Treas.
HJ
2412
.T71

# Taxation of Technical Services Personnel: Section 1706 of the Tax Reform Act of 1986

A Report to The Congress

**Department of the Treasury**
**March 1991**

TREAS.
HJ
2412
.T71

# Taxation of Technical Services Personnel: Section 1706 of the Tax Reform Act of 1986

A Report to The Congress

LIBRARY
ROOM 5030
MAR 13 1996
TREASURY DEPARTMENT

**Department of the Treasury**
**March 1991**

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

March 1991

The Honorable Dan Rostenkowski
Chairman
Committee on Ways and Means
House of Representatives
Washington D. C. 20515

Dear Mr. Chairman:

Section 6072 of Public Law 100-647, the Technical and Miscellaneous Revenue Act of 1988, provides that the Secretary of the Treasury shall conduct a study of the treatment provided by section 1706 of the Tax Reform Act of 1986 (relating to treatment of certain technical personnel).

Pursuant to that section, I hereby submit the "Taxation of Technical Services Personnel: Report on Section 1706 of the Tax Reform Act of 1986."

I am sending a similar letter to Senator Lloyd Bentsen, Chairman of the Committee on Finance.

Sincerely,

Kenneth W. Gideon
Assistant Secretary
(Tax Policy)

Enclosure

DEPARTMENT OF THE TREASURY
WASHINGTON

ASSISTANT SECRETARY

March 1991

The Honorable Lloyd Bentsen
Chairman
Committee on Finance
United States Senate
Washington D. C. 20510

Dear Mr. Chairman:

Section 6072 of Public Law 100-647, the Technical and Miscellaneous Revenue Act of 1988, provides that the Secretary of the Treasury shall conduct a study of the treatment provided by section 1706 of the Tax Reform Act of 1986 (relating to treatment of certain technical personnel).

Pursuant to that section, I hereby submit the "Taxation of Technical Services Personnel: Report on Section 1706 of the Tax Reform Act of 1986."

I am sending a similar letter to Representative Dan Rostenkowski, Chairman of the Committee on Ways and Means.

Sincerely,

Kenneth W. Gideon
Assistant Secretary
(Tax Policy)

Enclosure

## TABLE OF CONTENTS


PART ONE: EXECUTIVE SUMMARY . . . . . 1

CHAPTER 1: EXECUTIVE SUMMARY . . . . . 3
- I. BACKGROUND OF REPORT . . . . . 3
- II. REPORT MANDATE . . . . . 4
- III. EVALUATION OF ISSUES . . . . . 4
- IV. OPTIONS FOR FURTHER CONSIDERATION . . . . . 6

PART TWO: BACKGROUND INFORMATION . . . . . 9

CHAPTER 2: SOURCES OF EMPLOYEE MISCLASSIFICATION . . . . . 11
- I. OVERVIEW . . . . . 11
- II. DETERMINATION OF EMPLOYEE STATUS . . . . . 12
- III. DIFFERENCES IN TAX TREATMENT BETWEEN EMPLOYEES AND INDEPENDENT CONTRACTORS . . . . . 12
  - A. Differences Favoring Independent Contractor Status . . . . . 12
  - B. Differences Favoring Employee Status . . . . . 14
  - C. Five Hypothetical Examples of Differential Tax Treatment . . . . . 15
  - D. Validity of Differences . . . . . 26

CHAPTER 3: ORIGINS OF SECTION 1706 . . . . . 29
- I. SECTION 530 . . . . . 29
- II. SECTION 3509 . . . . . 31
- III. SECTION 1706 . . . . . 32

PART THREE: DISCUSSION OF ISSUES . . . . . 35

CHAPTER 4: GENERAL POLICY ISSUES . . . . . 37
- I. OVERVIEW . . . . . 37
- II. EFFICIENCY OF LABOR MARKETS . . . . . 37
  - A. Arrangements Between Workers and Firms . . . . . 37
  - B. Government Policy . . . . . 40
- III. NEUTRALITY IN TAX TREATMENT . . . . . 40
  - A. Maintaining Labor Market Efficiency . . . . . 40
  - B. Tax Equity . . . . . 42
- IV. ADMINISTRATIVE COSTS . . . . . 45
- V. NON-TAX POLICIES . . . . . 46

CHAPTER 5: TAX COMPLIANCE ISSUES . . . . . 47
- I. OVERVIEW . . . . . 47
- II. RATE OF MISCLASSIFICATION . . . . . 47

III. RATE OF NONCOMPLIANCE . . . . . 50
A. 1985 TCMP . . . . . 51
B. 1984 SVC-1 Employee Survey . . . . . 54
C. Summary . . . . . 55

CHAPTER 6: TAX ADMINISTRATION ISSUES . . . . . 57
I. OVERVIEW . . . . . 57
II. ADMINISTRATIVE PROBLEMS WITH SECTION 1706 . . . . . 57
III. ADMINISTRATIVE PROBLEMS WITH COMMON LAW TESTS OF EMPLOYEE STATUS . . . . . 58

PART FOUR: APPENDICES . . . . . 61

APPENDIX A: DIFFERENCES IN TREATMENT OF EMPLOYEES AND INDEPENDENT CONTRACTORS--DETAILED ANALYSIS . . . . . 63
I. OVERVIEW . . . . . 63
II. FEDERAL TAX LAW . . . . . 63
A. Employment Taxes . . . . . 63
B. Income Taxes . . . . . 66
C. Determination of Employee Status . . . . . 75
III. OTHER LAWS . . . . . 78
A. Federal Labor Laws . . . . . 78
B. Patent and Copyright Laws . . . . . 80
C. State Laws . . . . . 80
D. Determination of Employee Status . . . . . 81
IV. SUMMARY . . . . . 82

APPENDIX B: COMMON LAW FACTORS USED TO DETERMINE EMPLOYEE STATUS . . . . . 83

APPENDIX C: ADDITIONAL BACKGROUND TO TCMP AND SVC-1 . . . . . 85
I. TCMP . . . . . 85
II. SVC-1 . . . . . 86

## LIST OF TABLES

### Chapter 2


2-1 Major Differences in Treatment of Employees and Independent Contractors for Federal Tax and Other Purposes . . . . . 16

2-2 Comparison of Income and Taxation of $1,000 of Total Compensation for an Employee or Independent Contractor, Worker with a Typical Mix of Fringe Benefits and no Worker Expenses . . . . . 18

2-3 Comparison of Income and Taxation of $1,000 of Total Compensation for an Employee or Independent Contractor, Worker with a Typical Mix of Fringe Benefits, no Worker Expenses, and 5 Percent Non-Compliance by the Independent Contractor . . . . . 20

2-4 Comparison of Income and Taxation of $1,000 of Total Compensation for an Employee or Independent Contractor, Worker with a Typical Mix of Fringe Benefits and Worker Expenses of 10 Percent . . . . . 21

2-5 Comparison of Income and Taxation of $1,000 of Total Compensation for an Employee or Independent Contractor, Worker with Only Statutory Benefits and no Worker Expenses . . . . . 23

2-6 Comparison of Income and Taxation of $1,000 of Total Compensation for an Employee or Independent Contractor, Worker with Only Statutory Benefits, no Worker Expenses, and a "Wedge" Between Employee and Independent Contractor Total Compensation . . . . . 25


### Chapter 5


5-1 Percentage of Employers with Some Misclassified Employees, by Industry . . . . . 49

5-2 Reporting of Income and Expenses by Employees and Independent Contractors . . 52


### Appendix A


A-1 Tax-Favored Benefits Available to Employees and Independent Contractors . . . . 73

# PART ONE

# EXECUTIVE SUMMARY

# CHAPTER 1: EXECUTIVE SUMMARY

## I. BACKGROUND OF REPORT

Despite the wide variety of relationships between workers and firms, there are generally only two classifications of workers for Federal tax purposes: self-employed workers (sometimes called independent contractors) and employees. The proper classification is self-evident for many workers; for others, it is ambiguous. When the proper classification is ambiguous, the potential for worker misclassification increases. Inadvertent misclassification may occur if employers lack sufficiently detailed guidance to determine the correct classification. In addition, the various legal, economic, and tax consequences of the alternate classifications may provide incentives for deliberate misclassification.

Historically, misclassification of employees as independent contractors was a concern because self-employed workers faced significantly lower Social Security and Medicare tax rates than the combined rate for employers and employees. Misclassification was perceived as producing large losses of employment tax revenues. Now that self-employed workers face Social Security and Medicare tax rates comparable to the combined rate for employees and employers, concern about misclassification has shifted to potential losses of all tax revenues. Income and employment tax revenues may be lower due to differences in the income and employment tax bases and differences in compliance between employees and the self-employed.

In the late 1960s, when significant employment tax rate differentials still existed, the Internal Revenue Service (IRS) began to increase its employment tax enforcement activities, which previously had been sporadic, to address the misclassification of workers. Classification of a worker directly affects employment tax obligations and indirectly affects a worker's income tax treatment. As a result of the IRS' actions, the number of reclassifications increased substantially. Many reclassifications resulted in large retroactive assessments against employers.

Congress subsequently took several actions to address taxpayer concerns about worker reclassification. In section 530 of the Revenue Act of 1978 (section 530), it provided statutory relief from reclassification for certain employers involved in employment tax controversies with the IRS. Section 530 generally prohibited the IRS from challenging an employer's erroneous treatment of an employee as an independent contractor for employment tax purposes if the employer had a reasonable basis for such treatment and certain other requirements were met. It also generally prohibited the IRS from issuing regulations or publishing revenue rulings addressing the status of workers as employees or independent contractors for employment tax

purposes. Section 530 was initially intended as an interim measure. In 1982, Congress extended it indefinitely, and also limited employer liabilities in certain cases of retroactive reclassification.

Section 1706 of the Tax Reform Act of 1986 (section 1706) removed the statutory relief of section 530, but only for taxpayers that broker the services of technical services workers, *i.e.*, engineers, designers, drafters, computer programmers, systems analysts and other similarly-skilled workers engaged in a similar line of work. Thus, section 1706 only applies in multi-party situations involving (1) technical services workers, (2) companies that use the workers, and (3) firms that supply or broker the services of the workers.

Section 1706 does not change the rules for classifying workers as employees or independent contractors, nor does it change the legal status of anyone covered by the provision. It only permits the IRS to interpret and enforce the underlying rules for employment tax purposes for the covered technical services workers without regard to section 530. However, in practice the worker's employment tax classification generally determines whether the worker is treated as an employee or independent contractor for Federal income tax purposes.

## II. REPORT MANDATE

This report was prepared in response to a congressional mandate in the Technical and Miscellaneous Revenue Act of 1988 (TAMRA). Section 6072 of TAMRA directed the Secretary of the Treasury or his delegate to conduct a study of the treatment provided by section 1706 of the Tax Reform Act of 1986 (TRA 1986).

## III. EVALUATION OF ISSUES

According to the Conference Report on TAMRA,[1] the Treasury report was to include an evaluation of five issues. These issues, and the general findings of the report with respect to each, are described below.

---

[1] H.R. Conf. Rep. No. 1104, 100th Cong., 2d Sess. 167-68 (1988).

Administrability of section 1706. The Conference Report questioned whether there were difficulties in the administration of the provisions of section 1706. The report finds that:

- Section 1706 itself presents few administrative problems, particularly in comparison with section 530;
- Section 1706 actually improves the administrability of the present-law rules for classifying individuals as employees or independent contractors by partially repealing the prohibition in section 530 against the issuance of guidance; but
- The occupations covered by section 1706 could be clarified (*see* Chapter 6, section II).

Abuses in the reporting of income by independent contractors. The Conference Report questioned whether there were any abuses in the reporting of income by independent contractors that would justify the adoption of section 1706, including any evidence of greater noncompliance by independent contractors when compared to employees. The report finds that:

- Existing IRS data suggest that there are errors in the classification of employees as independent contractors and in the reporting of income by such individuals, which may call for legislative or administrative changes--
  - Underreporting of income by such individuals, and the more favorable treatment of independent contractor trade or business expenses, reduce tax revenue;
  - Misclassification of employees as independent contractors increases tax revenues, however, and tends to offset the revenue loss from undercompliance by such individuals, because direct compensation to independent contractors is substituted for tax-favored employee fringe benefits;
- Evidence suggests that compliance is somewhat better for technical services workers who are classified as independent contractors than for workers in general who are classified as independent contractors (*see* Chapter 5).

Chilling effect of section 1706 on the ability of technical services personnel to get work. The Conference Report questioned the effect of section 1706 on the ability of technical services personnel to get work. The report concludes that:

- Section 1706 does not affect the cost to firms of technical services workers relative to other workers, and does not affect the demand for firms' products; it is unlikely, therefore, that section 1706 affects the overall ability of technical services workers to get work;

- Section 1706 may, however, have had some transitory effects on the ability of some workers to find work in their accustomed classification (*see* Chapter 4).

Administrability of the present-law standards for classifying individuals as employees or independent contractors. The Conference Report questioned whether the present law standards for distinguishing between employees and independent contractors were administrable. The report finds that:

- The task of classifying workers as employees or independent contractors under the 20-factor common law tests generally used under present law can be difficult, in particular in the multi-party situations affected by section 1706;
- Section 530 has exacerbated this problem by preventing the IRS from issuing guidance in this area for over ten years; and
- Section 1706 may have improved tax administration by permitting the IRS to issue guidance with respect to certain workers and by denying the section 530 safe harbors to certain employers (*see* Chapter 6, section III).

Equity of distinguishing between independent contractors who work through brokers and those who do not. The Conference Report questioned the equity of providing rules that distinguish between independent contractors who work through brokers and those who do not. The report finds that:

- This distinction unnecessarily limits the beneficial effects of section 1706, and may have an adverse effect on the efficiency of the labor markets for such workers;
- Data are not available, however, to determine whether the distinction can be justified on the basis of differences in compliance rates between the two groups (*see* Chapter 4).

## IV. OPTIONS FOR FURTHER CONSIDERATION

The significance of the effects of section 1706 must be viewed in the context of existing substantive tax differences between independent contractors and employees, especially with respect to the exclusion of fringe benefits from gross income, the deductibility of employee business expenses, and differences in the Social Security and Medicare tax base. In that context,

and based on the findings of this report, the following options are presented for further consideration and analysis:

- Eliminate the difference in treatment under section 1706 between technical services workers working through brokers and those not working through brokers. This difference is difficult to justify on equity or other policy grounds. (*See* Chapter 4.)
- Clarify the occupations covered by section 1706. Difficulties in determining the occupations covered by section 1706 present an administrative problem. (*See* Chapter 6.)
- Repeal the prohibition in section 530 against the issuance of guidance by the IRS concerning employee status. This prohibition has significantly reduced taxpayers' ability to classify workers correctly as employees or independent contractors and has exacerbated the difficulty of applying the 20-factor common law standards. (*See* Chapter 6.)

# PART TWO

# BACKGROUND INFORMATION

# CHAPTER 2: SOURCES OF EMPLOYEE MISCLASSIFICATION

## I. OVERVIEW

A wide variety of relationships between service-providers and service-recipients exists in the modern economy. They differ with respect to the degree of control exercised by the service-recipient, whether the services are full-time or part-time, the method of compensation (*e.g.*, salaried versus hourly), the level of material support provided by the service-recipient, and many other factors. Despite this diversity, service-providers are generally grouped into one of two broad categories for Federal tax purposes: employees and independent contractors.

Misclassification of individuals as employees or independent contractors results when service-recipients and service-providers misapply the tests used to distinguish employees from independent contractors under the Code. Deliberate misclassification of employees as independent contractors results in part from the fact that there are numerous differences under the Internal Revenue Code (Code) between the treatment of employers and employees, on the one hand, and independent contractors and their clients, on the other, and from the perception that these differences systematically favor the second group.

