faith. Section 530 is not, and was never intended to be, a permanent solution, serving only to resolve specific cases that meet its very strict requirements.[41] Further, the provision may be used only by employers and does not provide relief for workers, who have presumably paid substantial self-employment tax when they were responsible only for FICA tax.

E. Recommendations

Technical amendments could be made to the tax code to reduce the complexity and ambiguity associated with the 20-factor test and the section 530 safe harbor, to lessen the compliance burden, and to

(Sept. 1982); section 170(a) of P.L. 99-514, the Tax Reform Act of 1986 (Oct. 1986); section 1122(a) of P.L. 104-188, the Small Business Jobs Protection Act of 1996 (Aug. 1996); and section 864 of P.L. 109-280, the Pension Protection Act of 2006 (Aug. 2006) (applicable to services performed after Dec. 31, 2006).

[31]Revenue Act of 1978, section 530(a)(1).

[32]The audit must have included an examination for employment tax purposes of whether the workers in question or those holding positions substantially similar to the workers were employees. *Id.* at section 530(e)(2)(A) and (a)(2)(B).

[33]*Id.* at section 530(a)(2)(A).

[34]*Id.* at section 530(a)(2)(C). A ''significant segment'' need not be more than 25 percent of the industry. *Id.* at section 530(e)(2)(B). Also, to be ''long-standing,'' the practice need not have continued for more than 10 years. *Id.* at section 530(e)(2)(C)(i).

[35]JCT, ''Present Law and Background Relating to Worker Classification for Federal Tax Purposes,'' JCX-26-07 (May 8, 2007).

[36]H.R. Rep. No. 1748, 95th Cong., 2d Sess. 5 (1978), 1978-3 C.B. (Vol. 1) 629-633.

[37]Revenue Act of 1978, section 530(b).

[38]*See* IRS Form SS-8, ''Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding,'' which allows employers and workers to request a determination of the status of a worker under the common law rules. The instructions to the form make clear that the IRS will not issue a determination letter for proposed transactions or on hypothetical situations but may issue an information letter when appropriate. *See also* IRS Publication 15-A, *supra* note 21.

[39]*See* IRS Form 8952, ''Application for Voluntary Classification Settlement Program (VCSP).''

[40]Announcement 2012-45, 2012-51 IRB 724.

[41]Courts have declared that there are no de minimis exceptions to the requirements of section 530. *See*, *e.g.*, *Institute for Resource Management Inc. v. United States*, 22 Cl. Ct. 114 (1990) (holding that for an employer to use section 530, all workers at issue must be consistently treated as independent contractors).

extend relief to workers in addition to employers. The Taxpayer Advocate Service has made suggestions along these lines that would make classification fairer for taxpayers and easier for the IRS to administer[42]:

1. Toll the refund statute of limitations during an employment tax audit. When the IRS reclassifies a worker as an employee, the employer's withholding rate on the worker's wages is set at 1.5 percent, and the FICA tax rate is set at 20 percent.[43] Therefore, while the employer receives some relief from reclassification, the employee receives no relief from the three-year limitations period for filing a claim for refund of self-employment tax. Consequently, section 6511, which prescribes the period a taxpayer has to claim a refund, should be amended to toll the running of the statute of limitations for claiming a refund during any period in which a taxpayer's employer is under audit regarding the taxpayer's status. Thus, if the employer is found liable for FICA tax, the worker would be able to obtain a refund for the amount of self-employment tax he paid in excess of his share of the FICA tax.

2. Offer access to the Tax Court to workers as well as employers in employment classification cases. Section 7436 allows employers who have been audited regarding worker statuses to petition the Tax Court to determine those statuses and decide whether the employer is entitled to section 530 relief. Inexplicably, this provision does not authorize reclassified workers to petition the court. There is no reason to give employers access to the Tax Court on this issue while denying it to the very workers being reclassified.

3. Extend section 530 to income tax. Section 530 applies only to employment taxes. Its relief should also apply to the withholding of income taxes.