Differences in treatment between employers and employees, on the one hand, and independent contractors and their clients, on the other, also occur under a number of other Federal and State laws, primarily those dealing with workers' compensation and unemployment insurance, labor-management relations, employment discrimination, and other labor issues. Misclassification designed to benefit from these differences in non-tax treatment can also contribute to misclassification for Federal tax purposes, since inconsistent treatment of an individual under these laws and Federal tax laws might invite scrutiny.

Misclassification of individuals as employees or independent contractors is problematic to the extent that it circumvents a policy decision to limit certain tax benefits or burdens to one group or the other, or results in a loss of revenue through noncompliance.

This chapter provides a general description of the factors used to distinguish employees from independent contractors under Federal tax and other laws, and of the differences in the treatment of employees and independent contractors that may encourage misclassification under each. A more detailed description of these issues is provided in Appendix A.

## II. DETERMINATION OF EMPLOYEE STATUS

The status of an individual as an employee or independent contractor for purposes of Federal employment, income and other tax laws is, with few exceptions, determined under the common law tests for determining whether an employment relationship exists. These tests focus on whether the service-recipient has the right to *direct and control* the service-provider, not only as to the result to be accomplished by the work, but also as to the details and means by which that result is accomplished. Over the years, the IRS has identified 20 important factors useful in determining whether the common law tests have been satisfied. These factors are listed in Appendix B.

The status of an individual as an employee or independent contractor for purposes of Federal and State labor and related laws is generally determined under standards that resemble the control-based common law standards applied under the Code. Depending on the purpose of the law involved, however, different factors are often emphasized in making this determination. Thus, IRS determinations of employee status based on the common law tests are generally persuasive but not determinative in other areas, and it is possible for an individual to be classified as an employee for some purposes and as an independent contractor for others.

## III. DIFFERENCES IN TAX TREATMENT BETWEEN EMPLOYEES AND INDEPENDENT CONTRACTORS

Current law does not consistently favor status as either an employee or an independent contractor. Employers and employees are treated differently than independent contractors and their clients under a number of Federal and State laws, however. Thus, depending on individual circumstances, misclassification may sometimes be advantageous to the service-provider, the service-recipient, or both.

### A. Differences Favoring Independent Contractor Status

Federal Tax Law. Prior to 1982, compensation earned by independent contractors was taxed at substantially lower rates under the Social Security and Medicare tax provisions of the Code than wage income, apparently creating a significant incentive for misclassification.[2] Subsequent legislation has essentially eliminated this important difference. The Social Security,

---

[2] To some extent, however, the rate differential may have been offset by differences in the compensation base to which the taxes applied.

Medicare, and income tax provisions of the Code may still favor classification as an independent contractor, however, where an individual has a small or unpredictable cash flow or significant employee business expenses. This is primarily because:

(1) Independent contractors face significantly fewer restrictions on their ability to deduct trade or business expenses than employees. In particular, employees generally may not deduct their trade or business expenses unless they "itemize" their deductions on their tax returns, and then only to the extent the expenses exceed two percent of their adjusted gross incomes from all sources. They must also satisfy additional requirements before they may deduct their automobile depreciation, home office, home computer and certain other expenses. These requirements are difficult for many employees to meet and in some cases constitute an effective barrier to a deduction.

(2) The estimated tax system used to collect Social Security, Medicare, and income taxes from independent contractors largely avoids the problem of over-withholding that can result when an employee incurs large business expenses, has net income that fluctuates during a year, or is employed for only part of a year. It also generally permits later and less frequent payments than the withholding system used to collect such taxes from employees.

As an essentially voluntary reporting system, the estimated tax system also provides fewer checks against underreporting of income and taxes than the withholding system and may, therefore, be favored by service-providers and service-recipients willing to violate the law and risk detection on audit; it also does not ensure the collectability of taxes to the same extent as the withholding system. Finally, the withholding system involves overhead costs, which employers may seek to shift to employees by classifying them as independent contractors.

The unemployment insurance tax provisions of the Code (and corresponding State laws) may in some cases also favor classification as an independent contractor. Independent contractors and their clients generally are not subject to unemployment insurance taxes. On the other hand, independent contractors generally are not eligible for unemployment insurance benefits. Other things being equal, employers will have an incentive to classify a worker as an independent contractor in order to avoid unemployment insurance taxes on an employee's wages (and the administrative costs of remitting such taxes and complying with other associated statutory requirements). Workers may prefer to be classified as independent contractors if they are not (or perceive that they are not) dependent on a single employer for their income.

Other Laws. State and Federal labor and related laws may in some cases also favor classification as an independent contractor. Such laws typically do not apply to independent contractors, providing protection only to employees. This is generally beneficial to clients of independent contractors, since it may allow them to avoid the direct costs of providing additional benefits and protections to the independent contractors, as well as the administrative cost of explaining the benefits and assuring that various other statutory requirements have been met. Thus, the difference in treatment may provide an incentive for employers to misclassify employees as independent contractors. Employees may also prefer to be misclassified as independent contractors in order to avoid coverage under these laws, if they are not willing to pay the indirect cost for the specific protection provided.

### B. Differences Favoring Employee Status

The Social Security, Medicare, and income tax provisions of the Code may, on the other hand, favor classification as an employee in cases where an individual prefers to receive some of her compensation in the form of fringe benefits rather than cash. This is because, under the Code, an employer may provide fringe benefits, such as pensions, accident and health and group-term life insurance, on a tax-favored basis to its employees but not to its independent contractors. Such benefits are generally excluded from employees' gross incomes subject to income tax as well as wages subject to Social Security and Medicare taxes. While independent contractors can generally establish their own fringe benefit plans, amounts used to purchase such benefits generally cannot be deducted or excluded from gross income subject to income tax, or from compensation subject to Social Security and Medicare taxes. Limited exceptions are provided for certain of the most significant benefits, including pensions and accident and health insurance; amounts used to purchase these benefits can to some extent be deducted or excluded from gross income subject to income tax by independent contractors, although they cannot be deducted or excluded from compensation subject to Social Security and Medicare taxes.

An employer may be reluctant to allow an independent contractor to participate in a plan as an employee, however, since that might involve additional costs to the employer. This is particularly true if the independent contractor is highly compensated, in which case her participation might require the employer to provide additional benefits to its non-highly compensated employees under the minimum coverage and nondiscrimination requirements of the Code. Also, short-service independent contractors may not derive any significant benefits from participation, and may therefore prefer to receive additional cash compensation, instead.

The various differences in tax treatment between employees and independent contractors discussed above are summarized in Table 2-1.

### C. Five Hypothetical Examples of Differential Tax Treatment

The preceding discussion indicates that Federal and State tax, labor and related laws do not systematically favor classification of an individual as an employee or independent contractor. The most beneficial classification for a particular individual depends instead on her circumstances, preferences, and negotiating skills. This section illustrates the effects of these differences using five hypothetical examples.

Each example begins with $1,000 which an employer or service-recipient could spend on worker compensation. In the employee situation, most of the $1,000 is used to pay the employee her normal salary plus holiday, vacation and sick pay. The remainder is used to pay employment taxes (including Social Security and Medicare taxes, and State and Federal unemployment insurance taxes) and to provide statutorily-required or voluntarily-provided fringe benefits (including contributions to retirement plans, health insurance premiums, and workers' compensation premiums). The employee pays any Federal and State income taxes and the employee share of the Social Security and Medicare taxes due on her salary, and also pays any work-related expenses (for tools, etc.).[3]

In the independent contractor situation, the $1,000 spent for worker compensation by the client is generally assumed to be paid to the independent contractor, although, depending on the knowledge and relative negotiating skills of the two parties, some might be retained by the client. The amount, if any, retained by the client is assumed to pass directly to the client's "bottom line" and, therefore, to be subject to Federal and State corporate income taxes.

In order to maintain the comparison between the employee and the independent contractor, the independent contractor is assumed to incur the same costs as the employee (although the tax treatment may be different) and is assumed to purchase directly the same

---

[3] Since the examples show the impact of *additional* income to the employee or independent contractor, a 28 percent Federal income tax rate and a 7.5 percent State income tax rate are assumed to apply to the additional taxable income. The assumed Federal corporate income tax rate is 34 percent, and the assumed State rate is eight percent. The various tax rates are based on those that would be paid by or for a middle-income worker.

# Table 2-1

## Major Differences in Treatment of Employees and Independent Contractors for Federal Tax and Other Purposes

| Employees | Independent Contractors |
|---|---|
| **Fringe Benefits[1]** | |
| Value of many employer-provided fringe benefits excluded from income and employment tax bases | Qualified retirement plan contributions excluded from income but not self-employment tax base |
| | 25 percent of health insurance costs deducted from income but not self-employment tax base |
| | Few other fringe benefits excluded from income or self-employment tax bases |
| **Trade or Business Expenses** | |
| May be deducted from income tax base only by itemizers and only to the extent expenses exceed two percent of adjusted gross income | May be deducted from income tax base |
| May not be excluded from employment tax base | May be excluded from self-employment tax base |
| Certain expenses subject to additional business purpose requirements | |
| **Administrative Costs** | |
| Withholding involves more administrative costs for employer but less for employee | Estimated tax system involves more administrative costs for independent contractor but less for client |
| | Estimated tax system allows modest delay in tax payments relative to withholding |
| **Compliance** | |
| | Somewhat more ability to be noncompliant due to lack of withholding, larger trade or business expenses, and somewhat more limited business purpose requirements with respect to such expenses |
| **Non-Tax Differences[2]** | |
| Less flexibility in choosing among fringe benefits; value of employer contributions to retirement plan may be lost if worker changes jobs frequently | May be unable to obtain fringe benefits, including statutory fringe benefits such as unemployment insurance and workers' compensation |
| Administrative (and other) costs associated with Federal and State laws applicable to employees, *e.g.*, minimum wage | May be unable to negotiate worker protections such as minimum wage and overtime |

Department of the Treasury
Office of Tax Policy

1. For a detailed comparison of the tax treatment of fringe benefits and business expenses, *see* Appendix A. Employer-provided fringe benefits may be subject to nondiscrimination requirements and other limits.

2. Some of the non-tax differences, such as minimum wage laws, may be more applicable to less advantaged workers than to occupations covered by section 1706.

benefits that the employee would receive as employer-paid fringe benefits.[4] It is further assumed that the independent contractor can purchase these benefits at the same cost an employer could when purchasing for all of its employees as a group.[5]

Example 1--Typical Mix of Fringe Benefits. Example 1 (Table 2-2) shows a situation in which an employee receives a typical mix of fringe benefits but does not incur any deductible trade or business expenses. The employer pays the employer share of Social Security and Medicare taxes, as well as the total cost of workers' compensation premiums and Federal and State unemployment insurance taxes. The employer also makes contributions to retirement and medical insurance plans for the employee, each costing six percent of total compensation. The employee receives regular, vacation, holiday and sick pay of $806, out of which the employee's share of Social Security and Medicare taxes, as well as Federal and State income taxes, are paid. The independent contractor receives the entire $1,000 in cash. Out of that, she pays Federal and State income taxes, Social Security and Medicare taxes, buys health insurance, and contributes to a tax-favored "Keogh" retirement plan. As shown in Table 2-2, the independent contractor pays $12 more in Federal income tax, $4 more in State income tax, and $18 more in Social Security and Medicare tax.

Taxes are higher for the independent contractor in Example 1 because the part of her cash income that was used to provide fringe benefits in the case of the employee is subject to Social Security and Medicare taxes, and some is also subject to income taxes. Current Federal law attempts to equate the tax rate for employees and self-employed persons for Social Security and Medicare tax purposes. Nevertheless, there are differences in the tax base. Self-employed persons may not exclude the value of fringe benefits they purchase for themselves from the Social Security and Medicare tax base (other than the employer portion of Social Security and Medicare taxes), while the value of employer-provided fringe benefits is typically excluded from that base in the case of employees. Hence, in Example 1, the Social Security tax is $18, or 15 percent, higher for the independent contractor than for the employee. The income tax system does provide deductions for self-employed persons for contributions to retirement plans (and for the equivalent to the employer portion of Social Security and Medicare taxes), but it only

---

[4] In practice, the lower after-tax price for voluntarily-provided fringe benefits would likely result in greater expenditures for these items in the employee case. Conversely, the lower after-tax price of certain trade or business expenses for independent contractors would likely result in higher trade or business expenses for such individuals.

[5] This assumption is made for simplicity and may be approximately correct for small employers. For large employers, economies of scale are probably important.

Table 2-2

EXAMPLE I: COMPARISON OF INCOME AND TAXATION OF $1,000 OF TOTAL COMPENSATION FOR AN EMPLOYEE OR INDEPENDENT CONTRACTOR, WORKER WITH A TYPICAL MIX OF FRINGE BENEFITS AND NO WORKER EXPENSES

| | Employer/Employee | | | Independent Contractor | | |
|---|---|---|---|---|---|---|
| | Employer | Employee | Combined | Service Recipient | Worker | Combined |
| Money Payment or Regular Salary | | 733 | 733 | | 1,000 | 1,000 |
| Holiday/Vacation/Sick Pay | | 73 | 73 | | | |
| MONEY PAYMENT OR TOTAL SALARY | | 806 | 806 | | 1,000 | 1,000 |
| Employer-Paid Taxes and Benefits | 194 | | 194 | | | |
| TOTAL COMPENSATION TO WORKER | | | 1,000 | | | 1,000 |
| Retained by Service Recipient | | | | 0 | | |
| TOTAL COMPENSATION | | | 1,000 | | | 1,000 |
| TAXES AND STATUTORY BENEFITS, TOTAL | 74 | 331 | 405 | 0 | 427 | 427 |
| Federal Income Tax 1/ 2/ | | 209 | 209 | 0 | 221 | 221 |
| State Income Tax 1/ 3/ | | 60 | 60 | 0 | 64 | 64 |
| Social Security (FICA/SECA) 4/ | 62 | 62 | 123 | | 141 | 141 |
| Unemployment Insurance (FUTA and State) 5/ | 4 | | 4 | | | |
| Workers' Compensation 6/ | 8 | | 8 | | | |
| VOLUNTARY FRINGE BENEFITS, TOTAL | 120 | 0 | 120 | 0 | 120 | 120 |
| Retirement/Keogh Contribution | 60 | | 60 | | 60 | 60 |
| Health Insurance Premiums | 60 | | 60 | | 60 | 60 |
| WORKER EXPENSES (DEDUCTIBLE), TOTAL | | 0 | | 0 | 0 | |
| Income and Social Security Tax Compliance Rate | | | 100.0% | | | 100.0% |
| For Worker | | | | | | |
| Total Compensation less Taxes and Statutory Benefits | | | 595 | | | 573 |
| Money Income less Worker Taxes | | | 475 | | | 573 |
| Money Income less Worker Taxes, Worker-Paid Benefits, and Worker Expenses | | | 475 | | | 453 |
| For Employer (Service Recipient) | | | | | | |
| Retained by Service Recipient less Taxes | | | 0 | | | 0 |

Department of the Treasury
Office of Tax Analysis

Note: Detail may not add to totals due to rounding.

1/ Taxable amount is money payment to the worker less deductions consistent with worker status. Employee has itemized deductions for state income taxes (for federal tax purposes but not for state tax purposes) and for worker expenses in excess of 2 percent of adjusted gross income (assumed to be 4 percent of money payment). Independent contractor deducts worker expenses, Keogh contributions, 25 percent of health insurance premium, and 50 percent of SECA tax.

2/ 28 percent rate for the worker, and 34 percent rate for the service recipient.

3/ 7.5 percent rate for the worker, and 8 percent rate for the service recipient.

4/ 7.65 percent rate for the employee and for the employer, or 14.12955 percent rate ([100%-7.65%]x15.3%) paid entirely by the independent contractor.

5/ Assumed to be 0.55 percent of total salary.

6/ Assumed to be 1 percent of total salary.

permits a deduction for 25 percent of medical insurance costs (and then only in some circumstances), and it does not permit a deduction for the cash equivalent of other fringe benefits, which in this example only consist of the costs of unemployment insurance and workers' compensation.

Example 2--Noncompliance. Independent contractors may have greater opportunity than employees to be less than fully compliant with tax laws. Employees are subject to withholding, and the amount of their wage income is reported with great precision to the IRS. Independent contractors may be able to omit some of their income on their tax returns, although that becomes more difficult when their gross income is reported to IRS on information returns (generally Forms 1099-MISC). Even if independent contractors report 100 percent of their income, however, they may be able to lower their reported tax liability by overstating expenses. Since the workers in Example 2 do not have trade or business expenses, the noncompliance consists solely of the failure to report all of gross income. Example 2 (Table 2-3) illustrates the effect of a lower compliance rate on the independent contractor's tax liabilities. Example 2 is the same as Example 1, except that the independent contractor is assumed to report only 95 percent of her net income from self-employment. As a result of this underreporting by five percent, the independent contractor's Federal and State income taxes are now virtually the same as for the employee, although the Social Security tax is still $11, or nine percent, higher.[6] At greater levels of noncompliance, the taxes of the independent contractors would be lower than those of the fully compliant employee.[7]

Example 3--Trade or Business Expenses. Employee business expenses can also differentially affect the tax treatment of employees and independent contractors. Example 3 (Table 2-4) is similar to Example 1, except that the worker is now assumed to have expenses equivalent to ten percent of total compensation. The independent contractor is able to deduct all of these expenses in calculating income subject to both income and Social Security and Medicare taxes. In contrast, the employee's Social Security and Medicare taxes are not adjusted at all to reflect these expenses. For income tax purposes, these expenses may be reflected if the worker itemizes deductions on her income tax return, but, even then, they are only deductible to the extent that they, together with other miscellaneous deductions, exceed two percent of her

---

[6] *See* Table 5-3 for a summary of the compliance rates found in one recent IRS study.

[7] *See* Table 5-2 for a summary of compliance rates actually found in one IRS study. For technical services workers in that study, reporting of gross receipts was 97.0 percent, and reporting of net income (*i.e.*, gross receipts minus business expenses) was 83.4 percent.

Table 2-3

EXAMPLE 2: COMPARISON OF INCOME AND TAXATION OF $1,000 OF TOTAL COMPENSATION FOR AN EMPLOYEE OR INDEPENDENT CONTRACTOR, WORKER WITH A TYPICAL MIX OF FRINGE BENEFITS, NO WORKER EXPENSES, AND 5 PERCENT NON-COMPLIANCE BY THE INDEPENDENT CONTRACTOR

| | Employer/Employee | | | Independent Contractor | | |
|---|---|---|---|---|---|---|
| | Employer | Employee | Combined | Service Recipient | Worker | Combined |
| Money Payment or Regular Salary | | 733 | 733 | | 1,000 | 1,000 |
| Holiday/Vacation/Sick Pay | | 73 | 73 | | | |
| MONEY PAYMENT OR TOTAL SALARY | | 806 | 806 | | 1,000 | 1,000 |
| Employer-Paid Taxes and Benefits | | | | | | |
| TOTAL COMPENSATION TO WORKER | | | 1,000 | | | 1,000 |
| Retained by Service Recipient | | | | | | |
| TOTAL COMPENSATION | | | 1,000 | | | 1,000 |
| TAXES AND STATUTORY BENEFITS, TOTAL | 74 | 331 | 405 | 0 | 404 | 404 |
| Federal Income Tax 1/ 2/ | | 209 | 209 | 0 | 209 | 209 |
| State Income Tax 1/ 3/ | | 60 | 60 | 0 | 61 | 61 |
| Social Security (FICA/SECA) 4/ | 62 | 62 | 123 | | 134 | 134 |
| Unemployment Insurance (FUTA and State) 5/ | 4 | | 4 | | | |
| Workers' Compensation 6/ | 8 | | 8 | | | |
| VOLUNTARY FRINGE BENEFITS, TOTAL | 120 | 0 | 120 | 0 | 120 | 120 |
| Retirement/Keogh Contribution | 60 | | 60 | | 60 | 60 |
| Health Insurance Premiums | 60 | | 60 | | 60 | 60 |
| WORKER EXPENSES (DEDUCTIBLE), TOTAL | 0 | 0 | | 0 | 0 | |
| Income and Social Security Tax Compliance Rate | | | 100.0% | | | 95.0% |
| For Worker | | | | | | |
| Total Compensation less Taxes and Statutory Benefits | | | 595 | | | 596 |
| Money Income less Worker Taxes | | | 475 | | | 596 |
| Money Income less Worker Taxes, Worker-Paid Benefits, and Worker Expenses | | | 475 | | | 476 |
| For Employer (Service Recipient) | | | | | | |
| Retained by Service Recipient less taxes | | | 0 | | | 0 |

Department of the Treasury
Office of Tax Analysis

Note: Detail may not add to totals due to rounding.

1/ Taxable amount is money payment to the worker less deductions consistent with worker status. Employee has itemized deductions for state income taxes (for federal tax purposes but not for state tax purposes) and for worker expenses in excess of 2 percent of adjusted gross income (assumed to be 4 percent of money payment). Independent contractor deducts worker expenses, Keogh contributions, 25 percent of health insurance premium, and 50 percent of SECA tax.

2/ 28 percent rate for the worker, and 34 percent rate for the service recipient.

3/ 7.5 percent rate for the worker, and 8 percent rate for the service recipient.

4/ 7.65 percent rate for the employee and for the employer, or 14.12955 percent rate ([100%-7.65%]x15.3%) paid entirely by the independent contractor.

5/ Assumed to be 0.55 percent of total salary.

6/ Assumed to be 1 percent of total salary.

Table 2-4

EXAMPLE 3: COMPARISON OF INCOME AND TAXATION OF $1,000 OF TOTAL COMPENSATION FOR AN EMPLOYEE OR INDEPENDENT CONTRACTOR, WORKER WITH A TYPICAL MIX OF FRINGE BENEFITS AND WORKER EXPENSES OF 10 PERCENT

| | Employer/Employee | | | Independent Contractor | | |
|---|---|---|---|---|---|---|
| | Employer | Employee | Combined | Service Recipient | Worker | Combined |
| Money Payment or Regular Salary | | 733 | 733 | | 1,000 | 1,000 |
| Holiday/Vacation/Sick Pay | | 73 | 73 | | | |
| MONEY PAYMENT OR TOTAL SALARY | | 806 | 806 | | 1,000 | 1,000 |
| Employer-Paid Taxes and Benefits | 194 | | 194 | | | |
| TOTAL COMPENSATION TO WORKER | | | 1,000 | | | 1,000 |
| Retained by Service Recipient | | | | 0 | | |
| TOTAL COMPENSATION | | | 1,000 | | | 1,000 |
| TAXES AND STATUTORY BENEFITS, TOTAL | 74 | 308 | 382 | 0 | 381 | 381 |
| Federal Income Tax 1/ 2/ | | 191 | 191 | 0 | 197 | 197 |
| State Income Tax 1/ 3/ | | 55 | 55 | 0 | 57 | 57 |
| Social Security (FICA/SECA) 4/ | 62 | 62 | 123 | | 127 | 127 |
| Unemployment Insurance (FUTA and State) 5/ | 4 | | 4 | | | |
| Workers' Compensation 6/ | 8 | | 8 | | | |
| VOLUNTARY FRINGE BENEFITS, TOTAL | 120 | 0 | 120 | 0 | 120 | 120 |
| Retirement/Keogh Contribution | 60 | | 60 | | 60 | 60 |
| Health Insurance Premiums | 60 | | 60 | | 60 | 60 |
| WORKER EXPENSES (DEDUCTIBLE), TOTAL | 0 | 100 | 100 | 0 | 100 | 100 |
| Income and Social Security Tax Compliance Rate | | | 100.0% | | | 100.0% |
| For Worker | | | | | | |
| Total Compensation less Taxes and Statutory Benefits | | | 618 | | | 619 |
| Money Income less Worker Taxes | | | 498 | | | 619 |
| Money Income less Worker Taxes, Worker-Paid Benefits, and Worker Expenses | | | 398 | | | 399 |
| For Employer (Service Recipient) | | | | | | |
| Retained by Service Recipient less Taxes | | | 0 | | | 0 |

Department of the Treasury
Office of Tax Analysis

Note: Detail may not add to totals due to rounding.

1/ Taxable amount is money payment to the worker less deductions consistent with worker status. Employee has itemized deductions for state income taxes (for federal tax purposes but not for state tax purposes) and for worker expenses in excess of 2 percent of adjusted gross income (assumed to be 4 percent of money payment). Independent contractor deducts worker expenses, Keogh contributions, 25 percent of health insurance premium, and 50 percent of SECA tax.

2/ 28 percent rate for the worker, and 34 percent rate for the service recipient.

3/ 7.5 percent rate for the worker, and 8 percent rate for the service recipient.

4/ 7.65 percent rate for the employee and for the employer, or 14.12955 percent rate ([100%-7.65%]x15.3%) paid entirely by the independent contractor.

5/ Assumed to be 0.55 percent of total salary.

6/ Assumed to be 1 percent of total salary.

adjusted gross income from all sources. In Example 3, it is assumed that the effective deduction floor is equivalent to four percent of total compensation, so that only the excess over that level is deductible. As a result of the differential treatment of these trade or business expenses, the extra Federal income tax paid by the independent contractor has been reduced from $12 to $6, and the extra State income tax has been reduced from $4 to $2. The extra Social Security tax has been reduced from $18 to $4, however.

Effect of Expenses on Noncompliance Rates. The noncompliance rate for net income generally does not equal the noncompliance rate for gross income. The rates are equal only when gross income and net income are equal because the worker has no trade or business expenses. When the worker has such expenses, the noncompliance rate for net income exceeds the noncompliance rate for gross income. The higher the level of expenses, the greater the difference between noncompliance rates becomes. Consider a worker with gross income of $1,000 and expenses of $400; net income is $600. If the worker understates gross income by ten percent, net income will be understated by 16.7 percent.[8]

The noncompliance rate for net income and the difference between the gross and net income compliance rates will be greater if the worker can use the existence of trade or business expenses to understate net income further by overstating expenses. In the example above, if the worker both understates gross income by ten percent and overstates expenses by ten percent, net income will be understated by 23.3 percent.[9]

Example 4--Statutorily-Required Fringe Benefits Only. In Example 4 (Table 2-5), the employer is assumed not to provide any voluntary fringe benefits. In addition to salary, the employer pays only for the employer portion of Social Security and Medicare taxes, the Federal and State unemployment taxes, and workers' compensation insurance premiums. Since fringe benefits, which cause the disparity between Social Security and Medicare tax levels for employees and independent contractors, have been greatly reduced, there is only a $1 difference in Social Security and Medicare taxes between the employee and the independent contractor. The additional Federal income tax paid by the independent contractor is $4, and the additional

---

[8] Net and gross income are both understated by $100. The noncompliance rate on gross income is $100/$1,000; the noncompliance rate on net income is $100/$600.

[9] Gross income is understated by $100. Expenses are overstated by ten percent, or $40. Net income is understated by $140. The noncompliance rate on net income is $140/$600.

Table 2-5

EXAMPLE 4: COMPARISON OF INCOME AND TAXATION OF $1,000 OF TOTAL COMPENSATION FOR EMPLOYEE OR INDEPENDENT CONTRACTOR, WORKER WITH ONLY STATUTORY BENEFITS AND NO WORKER EXPENSES

| | Employer/Employee | | | Independent Contractor | | |
|---|---|---|---|---|---|---|
| | Employer | Employee | Combined | Service Recipient | Worker | Combined |
| Money Payment or Regular Salary | | 916 | 916 | | 1,000 | 1,000 |
| Holiday/Vacation/Sick Pay | | 0 | | | | |
| MONEY PAYMENT OR TOTAL SALARY | | 916 | 916 | | 1,000 | 1,000 |
| Employer-Paid Taxes and Benefits | 84 | | 84 | | | |
| TOTAL COMPENSATION TO WORKER | | | 1,000 | | | 1,000 |
| Retained by Service Recipient | | | | 0 | | |
| TOTAL COMPENSATION | | | 1,000 | | | 1,000 |
| TAXES AND STATUTORY BENEFITS, TOTAL | 84 | 376 | 460 | 0 | 452 | 452 |
| Federal Income Tax 1/ 2/ | | 237 | 237 | 0 | 241 | 241 |
| State Income Tax 1/ 3/ | | 69 | 69 | 0 | 70 | 70 |
| Social Security (FICA/SECA) 4/ | 70 | 70 | 140 | | 141 | 141 |
| Unemployment Insurance (FUTA and State) 5/ | 5 | | 5 | | | |
| Workers' Compensation 6/ | 9 | | 9 | | | |
| VOLUNTARY FRINGE BENEFITS, TOTAL | 0 | 0 | | 0 | 0 | |
| Retirement/Keogh Contribution | 0 | | | | 0 | |
| Health Insurance Premiums | 0 | | | | 0 | |
| WORKER EXPENSES (DEDUCTIBLE), TOTAL | 0 | 0 | | 0 | 0 | |
| Income and Social Security Tax Compliance Rate | | | 100.0% | | | 100.0% |
| For Worker | | | | | | |
| Total Compensation less Taxes and Statutory Benefits | | | 540 | | | 548 |
| Money Income less Worker Taxes | | | 540 | | | 548 |
| Money Income less Worker Taxes, Worker-Paid Benefits, and Worker Expenses | | | 540 | | | 548 |
| For Employer (Service Recipient) | | | | | | |
| Retained by Service Recipient less Taxes | | | 0 | | | 0 |

Department of the Treasury
Office of Tax Analysis

Note: Detail may not add to totals due to rounding.

1/ Taxable amount is money payment to the worker less deductions consistent with worker status. Employee has itemized deductions for state income taxes (for federal tax purposes but not for state tax purposes) and for worker expenses in excess of 2 percent of adjusted gross income (assumed to be 4 percent of money payment). Independent contractor deducts worker expenses, Keogh contributions, 25 percent of health insurance premium, and 50 percent of SECA tax.

2/ 28 percent rate for the worker, and 34 percent rate for the service recipient.

3/ 7.5 percent rate for the worker, and 8 percent rate for the service recipient.

4/ 7.65 percent rate for the employee and for the employer, or 14.12955 percent rate ([100%-7.65%]x15.3%) paid entirely by the independent contractor.

5/ Assumed to be 0.55 percent of total salary.

6/ Assumed to be 1 percent of total salary.

State income tax is $1. The situation illustrated in Example 4 is typical of many temporary employees, whose fringe benefits are often restricted to those required by law.[10]

Note that in Example 4, as a result of higher cash wages exactly offsetting the reduction in fringe benefits, both workers' total current tax bills have increased compared with the workers in Example 1. For the employee, the sum of the Federal and State income taxes and the combined employer-employee Social Security and Medicare taxes has increased by $53, or 13 percent. For the independent contractor, the combined bill has increased by $25, or six percent.