4. Repeal prohibition of administrative guidance. The section 530 rule prohibiting Treasury and the IRS from issuing regulations or revenue rulings on worker classification adds to the confusion and uncertainty and causes employers to pause before hiring new workers. Given the evolution of employment relationships in the entrepreneurial economy of the 21st century, guidance in this area is needed to create sound and flexible tax administration policies. Without more than a mere list of case-by-case factors, taxpayers will inevitably make inadvertent misclassifications. But, more ominously, a lack of authority in this area serves to encourage deliberate efforts to evade employment tax. While the IRS has published descriptions of the problem,[44] these documents can only summarize the present uncertainty and, in any event, do not carry the force of law. Therefore, the prohibition on guidance in section 530 should be repealed, and the IRS should be directed to provide definitive rules that focus on the industries or vocations that need the most clarification.

5. Bright-line test. Whatever the merits of the above technical proposals may be, a much more fundamental revision of the law is needed. Any case-by-case approach to classification is simply too inefficient and uncertain. What is needed is a simple measure with objective standards that look to balance the benefits and burdens of withholding on employers, workers, and the IRS. Establishing objective standards that can be applied to all employment relationships will promote horizontal equity and foster compliance with withholding and reporting requirements.

Thus, a bright-line test should be enacted that calls for employer withholding in all cases except those in which (1) the worker formally declares to the employer that his annual deductible expenses associated with the performance of services for the employer will exceed 20 percent of the compensation for the services, or (2) the worker performed services for the employer for less than 24 days during the current or preceding calendar year quarter.[45]

The first exception to withholding allows for cases in which the worker has substantial out-of-pocket costs associated with the performance of his services. In these cases, withholding might impose a burden on the worker's cash flow, with the taxes paid likely exceeding the actual tax due on the worker's net income. Similarly, employment taxes withheld by the employer on the gross payments would greatly exceed the employment tax ultimately due on the net income.

The second exception reduces the compliance burden on employers who employ workers for

---

[42]*See* Nina Olson, "How Tax Complexity Hinders Small Businesses: The Impact on Job Creation and Economic Growth" (Apr. 13, 2011) (testimony of the national taxpayer advocate before the House Committee on Small Business).

[43]Section 3509(a).

[44]*See, e.g.*, IRS Publication 1779, *Independent Contractor or Employee?* and IRS Publication 15-A, *supra* note 21.

[45]For a more detailed description of this proposal, first offered by the Los Angeles County Bar Association, see Robert K. Johnson et al., "Legislative Proposal on Classification of Workers as Employees or Independent Contractors," *Tax Notes*, May 11, 1992, p. 821.

short periods. It draws upon the income tax withholding exception in section 3401(a)(4) for employees who, among other requirements, work for their employer for less than 24 days during a calendar year quarter.[46]

The two exceptions are illustrated below:

Example 1: 20 percent expense certification. A sales agent regularly performs services for a company and receives commissions for all sales made to customers. The sales agent certifies to the company that his expenses (excluding payments to the company) exceed 20 percent of his commissions. Consequently, the company has no withholding requirement, and the agent may deduct his expenses above the line and pay self-employment tax. If payments to the agent exceed $600 in a year, the company must file Form 1099.[47]

Example 2: Irregular service. Same facts as in Example 1, except that the agent's expenses are only 15 percent of his commissions and the agent works for several companies. If the individual works less than 24 days for the company in the current and preceding quarter, the company will have no withholding obligation and must file Form 1099 if the payments for the year exceed $600. The agent may deduct his expenses above the line.

Replacing the case-by-case approach with this bright-line test would provide certainty and yield greater compliance (and more tax revenue) than relying upon employer judgments, which too frequently result in unproductive and unnecessary disputes.

F. Conclusion

Worker classification is only part of the larger problem confronting our nation on how to achieve full employment. Small businesses are universally considered the key to creating new jobs, and simplifying the classification of workers will encourage small businesses to hire new people without worrying whether they have responsibilities for withholding tax. Thus, reducing this uncertainty will foster job creation and ultimately spur economic growth. It is not the solution to our economic ills, but it will contribute to an economic recovery.

---

[46]Specifically, section 3401(a)(4) exempts from the term "wages" — upon which withholding is required — any remuneration paid for services not in the course of the employer's trade or business performed in any calendar quarter by an employee, unless the cash remuneration is $50 or more and the service is performed by an individual who is regularly employed by that employer. For this purpose, an individual is considered regularly employed by an employer during a calendar quarter only if for at least part of 24 days during the quarter (or preceding quarter), the individual performs services for the employer not in the course of the employer's trade or business.

[47]*See* sections 6041 and 6041A for Form 1099 filing requirements.