Example 5--Lower Independent Contractor Compensation. Example 5 (Table 2-6) is similar to Example 4, except that the independent contractor's compensation is slightly lower because she has been unable to negotiate from her client the equivalent of the value of the employer's costs for workers' compensation and unemployment insurance (*i.e.*, her bargaining power is lower than in Example 4). Since this wedge between total employee compensation and total payments to the independent contractor is small, the resulting tax differences are also small. Because the independent contractor now has less income, her Social Security and Medicare taxes are now slightly lower ($1) than those paid by the employer and the employee. Also, the independent contractor's Federal and State income taxes are now the same as those of the employee. However, because the client must pay income tax on the funds it has retained, the combined income taxes of the independent contractor and her client are still $6, or two percent, higher than those of the employee.[11]

Summary. These examples illustrate that the difference in income, Social Security and Medicare taxes paid by employers and employees, on the one hand, and independent contractors and their clients, on the other, on the same amount of total compensation depends on the proportion of compensation the individual takes as fringe benefits, the extent of the individual's work-related expenses, and the relative compliance of employees and independent contractors. With typical patterns of fringe benefits and worker expenses, independent contractors and their clients tend to pay higher levels of taxes, especially Social Security and Medicare taxes, than

---

[10] U.S. Department of Labor, Bureau of Labor Statistics, *BLS Reports on its First Survey of Pay and Employee Benefits in the Temporary Help Supply Industry*, 88-260, page 8 (1988).

[11] Employees with substantial trade or business expenses and sufficient bargaining power may be able to negotiate with their employers to structure computer and auto expenses as required business expenses. In such a situation, the worker would still be subject to the two-percent floor, but would be able to deduct expenses that would normally not be deductible.

Table 2-6

EXAMPLE 5: COMPARISON OF INCOME AND TAXATION OF $1,000 OF TOTAL COMPENSATION FOR EMPLOYEE OR INDEPENDENT CONTRACTOR, WORKER WITH ONLY STATUTORY BENEFITS, NO WORKER EXPENSES, AND A "WEDGE" BETWEEN EMPLOYEE AND INDEPENDENT CONTRACTOR TOTAL COMPENSATION

| | Employer/Employee | | | Independent Contractor | | |
|---|---|---|---|---|---|---|
| | Employer | Employee | Combined | Service Recipient | Worker | Combined |
| Money Payment or Regular Salary | | 916 | 916 | | 986 | 986 |
| Holiday/Vacation/Sick Pay | | 0 | | | | |
| MONEY PAYMENT OR TOTAL SALARY | | 916 | 916 | | 986 | 986 |
| Employer-Paid Taxes and Benefits | 84 | | 84 | | | |
| TOTAL COMPENSATION TO WORKER | | | 1,000 | | | 986 |
| Retained by Service Recipient | | | | 14 | | 14 |
| TOTAL COMPENSATION | | | 1,000 | | | 1,000 |
| TAXES AND STATUTORY BENEFITS, TOTAL | 84 | 376 | 460 | 6 | 445 | 451 |
| Federal Income Tax 1/ 2/ | | 237 | 237 | 4 | 237 | 242 |
| State Income Tax 1/ 3/ | | 69 | 69 | 1 | 69 | 70 |
| Social Security (FICA/SECA) 4/ | 70 | 70 | 140 | | 139 | 139 |
| Unemployment Insurance (FUTA and State) 5/ | 5 | | 5 | | | |
| Workers' Compensation 6/ | 9 | | 9 | | | |
| VOLUNTARY FRINGE BENEFITS, TOTAL | 0 | 0 | | 0 | 0 | |
| Retirement/Keogh Contribution | 0 | | | | 0 | |
| Health Insurance Premiums | 0 | | | | 0 | |
| WORKER EXPENSES (DEDUCTIBLE), TOTAL | 0 | 0 | | 0 | 0 | |
| Income and Social Security Tax Compliance Rate | | | 100.0% | | | 100.0% |
| For Worker | | | | | | |
| Total Compensation less Taxes and Statutory Benefits | | | 540 | | | 541 |
| Money Income less Worker Taxes | | | 540 | | | 541 |
| Money Income less Worker Taxes, Worker-Paid Benefits, and Worker Expenses | | | 540 | | | 541 |
| For Employer (Service Recipient) | | | | | | |
| Retained by Service Recipient less Taxes | | | 0 | | | 9 |

Department of the Treasury
Office of Tax Analysis

Note: Detail may not add to totals due to rounding.

1/ Taxable amount is money payment to the worker less deductions consistent with worker status. Employee has itemized deductions for state income taxes (for federal tax purposes but not for state tax purposes) and for worker expenses in excess of 2 percent of adjusted gross income (assumed to be 4 percent of money payment). Independent contractor deducts worker expenses, Keogh contributions, 25 percent of health insurance premium, and 50 percent of SECA tax.

2/ 28 percent rate for the worker, and 34 percent rate for the service recipient.

3/ 7.5 percent rate for the worker, and 8 percent rate for the service recipient.

4/ 7.65 percent rate for the employee and for the employer, or 14.12955 percent rate ([100%-7.65%]x15.3%) paid entirely by the independent contractor.

5/ Assumed to be 0.55 percent of total salary.

6/ Assumed to be 1 percent of total salary.

employees and employers, provided that the income and expenses are reported correctly.[12] When independent contractors receive few fringe benefits that are not statutorily-required (as is typical for temporary workers), however, and have few or no trade or business expenses, they and their clients may pay about the same level of taxes as employees and employers, provided that the income and expenses are reported correctly.

### D. Validity of Differences

It is evident from the preceding discussion that a mere change in classification of an individual as an employee or independent contractor can result in differences in the total tax liability of the individual and the service-recipient, regardless of whether there has been any change in their economic circumstances. While such differences may seem arbitrary or unfair in the case of individuals whose relationship with a service-recipient places them close to the line between employee and independent contractor status, these differences can generally be justified for more "typical" employees and independent contractors. For example, withholding, the partial disallowance of trade or business expense deductions, and the imposition of additional business purpose requirements on those deductions, may be more administratively appropriate for employees than independent contractors, on the assumption that independent contractors typically have more volatile net incomes and larger trade or business expenses, and typically change jobs more frequently than employees. Similarly, the special treatment accorded to employee fringe benefits under the Code, and the special protections for employees found in Federal and State labor laws, may be justified if employees typically have less bargaining power than independent contractors and are more dependent on a single business for their livelihoods.

Even if these assumptions regarding "typical" employees and independent contractors are correct, the fact that a single broad distinction is drawn under the Code between employees and independent contractors means that some "atypical" individuals may not be treated properly. For example, withholding and the partial disallowance of trade or business expense deductions may not be appropriate (except as a compliance measure) for an employee who regularly incurs large expenses and changes jobs frequently: in such situations it might be preferable to treat the individual as an employee for one purpose and an independent contractor for another. Similarly, independent contractors who lack significant bargaining power or financial sophistication may be better off being treated as employees under the fringe benefit provisions of the Code and under Federal and State labor laws. Nevertheless, the costs of such inappropriate results in

---

[12] The higher levels of Social Security taxes may in some cases result in a comparable increase in Social Security benefits.

some cases must be balanced against the benefits of maintaining a single standard that applies for all purposes.

Of course, it may be that these assumptions regarding the characteristics of "typical" employees and independent contractors are not generally correct. If this is the case, and the current scheme therefore results in inappropriate results in *too many* cases, it may be desirable to develop new definitions of employee or even to reexamine the need for the current-law distinctions between employees and independent contractors. For example, if most independent contractors lack the means or the foresight to provide for their own retirement income or health insurance coverage, there may be no reason to limit the fringe benefit provisions of the Code to employees, except perhaps in the case of wealthier or more sophisticated individuals. Similarly, there may be no reason for the differences in treatment of employees and independent contractors with respect to the excludability of fringe benefits from the Social Security and Medicare tax base, which arose at a time when fringe benefits made up only a small portion of total income.

## CHAPTER 3: ORIGINS OF SECTION 1706

### I. SECTION 530

In the late 1960s, the IRS began to increase its employment tax enforcement activities, which had previously been sporadic, to address the misclassification of employees as independent contractors. Since, as noted above, independent contractors and their clients at that time faced significantly lower Social Security and Medicare tax rates than employers and employees, such misclassification was perceived to produce large revenue losses. As a result of the IRS' action, the number of reclassifications increased substantially.[13] Many of these reclassifications resulted in large assessments against the employers involved for employer Social Security, Medicare, and Federal unemployment insurance taxes, and unwithheld employee Social Security, Medicare, and income taxes.

Taxpayers complained to Congress that the reclassifications amounted to a change of position by the IRS in how it was applying the common law tests for determining an individual's status as an employee or an independent contractor.[14] House and Senate conferees reporting on the Tax Reform Act of 1976 urged the IRS "not to apply any changed position or any newly stated position which is inconsistent with a prior general audit position in this general area to past, as opposed to future[,] taxable years" until the completion of a study by the Joint Committee on Taxation on the independent contractor issue.[15]

The Joint Committee asked the General Accounting Office (GAO) to examine the IRS administration of employment taxes. This study was completed by the GAO in 1977.[16] The study recommended that a safe harbor test of independent contractor status dealing with situations where an individual carries her own trade or business be added to Code, and that

---

[13] *See IRS Annual Reports* for 1971-1978.

[14] *See* Staff of the Joint Committee on Taxation, 96th Cong., 1st Sess., *General Explanation of the Revenue Act of 1978*, 300-01 (Comm. Print 1979); H.R. Conf. Rep. No. 1800, 95th Cong., 2d Sess. 271 (1978); H.R. Rep. No. 1748, 95th Cong., 2d Sess. 5-6 (1978); S. Rep. No. 938, 94th Cong., 2d Sess. 604 (1976).

[15] H.R. Conf. Rep. No. 1515, 94th Cong., 2d Sess. 489 (1976).

[16] GAO, *Tax Treatment of Employees and Self-Employed Persons by the Internal Revenue Service: Problems and Solutions*, GGD-77-88 (1977).

certain other changes be made to reduce the financial burden of retroactive employment tax assessments. The study also found that employees misclassified as independent contractors on average reported 96 percent of their wages. This finding, however, was based on payments by a sample of only five employers involved in employment tax audits.[17] Noting limitations in the GAO sample, the IRS undertook its own study. Based on payments by a sample of 2,600 employers to 7,109 individuals that it had previously proposed to reclassify as wages, the IRS found an average income tax reporting compliance rate of 76.2 percent and an average employment tax reporting compliance rate of 70.0 percent.[18] It also found that compliance rates varied less by industry than by the size of payment and other factors, with small payments and those likely to have been made in cash much less likely to be reported.

In the Revenue Act of 1978, Congress, without mentioning the GAO study, provided statutory relief for certain taxpayers involved in employment tax controversies with the IRS. Section 530 of the Act prohibits the IRS from challenging an employer's treatment of an individual as an independent contractor for employment tax purposes if the employer (1) has a reasonable basis for such treatment and (2) consistently treats the individual, and any other individual holding a substantially similar position, as an independent contractor.[19] Section 530 does not merely provide relief from retroactive assessments: as long as these requirements are met with respect to an individual, the IRS is prevented from correcting an erroneous classification of that individual. Section 530 applies solely for purposes of the employment tax provisions of the Code (*e.g.*, Social Security, Medicare, unemployment insurance taxes, and income tax withholding). It does not affect an individual's classification as an employee for income tax purposes; treatment of an individual as an employee for income tax purposes may, however, violate the consistency requirement noted above and thereby cause the employer to lose

---

[17] *Id.* at 25 and 71. A larger sample showed compliance rates of only 87 percent. *Id.* at 25.

[18] *See id.*, Appendix V; Hearings Before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee, 96th Cong., 1st Sess. (June 20, 1979) (Statement of Donald C. Lubick, Assistant Secretary of the Treasury (Tax Policy)).

[19] Revenue Act of 1978, Pub. L. No. 95-600, § 530, 92 Stat. 2763, 2885 (1978). These requirements must be met *before* the commencement of any IRS compliance procedures with respect to an individual. Rev. Proc. 85-18, § 3.03(C), 1985-1 C.B. 518.

protection under section 530. Section 530 treats reasonable reliance on any of the following as a reasonable basis for treating an individual as an independent contractor:

(1) judicial precedent, published rulings, or letter rulings or technical advice memoranda issued to or with respect to the taxpayer;
(2) a past IRS audit in which there was no assessment attributable to the employment tax treatment of the individual or of individuals holding positions substantially similar to that of the individual; or
(3) a long-standing recognized practice of a significant segment of the industry in which the individual was engaged.

The IRS has issued a series of revenue procedures since 1978 explaining the application of section 530.[20]

Section 530 was originally described as an interim measure to provide relief until "Congress ha[d] adequate time to resolve the many complex issues involved in this area",[21] and was scheduled to expire after 1979. It was instead extended through a series of public laws, and was made permanent in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA).[22]

## II. SECTION 3509

In TEFRA, Congress added section 3509 to the Code to mitigate the problem of large retroactive employment tax assessments faced by employers who were *not* entitled to relief under section 530.[23] Under prior law, in the event of a misclassification an employer could be held liable for the full amount of unwithheld income taxes and the unwithheld employee share of Social Security and Medicare taxes. In addition, the employer remained liable for Federal unemployment insurance tax and the employer share of Social Security and Medicare taxes.

---

[20] Rev. Proc. 78-35, 1978-2 C.B. 536, was issued soon after enactment. The current version is Rev. Proc. 85-18, 1985-1 C.B. 518.

[21] Staff of the Joint Committee on Taxation, 96th Cong., 1st Sess., *General Explanation of the Revenue Act of 1978*, 300-01 (Comm. Print 1979).

[22] Pub. L. No. 96-167, § 9(d), 93 Stat. 1275, 1278 (1979); Pub. L. No. 96-541, § 1, 94 Stat. 3204 (1980); Pub. L. No. 97-248, § 269(c), 96 Stat. 325, 552-53 (1982).

[23] Pub. L. No. 97-248, § 270(a), 96 Stat. 325, 553 (1982).

Penalties and interest could also be assessed. The employer bore the burden of proving that the employee had paid income and Social Security and Medicare taxes on the wages in order to abate any liability.[24]

Section 3509 generally limits an employer's liability for failure to withhold income, Social Security or Medicare taxes on payments made to an individual whom it misclassified as an independent contractor to 1.5 percent of the wages paid to the individual plus 20 percent of the employee portion of Social Security and Medicare taxes on those wages.[25] Section 3509 has no effect on an employer's own liability for Federal unemployment insurance taxes or the employer portion of Social Security and Medicare taxes; it also does not apply in cases of intentional disregard of the withholding requirements.[26] As a *quid pro quo* for limiting the employer's liability for failure to withhold employee taxes, section 3509 prohibits the employer from reducing its liability by recovering any tax determined under the section from the employee, and gives the employer no credit for any income taxes ultimately paid the employee.[27]

## III. SECTION 1706

Section 530 affects different taxpayers differently, depending on whether they satisfy the conditions for relief contained therein. In particular, some taxpayers that have consistently misclassified their employees as independent contractors are entitled to relief under section 530, while other taxpayers in the same industry (that, for example, have sometimes taken more

---

[24] In many cases, the misclassified employee had paid SECA taxes on the wages. The employer could not require the employee to provide evidence of this payment, however.

[25] If the employer did not comply with the information reporting requirements associated with the treatment of an individual as an independent contractor, these percentages are doubled to 3.0 and 40 percent, respectively.

[26] If an employer's liability is determined under section 3509, the employee is liable for the entire amount of unwithheld Social Security and Medicare taxes, unreduced by any amount paid by the employer. Rev. Rul. 86-111, 1986-2 C.B. 176.

[27] Code § 3509(d)(1). In some instances, an employer would be better off under the old rules, *e.g.*, if it can establish that its workers have paid their income taxes in full despite its failure to withhold, and therefore have its liability abated. Section 3509 is a mandatory provision, however.

conservative positions on classification issues) are not, because they cannot satisfy the consistency requirements of the section.

In the mid-1980s, some employers in the technical services industry complained that this difference in treatment under section 530 created an unfair advantage for certain of their competitors. According to the staff of the Joint Committee on Taxation,

> Congress was informed that many employers in the technical services industry that did not qualify for relief under section 530 nonetheless had claimed that their workers were independent contractors, despite the fact that such workers would be classified as employees under the common-law test. It is further contended that some of these employers were relying on erroneous interpretations of section 530, while others simply perceived that the IRS would not aggressively enforce employment tax issues.[28]

The dispute was primarily between two groups of taxpayers, both of which were engaged in the business of arranging for the provision of services by technical services personnel to other companies. One group (sometimes called "technical service firms") generally treated the service-providers as their employees, and they argued that the other group (sometimes called "brokerage firms" or "job-shops") achieved unfair cost savings by treating the service-providers as independent contractors.[29] As explained in Chapter 2, however, misclassification of an employee as an independent contractor does not necessarily result in any cost savings unless the misclassification is accompanied by underreporting of income or similar compliance problems by the independent contractors, or unless the client is able to pay the independent contractor less than the sum of the cash compensation and fringe benefits it would have paid to an employee.

As a result of these complaints, Congress in TRA 1986 excluded taxpayers that broker the services of engineers, designers, drafters, computer programmers, systems analysts and "other similarly skilled workers engaged in a similar line of work" from the safe harbor

---

[28] Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986*, 1344 (Comm. Print 1987).

[29] The first group is represented in part by two trade associations, ADAPSO and the National Technical Services Association (NTSA). The second group is represented in part by the National Association of Computer Consultant Businesses (NACCB).

provided by section 530, effective for payments made after December 31, 1986.[30] Section 1706 applies exclusively to multi-party situations, *i.e.*, those involving (1) technical services workers, (2) a company that uses the workers, and (3) a firm that supplies the workers. The effect of section 1706 is to deny relief solely to the firm that supplies the workers. Section 1706 did not affect the application of section 3509 to such firms.

Congress may have believed that the denial of section 530 relief to this group of taxpayers would cause most or all technical services workers to be reclassified as employees.[31] Section 1706 does not, however, actually require that the individuals listed in the provision be treated as employees: it merely requires them to be classified as employees or independent contractors for employment tax purposes under the usual common law tests, and permits the IRS to issue guidance with respect to such classification.[32]

Since the enactment of section 1706, the IRS has increased its enforcement activity in the employment tax area across the board, including the technical services industry. It has also issued guidance on the proper classification of technical services workers as employees or independent contractors.[33]

---

[30] Pub. L. No. 99-514, § 1706, 100 Stat. 2095, 2781 (1986).

[31] *See* H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-834 (1986); 132 Cong. Rec. S8088-89 (June 20, 1986) (floor Statement by Sen. Moynihan introducing predecessor to section 1706).

[32] Notice 87-19, 1987-1 C.B. 455. As described in footnote 57, however, there was some initial confusion over this point after the enactment of section 1706.

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

# PART THREE

# DISCUSSION OF ISSUES

# CHAPTER 4: GENERAL POLICY ISSUES

## I. OVERVIEW

Differences in treatment between employees and independent contractors under Federal and State tax and other laws were described in Chapter 2. This chapter addresses the policy issues underlying these differences in treatment. This report proceeds from the assumption that the government's basic role is to maintain the efficiency of labor markets by not interfering in the natural diversity of firm/worker arrangements unless specific policy goals require intervention. The source of this diversity and its importance to the efficient functioning of labor markets is discussed in Section II of this chapter. Neutrality in the tax treatment of employees and independent contractors, addressed in Section III, in most circumstances is necessary to maintain the efficiency of labor markets and is required to insure tax equity between the two groups of workers. These tax policy issues are illustrated using the examples presented in Chapter 2. An additional goal of tax policy, addressed in Section IV, is to minimize tax compliance costs for firms, workers, and tax administration agencies while maximizing taxpayer compliance. Finally, the non-tax policies of the Federal and State governments affecting labor markets are described in Section V.

## II. EFFICIENCY OF LABOR MARKETS

Well-functioning labor markets have a diversity of arrangements between workers and firms. The diversity arises naturally from differences in workers' skills and preferences and differences in firms' organizations and production processes. Workers search out firms that offer arrangements that best match the worker's skills and preferences. Likewise, firms search out workers whose skills and preferences best match the firms' needs. Searching by workers and firms is accomplished through labor markets, which may be informal or well organized. However organized, the more efficiently labor markets work--that is, the more closely workers' skills and preferences are matched to firms' needs--the greater will be workers' real income and firms' productivity.

### A. Arrangements Between Workers and Firms

Workers' Skills and Preferences. The significant differences in the level and range of workers' skills are important determinants of the occupations and industries that workers enter, as well as the particular firms for which they choose to work. There are also significant differences in preferences across workers. For example, some workers prefer a stable

relationship with a firm, with a low risk of being laid off, while other workers prefer greater variety in their work or greater autonomy over their work, than could normally be provided by a single employer. Other things being the same, workers with the first set of preferences are more likely to enter long-term employer/employee arrangements with firms. Workers with the second set of preferences, in contrast, are more likely to work as independent contractors for a number of firms (service-recipients), perhaps working for none of the firms for any extended period of time, and perhaps working for more than one simultaneously. It is important to recognize that these differences in arrangements between workers and firms would arise in a well-functioning labor market even in the absence of any government policies that affect the labor market. The different arrangements exist because they are to the mutual benefit of workers and firms.

Workers' preferences vary in many other respects. Workers may differ in their preferences about the timing of work. For example, some workers may want to alternate between long periods of intense work effort and leisure rather than working conventional 40-hour weeks.

Workers may also have different preferences over the form of compensation they receive. Workers may prefer cash compensation because they place a low value on the fringe benefits supplied by the employer, or because employers provide more of the fringe benefits than workers prefer. For example, some workers may consider themselves unlikely to need medical care, so place little value on employer-paid health insurance. Other workers may already have health insurance coverage through a spouse's employer and as an employee be unable to decline the coverage and receive the employer's savings in the form of cash compensation. Workers may also value pensions quite differently. A worker who knows she will change employers before eligibility for pension benefits becomes vested would place no value on the employer's pension contributions. Each of these preferences increases the likelihood that a worker would prefer to be an independent contractor.[34]

Finally, workers may differ in their aversion to possible health and safety risks associated with certain jobs. Since the insurability of such risks are quite different for employees and independent contractors, workers who are risk-averse are more likely to be employees.

---

[34] Note that cafeteria plans blur the distinction between the benefit flexibility of employees and independent contractors.

Firms' Organization and Production Processes. Just as individuals have preferences about the characteristics of firms, firms have preferences about the characteristics of workers. These preferences are determined by a firm's organization and production processes and therefore vary widely across firms. A firm's preference for workers determines the mix of worker skills and preferences best suited to the firm.

Firms may differ in the amount of firm-specific knowledge they require of their workers. Firms that require relatively little firm-specific knowledge may be less willing to make long-term employment commitments to their workers than firms that require relatively high levels. Firms may also have different costs of providing fringe benefits to their employees; larger firms generally can provide benefits at lower costs.

Variability in the demand for their product may also differ among firms. Firms experiencing greater variability may be less willing to make long-term employment commitments to their workers, or at least to some of their workers, than firms with relatively more stable product demand. Firms may differ in the production processes they use to produce similar goods, leading to differences in the most suitable skill levels of their workers. Differences in the way that firms organize themselves also can result in differences in the firms' abilities to determine whether their workers actually accomplish the tasks for which they are paid. Firms with higher monitoring costs may hire those workers they believe will require less monitoring and supervision, or workers who are more willing to be monitored.

Arrangements Between Workers and Firms. The differences in workers' skills and preferences and in firms' organization and production processes will lead to a diversity of arrangements between workers and firms. These differences in workers and firms are found in numerous combinations, so that a simple characterization of the diversity in firm/worker arrangements is not possible.

Generally, firms that demand a high degree of control over their production process or require workers to have a high level of firm-specific knowledge are more likely to enter into long-term employer/employee arrangements with workers. Such arrangements are also more likely for firms that have a sufficient scale to provide fringe benefits to workers at a lower cost than the worker faces purchasing similar benefits directly. The workers who enter such arrangements are likely to be more risk-averse, or to have higher preferences for fringe benefits. Conversely, firms that can provide fringe benefits only at high costs or that have high costs of monitoring and supervising workers are more likely to prefer independent contractor arrangements with workers. Firms are also more likely to enter independent contractor

arrangements in circumstances where they have a high degree of variability over time in their need for workers with specific skills. The workers who enter such arrangements generally prefer more variety and autonomy, greater flexibility in scheduling work, and more cash compensation than they would receive as employees.

Although firms generally enter into arrangements with workers directly, third parties may be involved in certain circumstances. For example, short-term arrangements for experienced or higher-skilled workers are often a small segment of these labor markets, so the cost to firms and workers of locating each other and making matches may be quite high. Third parties such as temporary worker organizations and brokers reduce such costs by gathering the necessary information and making it available to firms and workers.

### B. Government Policy

The diversity of arrangements between workers and firms reflects the outcome of well functioning labor markets. This report proceeds from the assumption that a fundamental goal of government policy should be to maintain the efficiency of labor markets, which generally requires noninterference with diversity. Government intervention in labor markets is warranted only in those relatively narrow and well-defined instances in which imperfections in the markets result in inefficiencies or in which overriding social goals can be achieved, cost effectively, through such intervention. Section V of this chapter briefly discusses such government interventions.

## III. NEUTRALITY IN TAX TREATMENT

### A. Maintaining Labor Market Efficiency

Tax treatment that is neutral between employee and independent contractor status is necessary to maintain labor market efficiency. Tax treatment that is not neutral creates artificial incentives for workers to be classified as employees rather than independent contractors, or *vice versa*. Although particular firms and workers may gain by responding to such artificial incentives, the economy as a whole does not; aggregate labor market efficiency is reduced, as are aggregate worker real income and firm production.

Determining the efficiency effects of section 1706 on the market for technical services workers is difficult because the underlying efficiency of the market to which section 1706 applies is unknown, and because that market had already been affected by prior legislation by the time

section 1706 was enacted.[35] Thus, the previous efficiency of the market could not be taken for granted.

Determining the efficiency effect of section 1706 is also complicated by the fact that section 1706 is limited to situations involving a third-party broker. The limitation creates a separate category of workers for employment tax purposes; depending on the effect of prior legislation, the limitation could cause a non-neutrality in the market.

Section 1706 may also have indirectly affected worker classification. Publicity surrounding section 1706 made workers and firms aware of the common law tests and the correct interpretation of section 530. Workers and firms that had incorrectly believed that section 530 required certain workers to be classified as independent contractors learned that it did not. At the same time, by removing the relief in section 530 from employer penalties for misclassifying technical services workers as independent contractors, section 1706 increased the risk to some employers of misclassification.

It is reasonably certain that section 1706 reduced efficiency in some cases and increased it in others. There is not enough information, however, to reach any conclusions about the overall effect of section 1706 on labor market efficiency.

The TAMRA conferees requested an evaluation of the extent to which Section 1706 has had a chilling effect on the ability of technical services personnel to get work. Assuming that, prior to the enactment of section 1706, the compensation level of technical services workers did not depend on their worker classification (although the compensation mix may have varied), section 1706 should not have affected the total demand for technical services workers. As long as the total compensation of independent contractors and employees is the same (although perhaps paid in different forms), there is no reason to expect the total demand for technical services workers to decline.

Although section 1706 probably did not reduce the overall demand for technical services workers, it may have resulted in some workers being unable to find work with their accustomed form of compensation and working conditions. Removing the safe harbor provision of section

---

[35] The prior legislation includes income and employment tax and labor law, section 530 restrictions on issuing guidance about classification under employment laws, and section 3509 reductions in employer costs for misclassification. Each of these pieces of legislation may have reduced or increased the underlying market efficiency.

530 for technical services workers focused employers' attention on the need to classify workers correctly. Some independent contractors may have been able to continue their current work only as employees. If the classification change required the workers to accept a package of fringe benefits in lieu of some amount of cash compensation, the value to them of their entire compensation package may have changed. They would have been better off to the extent that they considered the fringe benefit package and its accompanying tax-preferred benefits more valuable than the loss in cash income. For example, workers who would previously have preferred to be classified as employees, but were not because of resistance from service-recipients, would be better off. Conversely, workers who did not find the substituted fringe benefit package more valuable may have found the value of their income reduced. Similarly, workers who would not have preferred to be classified as employees include those with considerable trade or business expenses, whose opportunity to deduct these expenses would have become constrained, and those who tended to understate receipts or overstate deductions. In addition, workers whose classification was questionable and who were used to working through brokers may have found that work as independent contractors could no longer be secured through a broker; these workers may have been able to continue work as independent contractors by contacting service-recipients directly.

### B. Tax Equity

Equitable tax treatment requires that taxpayers in equivalent situations, with the same incomes, be taxed equally. Thus, providing equivalent tax treatment to employees and independent contractors is required to insure tax equity between the two groups of workers. The examples presented in Chapter 2 can be used to illustrate potential inequities in the tax treatment of employees and independent contractors.[36] As the discussion in Chapter 2 concluded, section 1706 does not systematically favor either status.

Worker with Typical Mix of Fringe Benefits. Example 1, which is summarized in Table 2-2 in Chapter 2, shows the situation of an employee who receives total compensation of $1,000, consisting of wages and a typical mix of fringe benefits. The worker does not have any potentially deductible work-related expenses, such as union dues, home office expenses, or travel expenses. The independent contractor receives the entire $1,000 in cash, out of which Federal and State income taxes and the Social Security and Medicare taxes for self-employed workers

---

[36] *See* Section III.C of Chapter 2 for a description of the approach taken in developing these examples.

are paid, health insurance is purchased, and contributions to a tax-favored "Keogh" retirement plan are made.

As shown in the bottom portion of Table 2-2, the money income of the self-employed worker, after paying taxes and purchasing medical and retirement benefits, is $22 or about five percent ($22/$475) lower than that of the employee. The $22 is the net of $34 of additional taxes less $12 saved by not purchasing unemployment insurance and workers' compensation. Thus, the self-employed worker' has $22 less money income despite not having the protection of either unemployment insurance or workers' compensation. As explained in Chapter 2, taxes are higher for the self-employed worker because that part of cash income which would have purchased employer-paid fringe benefits is subject to Social Security and Medicare taxes and some is also subject to income taxes. Thus, in Example 1, the differential treatment of certain fringe benefits for tax purposes, especially for Social Security and Medicare taxes, causes an inequitable distribution of taxes between employees and independent contractors.[37]

Noncompliance. The administrative rules governing the form and timing of tax payments and where income is reported on tax returns differ for employees and independent contractors, with stricter rules generally applying to employees (*see* Chapter 2 and Appendix A). Thus, independent contractors may have greater opportunity than employees to be less than fully compliant with tax laws. If the situation in Example 1 is maintained, except that the independent contractor understates net income from self-employment by five percent, the after-tax money income of the independent contractor and the employee would be equal. That situation is illustrated in Example 2 (Table 2-3). If the underreporting of net income were to exceed five percent, the independent contractor would have a higher after-tax money income than the employee.

Worker Expenses. Because worker expenses are treated more favorably for independent contractors than for employees, workers who have such expenses are not taxed equally. Example 3 (Table 2-4) illustrates the same situation as Example 1, except that the worker has work-related expenses equal to ten percent of gross compensation. This level of worker expenses is just sufficient to make the money income net of taxes and worker expenses of the independent contractor equal to that of the employee. At higher levels of worker expenses, the independent contractor would have a higher after-tax income.

---

[37] Note, however that because the independent contractor's Social Security taxes are being paid on a higher level of income, his or her future Social Security benefits might also be slightly higher.

No Voluntary Fringe Benefits. In Example 4 (Table 2-5), the employer provides only those fringe benefits mandated by Federal or State law: Social Security and Medicare; unemployment insurance, and workers' compensation. Otherwise, the facts are the same as in Example 1. In Example 1, the net after-tax income of the independent contractor was $22, or about five percent, lower than that of the employee. In Example 4, with no voluntary fringe benefits, the results are reversed; the independent contractor's money income is $8, or 1 percent, greater than the income of the employee. The independent contractor's greater after-tax income is due to the cost of the employee's coverage under unemployment insurance and workers' compensation and the income tax treatment of the employer's payments for that coverage. Inequity does not arise directly from the difference in income stemming from the cost of unemployment insurance and workers' compensation. Although the independent contractor has a higher after-tax income because she does not make payments for such coverage, the independent contractor also is not eligible for the benefits from these programs. The inequity is due to the exclusion from the employee's taxable income of the employer payments for unemployment insurance and workers' compensation.

Summary. The examples indicate that the difference in after-tax income between employees and independent contractors would typically be quite small, if firms classify workers correctly. The differences may be significant, however, for certain sets of worker preferences. Thus, a worker who has substantial business expenses and no desire for employee benefits may have much higher after-tax income as an independent contractor. Conversely, a worker who has few business expenses and a strong desire for all the employee benefits that a firm offers may have much higher after-tax income as an employee.

While it is possible for one set of tax differentials to offset another exactly, as Examples 2 and 3 illustrate, such exact offsets are unlikely in practice. The typical situation is for the combined effects of the various differentials in tax treatment not to leave employees and independent contractors treated exactly equally, and, therefore, to create inequities.

Even in cases where differences in the after-tax income of the worker are small, the consequences of a retroactive IRS determination of misclassification may be significant for the firm. Because the firm did not provide employee benefits to the independent contractor, the cash compensation to the independent contractor generally had equalled the sum of the wage payment which would have been received by an employee and the amount the employer would have spent for employee benefits. With reclassification, the entire amount of cash compensation paid to the independent contractor is deemed to have been wages that the firm would have paid to the worker as an employee, and the employer's liability for Social Security and Medicare taxes and

for the withholding of income taxes is larger than if the firm had treated the worker as an employee and divided the worker's compensation into taxable wages and non-taxable fringe benefits.

Classifying workers as employees nominally shifts much of the tax compliance burden to employers and permits tax collection through withholding, which is extremely efficient. Similarly, employers incur the direct compliance costs of supplying legally-required as well as voluntary, but somewhat regulated, fringe benefits. However, the extent to which such compliance burdens are shifted to employees through reduced levels of compensation is not known.

## IV. ADMINISTRATIVE COSTS

Although compliance with tax laws is necessary, the administrative costs of compliance divert resources from other uses. A goal of tax policy is, therefore, to minimize tax compliance costs while achieving the desired level of efficiency and equity in the tax system. While the principles are clear, implementing them can be difficult. The inherent tradeoffs between low compliance costs, efficiency, and equity help explain some of the differentials in the tax treatment of employees and independent contractors.

For example, the Federal Social Security and Medicare system generally taxes employees on their stated salaries; it does not permit adjustments for various work-related expenses which employees may incur. As a result of this simplification, the income to which the Social Security and Medicare taxes are applied in the case of employees may be mismeasured: that is, it may differ from their economic incomes. The mismeasurement may be significant in a small percentage of cases, and both the tax liability and the effective tax rate may be higher than if employees were taxed, as independent contractors are, on their net income from employment. In this situation, the compliance burdens of employees are greatly reduced as a result of the simplification, but at the cost of a certain degree of equity.[38]

---

[38] However, the benefits of excluding employer-paid fringe benefits from Social Security and Medicare income bases for employees but not completely for independent contractors may reduce or even outweigh the extra tax burden on employees from the failure to exclude employees' work-related expenses from the employee's Social Security, Medicare, and income tax bases. Moreover, workers' eventual disability or retirement benefits may be increased as the result of the differential in Social Security tax treatment, thus partially offsetting any potential equity loss.

Similarly, for income tax purposes, an employee cannot deduct any employment-related expenses unless she itemizes deductions on her income tax return and unless these expenses exceed two percent of income from all sources. Moreover, there are classes of expenses for which a deduction is further limited or effectively prohibited. In contrast, an independent contractor has much greater freedom to take such deductions for income (and Social Security and Medicare) tax purposes. There are, however, compliance costs to the independent contractor associated with this freedom. The costs include the burden of maintaining complete sets of records which might not otherwise have to be maintained, the burdens and expense of filing more complicated tax returns, and the costs of being excluded from using the highly efficient payment system provided by the withholding of taxes by, and payment through, an employer. In addition, the costs to the government of assuring compliance with tax laws through examination of a sample of workers' tax returns and matching information from various information documents against the information reported on workers' tax returns is usually higher for self-employed taxpayers.

## V. NON-TAX POLICIES

Federal and State governments have a number of non-tax policy objectives which affect labor markets. Some of these may increase the efficiency of labor markets by reducing or removing imperfections, and others may achieve various politically-determined goals. While these policies may have important effects on workers' choices of arrangements with firms, because this report focuses on specific tax policies, these non-tax policies are merely listed here. The policies are: retirement security; access to health care; protection of workers (occupational health and safety); unemployment security; employment standards (minimum wage and hours); and nondiscrimination in employment practices.[39]

Much of the legislation implementing non-tax policies applies only to employees, not to independent contractors or other self-employed workers. The definition of an employee may vary under different legislation, however, so that, for example, a limited number of workers might be deemed independent contractors for tax purposes, while being deemed employees under wage and hours legislation. Such differences may be warranted by the differences in policies of the various legislation, but they do impose additional compliance costs on both firms and workers. Much of the additional cost stems from the confusion caused by seemingly inconsistent treatment, as Examples 2 and 3 illustrate.

---

[39] Legislation implementing these policies is summarized in Chapter 2 and Appendix A.

# CHAPTER 5: TAX COMPLIANCE ISSUES

## I. OVERVIEW

The TAMRA conferees questioned whether there were abuses in the reporting of income by independent contractors (as compared to employees) that justified the adoption of section 1706. This question has been evaluated in terms of whether there was a significant revenue loss attributable to noncompliance that section 1706 could have been expected to reduce.[40] Whether this is true depends in part on (1) the extent of the misclassification of technical services workers covered by section 1706 and (2) the noncompliance rate of such misclassified employees relative to the rate that would be expected if they were properly classified. This chapter provides data relevant to these questions.[41]

## II. RATE OF MISCLASSIFICATION

IRS studies suggest that misclassification of employees as independent contractors is significant.[42] Recent studies of this problem include the IRS' Strategic Initiative on Withholding Noncompliance (SVC-1).

---

[40] The revenue effect also depends on the existence of other differences in the level of tax paid by employees and independent contractors, *e.g.*, the proportionately larger tax expenditures associated with employee fringe benefits. These differences are discussed in Chapter 2 and Appendix A to this report. They are not taken into account here, however, because their use is not considered abusive within the meaning of the TAMRA conferees.

[41] At the initial stage of this study, it was determined that existing IRS data would be used in addressing these questions, and that no new surveys would be undertaken to measure the compliance of technical services workers or the population of those who had been affected by section 1706.

[42] *See also* GAO, *Information Returns Can Be Used to Identify Employers Who Misclassify Workers* Appendix II, GGD-89-107 (1989). In that study, individuals receiving more than $10,000 in income reportable on Form 1099 from one payor were identified. A random sample of 408 of the payors was interviewed. The interviews indicated that 157 (138-176 at a 95 percent confidence level), or 38 percent, misclassified at least some of their employees as independent contractors.

The employer portion of SVC-1 examined employment tax and withholding compliance for tax year 1984 for a sample of 3,331 employers.[43] It includes an estimate of the percentage of employers that misclassified at least some of their employees as independent contractors.[44] Some of the results for different sectors are shown in Table 5-1. For purposes of the table, employees were considered misclassified if they were determined to be employees under the common law tests (regardless of whether section 530 applied), but had been treated as independent contractors by their employers. Employers were considered to have misclassified employees if they misclassified one or more of their employees, regardless of the total number they misclassified.

Table 5-1 does not provide definitive proof that misclassification is a bigger problem among employers subject to section 1706 than among other employers. The table indicates that misclassification rates among employers in the service sector were not much higher than among employers in other sectors in the sample population.[45] It is difficult to estimate the percentage of misclassified employees in each sector reliably because the SVC-1 survey was designed to determine the frequency of employ*ers* that misclassify, rather than the frequency of misclassified employ*ees*. It appears, however, that the percentage of service sector employees who were misclassified was higher than in other sectors in the sample population, suggesting that employers in the service sector that had misclassified employees tended to misclassify a larger

---

[43] The employers were selected at random from employers with previous employment tax records (Form 940 or 941E) listed on the business master file (BMF) for 1984. Form 941 is the Employer's Quarterly Federal Tax Return. State and local governments and other employers that generally only withhold income taxes and do not pay FICA or FUTA taxes instead file Form 941E, Quarterly Return of Withheld Federal Income Tax. Thus, the employer sample does not include organizations with no employees or those that were legally required to file a Form 941 or 941E for 1984, but had no previous records on the BMF.

[44] The employer portion of SVC-1 also measured compliance with reporting requirements with respect to employment tax returns and W-4 submittals, and compliance of U.S. citizens claiming exemption from withholding on foreign-source income.

[45] Misclassification rates were not separately calculated for the section 1706 group because the SVC-1 sample contained very few workers in technical fields (only about 0.4 percent), and because the SVC-1 survey did not gather sufficient data to identify employers in these fields that were actually subject to section 1706.

# Table 5-1

## Percentage of Employers with Some Misclassified Employees, by Industry

| Industry | Number of Employers in Sample | Number of Employers, Weighted to Represent Total Population | Number of Employers with Misclassified Employees, Weighted to Represent Total Population | Percentage of Employers in Total Population with Misclassified Employees |
|---|---|---|---|---|
| Agriculture | 286 | 36,435 | 6,080 | 16.7% |
| Mining, Oil, Gas | 260 | 16,819 | 3,324 | 19.8% |
| Mining, Other | 276 | 7,624 | 1,228 | 16.1% |
| Construction, Heavy | 288 | 13,247 | 1,571 | 11.9% |
| Construction, Other | 205 | 249,409 | 50,446 | 20.2% |
| Manufacturing | 261 | 235,593 | 37,154 | 15.8% |
| Transport, Air | 272 | 2,662 | 529 | 19.9% |
| Transport, Other and Public Utilities | 264 | 79,995 | 8,700 | 10.9% |
| Wholesale and Retail Trade | 121 | 781,123 | 74,855 | 9.6% |
| Finance, Insurance and Real Estate | 255 | 241,665 | 46,629 | 19.3% |
| Services | 124 | 848,514 | 130,828 | 15.4% |
| Government | 282 | 68,521 | 6,595 | 9.6% |
| Not Elsewhere Classified | 437 | 2,569,958 | 324,550 | 12.6% |
| TOTAL | 3,331 | 5,151,525 | 692,489 | 13.4% |

Department of the Treasury

Source: Strategic Initiative on Withholding Noncompliance (SVC-1) Employer Survey.

percentage of their employees.[46] This may reflect the fact that the service sector contains a disproportionate number of smaller employers, and studies suggest that smaller employers misclassify a larger percentage of their employees. (It may also reflect somewhat greater difficulty in applying the common law tests of employee status in the service sector.)

For several reasons, no strong conclusions can be drawn from the SVC-1 data regarding current misclassification patterns among employers subject to section 1706. First, there have been significant changes in the tax laws and IRS enforcement activity since 1984, which may have affected employers' abilities and incentives to misclassify workers.[47] Second, the SVC-1 survey covered a relatively small sample of employers and has a relatively high sampling error for small populations. Third, the population from which the sample was drawn included mainly service-recipients that reported having at least some employees, and did not include service-recipients that treated all of their workers as independent contractors.

Finally, misclassification rates for employers subject to section 1706 could not be specifically determined from the data. The service sector misclassification rate may be indicative of the rate for employers subject to section 1706, since service brokers would tend to be classified in the service sector. The service-recipients may be in any industry, however, including manufacturing or government. There may be reason to believe that, regardless of the sector to which they are allocated, the relatively independent nature of the work done by employees covered by section 1706, and the frequently temporary nature of the employment relationship, may create a misleading appearance of independent contractor status under the common law tests. In addition, the particular importance of computers in this area, and the greater ease with which independent contractors can deduct their legitimate computer-related expenses, may create an incentive to misclassify such employees as independent contractors.

## III. RATE OF NONCOMPLIANCE

Misclassification can cause compliance problems if misclassified employees have a greater tendency to underpay their taxes, whether due to underreporting of income, overstate-

---

[46] Service firms in the SVC-1 sample accounted for about 19 percent of reclassified workers but only ten percent of W-2 forms. In contrast, the percentage of employers in the service sector that had at least one misclassified employee was only slightly higher than for all employers in the survey (Table 5-1).

[47] *See generally* Appendix A.

ment of deductions, nonpayment of reported liabilities, or other factors. In fact, IRS studies consistently find lower compliance rates for non-wage compensation income than for wage income.[48] Recent studies include the 1985 Tax Compliance Measurement Program (TCMP) and the employee portion of the 1984 SVC-1 survey. The 1985 TCMP is more comprehensive, but is less useful for the specific purposes of this report than the 1984 SVC-1 survey because the former covers all workers rather than just misclassified employees--the only group actually affected by section 1706.

### A. 1985 TCMP

The 1985 TCMP measured wages, Schedule C gross profit, and other categories of income and deduction reported by a randomly-selected sample of 50,000 individual taxpayers, compared them to the correct amounts (determined after an examinations of the taxpayers' returns), and expressed the ratios as voluntary reporting percentages (VRP).[49] Data from the survey were then used to estimate the values for the entire population of taxpayers from which the sample was selected. The results are shown in Table 5-2. For purposes of this table, the sample data have been divided between employees and independent contractors,[50] and between technical services workers and other workers.[51]

---

[48] In addition to the IRS and GAO studies cited above, these include IRS studies of (1) 1975 and 1976 information returns (covering filers receiving commissions or fees); (2) 1979 Forms 1099-NEC (covering filers receiving nonemployee compensation); and (3) 1977 delinquent Forms 1099-MISC (follow-up study covering U.S. residents required to file Form 1040).

[49] *See generally* Fratanduono & Bucci, *Trends in the Voluntary Compliance of Taxpayers Who File Individual Income Tax Returns*, in Department of the Treasury, Internal Revenue Service, 1989 Update, *Trend Analyses and Related Statistics*, Document 6011 (1989).

[50] For this purpose, employees are defined as individuals with over $10,000 in wage income (as examined), *and* more wages than Schedule C income, while independent contractors are defined as those with over $10,000 in Schedule C income (as examined), more Schedule C income than wage income, *and* less than $5,000 in wage payments. Using this definition, approximately three percent of the taxpayers in the entire weighted TCMP sample were independent contractors, 55 percent were employees, and 41 percent did not fall into either category. For technical services workers, two percent of the sample were independent contractors, 92 percent were employees, and six percent did not fall into either category.

[51] See Appendix C for a definition of technical services worker used for this purpose.

# Table 5-2

## Reporting of Income and Expenses by Employees and Independent Contractors

| | Technical Services Workers | | | Other Workers | | |
|---|---|---|---|---|---|---|
| | As Reported ($billions) | As Examined ($billions) | Voluntary Reporting Percentage | As Reported ($billions) | As Examined ($billions) | Voluntary Reporting Percentage |
| | | | **Employees** | | | |
| Wages, Salaries and Tips | 171.1 | 171.1 | 100.0% | 1521.9 | 1534.1 | 99.2% |
| Schedule C Gross Receipts | 3.0 | 3.1 | 95.2% | 37.9 | 39.2 | 96.5% |
| Schedule C Gross Profit | 2.2 | 2.4 | 94.3% | 23.9 | 25.4 | 94.1% |
| Schedule C Total Deductions | 1.9 | 1.6 | 117.3% | 22.1 | 18.9 | 116.9% |
| Schedule C Net Profit | 0.4 | 0.9 | 50.6% | 3.0 | 7.8 | 38.7% |
| Adjusted Gross Income | 170.9 | 173.0 | 98.8% | 1,566.9 | 1,592.0 | 98.4% |
| Total Taxable Income | 178.6 | 180.4 | 99.0% | 1,638.4 | 1,660.0 | 98.7% |
| | | | **Independent Contractors** | | | |
| Wages, Salaries and Tips | 1.1 | 1.1 | 100.4% | 17.2 | 16.9 | 101.0% |
| Schedule C Gross Receipts | 4.4 | 4.5 | 97.0% | 190.2 | 202.0 | 94.2% |
| Schedule C Gross Profit | 3.8 | 4.0 | 95.9% | 113.4 | 124.9 | 90.8% |
| Schedule C Total Deductions | 2.0 | 1.8 | 113.4% | 72.1 | 65.5 | 110.0% |
| Schedule C Net Profit | 2.1 | 2.5 | 83.4% | 47.3 | 65.6 | 72.1% |
| Adjusted Gross Income | 3.1 | 3.7 | 83.9% | 74.0 | 95.0 | 77.3% |
| Total Taxable Income | 3.4 | 4.0 | 85.1% | 79.1 | 100.2 | 79.0% |

Department of the Treasury

Source: Taxpayer Compliance Measurement Program (TCMP) for Tax Year 1985.

Table 5-2 shows that the VRPs for the Schedule C income (and total taxable income) of the independent contractors included in the 1985 TCMP were generally worse than the comparable VRPs for the wages (and total taxable income) of employees, but that both measures were generally better for technical services workers than for other workers. It also shows that underreporting of income was not the only reason for the independent contractors' low VRPs: in particular, the low VRPs for their net Schedule C income also resulted from the overstatement of the cost of goods sold and/or operations (resulting in underreporting of Schedule C gross profit), and the overstatement of other Schedule C deductions (resulting in underreporting of Schedule C net profit). The overstatement of Schedule C deductions contributes about two-thirds of the total understatement of net profit shown for technical services independent contractors. Some of the reported overstatement of deductions may have been attributable to inadequate record-keeping.

For independent contractors, the actual reporting of Schedule C income may have been slightly better than indicated. Table 5-2 shows that wages and salaries tend to be slightly overreported by independent contractors, whereas Schedule C gross receipts tend to be slightly underreported. Some of the wage and salary overreporting may be due to Schedule C income being reported incorrectly as wage or salary income, however, which may lead to failure to collect any Social security or Medicare tax on that income. Thus, actual Schedule C VRPs may be somewhat higher than shown on Table 5-2. Also, it may be particularly hard for IRS examiners to detect wage and salary underreporting when the underreporting is due to collusion between employers and employees. Thus, actual wage and salary VRPs may not be as high as reported as shown on Table 5-2.

General conclusions drawn from the TCMP data with respect to workers actually covered by section 1706 are subject to several reservations. First, it was impossible to calculate separate VRPs for such workers, so a broader group of technical services workers was used a proxy.[52] The compliance patterns in the two groups may have been different. Second, there have been significant changes in the tax laws and IRS enforcement activity since 1985 that may have affected individuals' incentive and ability to underreport their income or overstate their deductions. Specifically, the tightening of the requirements for certain business deductions in TRA 1986 may have reduced the extent to which itemized deductions and Schedule C deductions

[52] See Appendix C for a description of the occupations included in this group.

are overstated.[53] Third, the population from which the sample was drawn includes only individuals for whom a return was filed, and thus the data do not measure compliance in the so-called "underground" economy. Fourth, as indicated above, it was not possible to distinguish misclassified workers from other workers in the TCMP sample. Therefore, the data relates to the relative compliance of independent contractors generally, rather than the narrower group of misclassified employees actually affected by section 1706. Finally, the VRPs are not adjusted to reflect TCMP audit sustension rates and, therefore, may not indicate the actual revenue potential from legislative or administrative changes affecting compliance.

### B. 1984 SVC-1 Employee Survey

As explained above, the SVC-1 survey examined employment tax and withholding compliance for a sample of businesses for tax year 1984. The employer portion of the survey identified employees who were misclassified (by their employers) as independent contractors. A follow-up survey of 3,260 misclassified employees was also conducted to determine their level of individual reporting compliance. Data covering the 2,406 employees for whom a Form 1099 had been filed were then weighted to represent values for the entire population of misclassified employees.[54] Misclassified technical services workers were found to have reported 92.6 percent of their misclassified compensation. For other workers, the VRP was 77 percent of misclassified compensation. Other data from the employee portion of the SVC-1 survey suggest that information reporting may also play a substantial role in subsequent compliance by misclassified employees.[55]

---

[53] *See, e.g.*, the discussion of the two-percent floor on itemized deductions and sections 280A and 280F in Appendix A.

[54] Forms 1099 had been filed for 37 of the 43 technical services workers and 2,369 of the 3,217 other workers in the misclassified employee sample. The sub-sample used to generate the estimates in the table was limited to employees for whom a Form 1099 had been filed because these are the only employees covered by section 530, and the issue for resolution is whether section 530 protection for misclassified workers has permitted significant compliance problems to develop.

[55] The survey found that information returns were filed for 84 percent of misclassified employees in the sample whose payments exceeded $600. While 77.2 percent of the misclassified compensation for which a Form 1099 was filed was reported, only 28.8 percent of the misclassified compensation for which no Form 1099 was filed was reported. This contrasts with the results of a 1977 study, in which misclassification was *not* an issue, which

The data from the employee portion of the SVC-1 generally suffer from the same problems as the TCMP data described above. In addition, the small number of technical services workers covered by the survey means that any differences found between them and other workers have a high sampling error. The TCMP data also indicate that Schedule C reporting of both income and deductions for workers whose primary source of income is Schedule C income is superior to that of workers who have only occasional Schedule C income. This is true for both technical services workers and other workers. There is no way to determine from the data whether there are differences in Schedule C reporting for correctly classified independent contractors and those who are incorrectly classified. Furthermore, workers covered by section 1706 may have more than one job during a year, and may be misclassified in one job but not another. Thus, correct classification may not result in correct reporting of the entire Schedule C amount.

### C. Summary

The 1985 TCMP and the 1984 SVC-1 misclassified employee survey suggest that there is more underreporting of income by independent contractors than by employees. They do not, however, support assertions that technical services workers are less compliant than other workers. Taken together, the 1985 TCMP and 1984 SVC-1 data suggest that the reporting of non-wage income by workers covered by section 1706 is at least as good as, and perhaps superior to, reporting by other misclassified workers, but not as good as the reporting of wage and salary income. The 1985 TCMP also indicates that overstatement of deductions is responsible for much of the understatement of net profit for independent contractors in technical services (and independent contractors in general).

---

found that 83.2 percent of the compensation for which no Form 1099 MISC was filed was reported.

## CHAPTER 6: TAX ADMINISTRATION ISSUES

### I. OVERVIEW

The TAMRA conferees questioned whether there were problems with the administration of section 1706 itself, or with the common law tests that employers subject to section 1706 must generally use in classifying workers as employees or independent contractors. This chapter addresses these issues and concludes that both the scope of section 1706 and the common law tests could be further clarified.

### II. ADMINISTRATIVE PROBLEMS WITH SECTION 1706

Compared to section 530, section 1706 raises few administrative or interpretive issues. Those that have arisen concern primarily its effect (including its relationship to the common law tests for determining employee status) and its scope (including the occupations covered under it).

Many taxpayers were initially confused about the effect of section 1706, believing that it *required* that the individuals covered by the provision be treated as employees. Apparently, some service-recipients reacted by treating all their technical services workers as employees, even though that was sometimes contrary to the results under the common law tests. This misconception probably sprang from some imprecise language in the legislative history of the provision[56] and an IRS publication issued soon after enactment,[57] plus the common misconception that section 530 had previously *required* that these individuals be treated as independent contractors regardless of whether there was a basis for doing so. This misconception has been largely corrected through a combination of industry education and IRS guidance, which

---

[56] *See* footnote 31 above.

[57] In January, 1987, the IRS published a revised Publication 15 (Circular E) which discussed section 530 and Stated that "[i]f you have any reason for treating a worker other than as an employee you will not be liable for employment taxes on payments to the worker. This relief is not available, however, for any arrangement you may have for services provided to you by certain technical personnel, such as engineers, computer programmers, and systems analysts." In *Resource Technical Consultants (U.S.A.), Inc. v. Baker*, 88-1 U.S.T.C. ¶ 9111 at 83,033 (S.D.N.Y. 1987), the district court found that "the Circular makes no misstatements and is at worst confusing."

explained that technical services workers would "be classified as independent contractors or employees under generally applicable common law standards."[58]

Many taxpayers are still confused about the scope of section 1706, in particular about the occupations it covers. The provision mentions "engineers, designers, drafters, computer programmers, systems analysts and other similarly skilled workers engaged in a similar line of work." These terms are not defined in the legislative history, however, and are not well defined in other sources.[59] Nor do they correspond well to industry usage or to the occupational categories used by the IRS for Schedule C purposes. The phrase "similarly skilled workers engaged in a similar line of work" is particularly vague, since it is not clear how much similarity is required. For example, are scientists included if they are engaged in engineering-type activities, such as oil exploration, or are they excluded because they do not have similar skills to engineers? Are architects included because they often perform drafting, or was the term "drafting" meant to be read more narrowly for purposes of section 1706? These problems have made it difficult in some cases for employers to identify covered workers and for the IRS systematically to target such workers for enforcement or even to gather sufficient data on their levels of compliance.

## III. ADMINISTRATIVE PROBLEMS WITH COMMON LAW TESTS OF EMPLOYEE STATUS

As explained in Chapter 2, whether an individual is an employee for Federal tax purposes is generally determined under the common law tests for determining whether an employment relationship exists. As explained in Chapter 3, section 530 allows employers to rely on their own erroneous classification under some circumstances. Section 1706 denies this relief to certain employers in the technical services field, and thus requires these employers to apply the common law tests in all cases. In a sense, section 1706 restores pre-section 530 law for these employers.

---

[58] Notice 87-19, 1987-1 C.B. 455; News Release IR-87-8 (January 21, 1987); News Release IR-87-68 (May 21, 1987). This guidance also clarified that section 1706 applies only to brokers or job-shops, and does not apply to service-recipients generally.

[59] *See, e.g.*, U.S. Department of Labor, Employment & Training Administration, *Dictionary of Occupational Titles* (4th ed. 1977 & Supp. 1986).

The common law tests, like most facts-and-circumstances tests, lack precision and predictability. Since they were developed in an entirely different context from Federal tax law (primarily the law of employer liability for employee torts), they may also produce inappropriate results for some tax purposes. As then-Assistant Secretary (Tax Policy) John Chapoton stated in 1982, "[i]n many cases, applying the common law test in employment tax issues does not yield clear, consistent, or satisfactory answers[,] and reasonable persons may differ as to the correct classification."[60]

Although the subjectivity of the common law tests is no doubt one problem,[61] a bigger problem may be the large number of factors with which taxpayers and the IRS must contend, and the consequent difficulty in determining the relative weight of any one factor.[62] Thus, an important feature of many proposed legislative solutions has been to limit the number of factors to be taken into account.[63]

The common law tests may be particularly difficult to apply in the multi-party contract situations, which are the only situations covered by section 1706. This is because the service-broker and the service-recipient often share control over the service-provider's performance of

---

[60] Hearings Before the Subcommittee on Oversight of the Internal Revenue Service of the Committee on Finance, 97th Cong., 2d Sess. (April 26, 1982). *See also* Hearings Before the Subcommittee on Commerce, Consumer and Monetary Affairs of the Committee on Government Operations, 101st Cong., 1st Sess. (May 16, 1989) (acting Commissioner of Internal Revenue stating that "[o]ne of the most difficult and controversial issues in the employment tax area is the definition of 'employee' under the so-called 'common law rules' . . . . IRS' preference has been and continues to be for a legislative solution.").

[61] *See, e.g.*, GAO, *Information Returns Can Be Used to Identify Employers Who Misclassify Workers* 3, GGD-89-107 (1989).

[62] In an August 5, 1987 letter to Lawrence B. Gibbs, Commissioner of Internal Revenue, Frank S. Swain, the U.S. Small Business Administration Chief Counsel for Advocacy, requested that the IRS clarify which factors are important, and which are not important, in determining employee status in the technical services area.

[63] *See, e.g.*, the proposals described in Hearings Before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means, 97th Cong., 2d Sess. (June 11, 1982) (joint Statement of John E. Chapoton, Assistant Secretary of the Treasury (Tax Policy), and Roscoe L. Egger, Jr., Commissioner of Internal Revenue).

services, as well as sharing other incidents of employment.[64] In some cases, both may legitimately be considered the individual's employer. While the parties may request a determination letter from the IRS, this may be too difficult and time-consuming to be practical.[65] Moreover, even if the service-recipient is considered the individual's sole employer, the broker may have sufficient control over payments made to the individual to be treated as her "imputed employer" and be subject to a withholding requirement.[66] Finally, even if the broker is considered the sole employer, the client may be treated as the employer for certain employee fringe benefit purposes under the leased employee rules.[67]

Problems with the common law tests have been exacerbated by the fact that labor markets have undergone significant changes--including the proliferation of multi-party arrangements--since the enactment of section 530 in 1978, during which period section 530 has virtually prevented the IRS from issuing any general guidance reflecting its interpretation of the common law tests. This has made it very difficult for taxpayers and IRS personnel alike to analyze employment relationships consistently, and has greatly reduced employers' ability to predict when the common law tests require a particular worker to be treated as an employee or independent contractor. The enactment of section 1706 has permitted the IRS to issue guidance[68] in some very narrow circumstances, only, and significant gaps therefore remain.

---

[64] The situation becomes even more complicated when the individual operates through a corporation. *See* Appendix A for a discussion of the relevance of incorporation in this context.

[65] For a third-party broker with dozens of independent contractors at many different clients, the number of determination letter requests (Form SS-8) to be completed--even if a sampling is used--can be very large if the firm wants to cover all typical factual settings. Moreover, client projects often last only weeks or months, making it difficult to obtain a ruling before the independent contractor changes job settings.

[66] Code § 3401(d)(1); Treas. Reg. § 31.3401(d)-1(f). *See Otte v. United States*, 419 U.S. 43 (1974).

[67] *See* Code § 414(n). Section 1706 does not affect the application of section 414(n). Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986*, 1345 (Comm. Print 1987).

[68] *See, e.g.*, Rev. Rul. 87-41, 1987-1 C.B. 296.

# PART FOUR

# APPENDICES

## APPENDIX A

## DIFFERENCES IN TREATMENT OF EMPLOYEES AND INDEPENDENT CONTRACTORS--DETAILED ANALYSIS

### I. OVERVIEW

Employees and employers face significantly different treatment from independent contractors and their clients under a wide range of laws, including Federal and State employment tax, income tax and labor laws. Differences that significantly favor one group over the other may encourage deliberate misclassification of an individual as an employee or independent contractor. This appendix describes the major differences in treatment between employees and employers on the one hand and independent contractors and their clients on the other, and the factors used to distinguish between them. It also compares the relative advantages of both types of treatment and attempts to determine whether current law creates unnecessary incentives for misclassification. It concludes that current law does not consistently favor one classification over the other.

### II. FEDERAL TAX LAW

#### A. Employment Taxes

Social Security and Medicare. Wages paid to employees are generally subject to Social Security and Medicare taxes under the Federal Insurance Contribution Act (FICA). Compensation paid to independent contractors, by contrast, is generally subject to Social Security and Medicare taxes under the Self-Employment Contributions Act (SECA).[69]

Since 1990, the combined tax rates on employees and their employers on the one hand and independent contractors and their clients on the other have been virtually identical under both FICA and SECA.[70] Prior to 1983, the tax rates on independent contractors were

---

[69] *See* Code Subtitle A, Chapter 2, and Subtitle C, Chapter 21.

[70] The combined Social Security and Medicare tax rate for 1991 is the same (15.3 percent) under both. Code §§ 1401, 3101 and 3111. Under both, only the first $53,400 of compensation is subject to Social Security tax, while the first $125,000 is subject to Medicare tax. Code §§ 1402(k) and 3121(x), as added by the Omnibus Budget Reconciliation Act of 1990 (OBRA 1990), Pub. L. No. 101-508, 104 Stat. 1388 (1990); Notice, 55 Fed. Reg. 45856 (October 31,

significantly lower, even though they were generally eligible for the same Social Security and Medicare benefits as employees.[71] In 1982 testimony, Treasury recommended that the rate differential be reduced to "help neutralize the decision whether to hire an independent contractor or an employee, and relieve pressure on the question of employment status."[72] 1983 legislation mostly eliminated the rate differential effective in 1984, and made other conforming changes that became fully effective in 1990.[73]

Some differences still remain, however. In some cases they can be significant. While the gross tax base is generally the same under FICA and SECA,[74] items that reduce FICA wages generally do not reduce compensation subject to SECA tax unless they are deductible on Schedule C for income tax purposes. In particular, contributions to a qualified pension plan or an accident and health plan generally are not includible in employee FICA wages, but are subject to SECA tax.[75] Contributions to certain nonqualified plans may also receive more favorable

---

1990). While, technically, the employer pays half of the FICA taxes imposed on an employee's wages, the economic effect is the same as if the employee paid the entire amount. Special deductions are also provided to self-employed individuals subject to SECA, which produce nearly the same effect as the fact that employees are not subject to income or FICA taxes on the employer's share of FICA. Code §§ 164(f) and 1402(a)(12).

[71] In 1980, for example, the combined FICA tax rate (employer and employee) was 12.26 percent, while the combined SECA tax rate was 8.1 percent.

[72] Hearings Before the Subcommittee on Oversight of the Internal Revenue Service of the Committee on Finance, 97th Cong., 2d Sess. (April 26, 1982) (Statement of John E. Chapoton, Assistant Secretary of the Treasury (Tax Policy)).

[73] Social Security Amendments of 1983, Pub. L. No. 98-21, § 124, 97 Stat. 65, 89 (1983). *See also* H.R. Conf. Rep. No. 47, 98th Cong., 1st Sess. 125-26 (1983).

[74] *Commissioner v. Braddock*, 95 T.C. No. 45 (1990).

[75] *Compare* Code §§ 1402(a) and 3121(a)(5); *see* Code § 62(a)(6). Health and accident plan contributions are included in SECA compensation even though they are partially deductible for income tax purposes. *See* Code §§ 162(l)(4). The treatment of pension plan contributions may be explained by viewing contributions by self-employed persons as essentially elective. Employee elective contributions are includible in FICA wages. Code § 3121(v)(1). This explanation does not apply to accident and health plan contributions, however, since these may be excluded from FICA wages even when provided under an elective arrangement. Code § 3121(a)(5)(G).

treatment under FICA.[76] These advantages are to a limited extent offset, however, by the fact that trade or business expenses may be deducted from compensation before SECA compensation is calculated, but cannot be so deducted for FICA purposes, and that excess FICA taxes may be imposed on the employer when an employee changes jobs in mid-year.[77] Finally, unlike employees, independent contractors who are eligible for Social Security benefits can sometimes avoid application of the Social Security earnings test through the use of deferred compensation.[78]

Unemployment Insurance. The first $7,000 of wages paid to an employee is generally subject to tax under the Federal Unemployment Tax Act (FUTA).[79] Under the integrated Federal/State system, part of the tax is ordinarily paid to the State of employment, while part is paid to the Federal government; the combined rate averaged approximately 2.8 percent in

---

[76] There is no analogue to section 3121(v)(2) in SECA. OBRA 1990 deleted an analogous rule for corporate directors in section 1402(a) for tax purposes; however, a similar rule still exists for purposes of the Social Security earnings test. *See* Social Security Act § 211(a), 42 U.S.C. § 411(a).

[77] This results from the fact that, in computing FICA taxes on a new employee's wages, an employer generally may not take into account the fact that the employee has already earned wages in excess of the taxable wage base. Treas. Reg. § 31.3121(a)(1)-1(a)(3). If this results in an overpayment, the employee may be entitled to a refund, but *not* the employer. Code § 6413(b); Treas. Reg. § 31.6413(c)-1; Rev. Rul. 55-584, 1955-2 C.B. 394. SECA taxes are also considered income taxes, which are collected through the estimated tax system. Thus, while FICA taxes are generally collected and deposited with the Federal government every pay period, SECA taxes are generally paid quarterly. *Compare* Treas. Reg. §§ 1.1401-1(a) and 31.6302(c)-1. Similarly, SECA taxes may be contested in the Tax Court, while FICA taxes may not.

[78] Under the Social Security earnings test, benefits through age 69 are reduced by a fraction of the payee's other earnings in excess of an exemption amount. Social Security Act § 203, 42 U.S.C. § 403. In the case of an independent contractor, deferred compensation is generally taken into account for this purpose when it is received, whereas, in the case of an employee, deferred compensation is generally taken into account when earned. *Compare* Social Security Act §§ 209 and 211, 42 U.S.C. §§ 409 and 411 (as noted above, an exception is provided for deferred directors' fees). Therefore, some independent contractors defer receipt of compensation that would otherwise reduce their Social Security benefits until after age 70.

[79] *See generally* Code Subtitle C, Chapter 23.

1990. The Federal portion of the tax is paid quarterly. Independent contractors are not subject to FUTA tax, but likewise generally are not eligible to receive any unemployment benefits.[80]

### B. Income Taxes

Collection Mechanisms. Income taxes on employees are collected mainly through the withholding system, whereas income taxes on independent contractors are collected mainly through the estimated tax system. Both systems are backed up by information reporting requirements imposed on service-recipients.

Employers are generally required to withhold a portion of their employees' wages as they are paid and remit it to the Federal government as payment of the employees' income taxes.[81] Withholding rates are specified in tables and procedures published by the IRS, and are calculated to collect approximately the same amount of tax as the employees will ultimately owe with respect to the wages if they work all year at the same wage level.[82] Withholding must generally be done at the same rate each pay period,[83] and the amounts withheld must generally be deposited, along with FICA taxes, soon thereafter in a Federal depositary.[84] Withholding can generate significant overhead expenses.[85] Independent contractors and their clients

---

[80] Eligibility is a matter of State rather than Federal law. *See* footnotes 140 and 143 below for a discussion of State eligibility standards.

[81] *See generally* Code § 31 and Subtitle C, Chapter 24.

[82] *See generally* Code § 3402; IRS Publication 15 (Circular E), *Employer's Tax Guide* (Rev. January, 1991). Withholding rates are generally based on the employee's rate of compensation, marital status, and the number of allowances claimed on Form W-4. Withholding rates may be increased if an employee anticipates receiving additional income during a taxable year that is not subject to withholding, or reduced if large deductions are anticipated.

[83] *But see, e.g.*, Announcement 85-113, 1985-31 I.R.B. 31 (special accounting rule for fringe benefits); *cf.* Code § 3501(b).

[84] The actual schedule depends on the size of the payroll. *See* Treas. Reg. § 31.6302(c)-1.

[85] Some argue that the government is the main beneficiary of withholding, in that it enables tax authorities to shift a large portion of the collection burden to the private sector. On the other hand, it is not clear that withholding is any more burdensome on employers than increased estimated tax payments (which would be necessary without withholding) would be on employees. Withholding may also provide benefits to some employers because they have the use of withheld funds for a short period of time before they must remit them to the government. Moreover,

generally are not subject to a withholding requirement with respect to their compensation income.

Unless certain exceptions apply, both employees and independent contractors must pay their estimated income tax liabilities for the current year in quarterly installments throughout the year.[86] The installments are due on April 15, June 15, September 15, and January 15 of the following year. The amount of each installment is generally one quarter of the lesser of the taxpayer's income tax liability for the prior year, or 90 percent of her liability for the current year. Because of withholding, however, employees generally do not have to make any estimated tax payments. This is because withholding generally requires earlier payments than would be necessary under the estimated tax system, and these amounts are credited towards employees' estimated tax obligations.[87] Thus, employees are generally only required to make estimated tax payments if they have significant non-wage income.

Employers generally must report all wages paid to an employee annually on Forms W-2.[88] Similarly, clients must generally report all compensation paid to independent contractors annually on Form 1099-MISC; no Form 1099-MISC is generally required, however, for payments to a corporation, payments that are not made by a business (*e.g.*, homeowners' payments to a house painter), or payments to a service-provider aggregate less than $600 in a calendar year.[89] The administrative burden is about the same for each.

Copies of Form W-2 must be sent to the employee and to the Social Security Administration.[90] The Social Security Administration subsequently sends information from the forms to the IRS. Also, the employee is required to attach any copies she receives to her income tax return. Using this information, the IRS can determine whether wages have been

---

employers may be able to shift some of their administrative costs of withholding to the worker in the form of lower compensation.

[86] *See generally* Code §§ 6315 and 6654.

[87] Code § 6654(g).

[88] Code § 6041A; Treas. Reg. §§ 1.6041-1(a) and 1.6041-2.

[89] Code § 6041; Treas. Reg. §§ 1.6041-1 and 1.6041-3.

[90] Code § 6051; Treas. Reg. §§ 31.6051-1 and 31.6051-2.

underreported. While 1099s must be sent to the independent contractor and the IRS, there is no requirement that they be attached to an individual's return.

Trade or Business Expense Deductions. Under current law, independent contractors face significantly fewer restrictions on their ability to deduct trade or business expenses than employees. In particular, employees (but not independent contractors) generally may not deduct their trade or business expenses unless they itemize their deductions on their Federal income tax returns, and even then only to the extent they exceed two percent of their adjusted gross income from all sources. Also, they must satisfy additional requirements before they may deduct their automobile, home office and certain other expenses.

Independent contractors' trade or business expenses are generally deductible "above-the-line", *i.e.*, as a direct reduction in their business income reported on Schedule C. Employees' trade or business expenses, by contrast, are generally only deductible "below-the-line", *i.e.*, as itemized expenses.[91] Especially for lower-income employees, use of the standard deduction is often more favorable than itemization of expenses; such individuals effectively get no tax benefit from their trade or business expenses.[92] In addition, since 1986, employees' trade or business expenses have generally been deductible only to the extent they (plus any other miscellaneous itemized deductions) exceed two percent of the employee's adjusted gross income from all sources.[93]

The two-percent floor generally does not apply to an employee's trade or business expenses to the extent they are reimbursed by her employer: in such case, generally no deduction is necessary, because the reimbursement is not included in the employee's taxable income in the first place. Only reimbursement arrangements that require the employee to account to the employer for any expenditures are eligible for this treatment, however.[94] This

---

[91] Code § 62(a).

[92] *See* Rev. Proc. 90-64, 1990-53 I.R.B. 27, for the standard deductions in effect for 1991.

[93] Code § 67. This requirement reversed the earlier trend to conform the treatment of employees and self-employed persons as much as possible.

[94] Code § 62(c); Treas. Reg. § 1.62-2; *cf.* Treas. Reg. § 1.132-5(a)(1)(v) (similar rules for working-condition fringe benefits). Somewhat different accounting rules apply depending on whether the expense is subject to the substantiation requirements of section 274(d), and whether the arrangement is a *per diem* or mileage plan. *See* Code § 62(c); Treas. Reg. §§ 1.62-2(e) and 1.274-5T(g) and (j).

prevents employees from excluding from income amounts greater than that which they could have deducted.[95] Client reimbursements are always included in an independent contractor's gross income, and the expenses for which they are made must be deducted. Inadequate accounting by the independent contractor to the client is therefore generally irrelevant in this context.[96]

Unlike independent contractors, employees may not deduct interest expenses incurred in their trade or business of being an employee: such interest is considered a personal expense.[97]

Entertainment expenses generally may not be deducted unless they satisfy the business purpose requirements of section 274(a). The rules applicable to employees and their employers on the one hand and independent contractors and their clients on the other are about the same for this purpose.[98] Special exemptions are provided, however, for food or beverages furnished on an employer's business premises primarily for its own employees, and for recreational or

---

[95] Excess reimbursements must be returned to the employer. If the accounting requirements are not met, the employee may still be able to deduct the underlying expenses. They will, however, be subject to the two-percent floor. In addition, failure to account will shift the burden of complying with various requirements of section 274, including the business purpose requirement of section 274(a), the substantiation requirement of section 274(d), and the 80-percent deduction limit of section 274(n), from the employer to the employee. Code § 274(e)(2), (e)(3)(A) and (n)(2)(A); Treas. Reg. §§ 1.274-2(f)(iv), 1.274-5T(f)(2) and 31.3401(a)-4.

[96] As with employees, however, if an independent contractor does not adequately account to her client, the burden of complying with various requirements of section 274 will shift from the client to her. Code § 274(e)(3)(B) and (e)(9); Treas. Reg. § 1.274-2(f)(2)(iv); *see* Treas. Reg. § 1.274-5T(h)(3) for the definition of an adequate accounting for this purpose; *see also* Treas. Reg. § 1.274-2(f)(2)(iv)(a) and (c)(1) (definitions of adequate accounting and reimbursement arrangement). The substantiation requirements of section 274(d) are an exception; an independent contractor continues to be subject to these requirements even if she makes an adequate accounting to her client. *See* Treas. Reg. § 1.274-5T(h)(2); Rev. Proc. 63-4, Q&A-28 and 29, 1963-1 C.B. 474; *Smith v. Commissioner*, 80 T.C. 1165 (1983). This distinction presumably reflects the fact that, while employees generally need not deduct reimbursed expenses because the reimbursements are simply excluded from their gross income, independent contractors must generally deduct the amounts.

[97] Code § 163(h)(2)(A).

[98] *See* footnotes 95 and 96 above for rules relating to the allocation of the burden of substantiation in the case of reimbursed expenses.

social activities primarily for their benefit.[99] Independent contractors may, however, benefit from both as long as they are not provided primarily for the contractors' benefit.

Travel and entertainment expenses, business gifts, and expenses associated with "listed property" (including automobiles, computers, cellular telephones and property used for entertainment) also may not be deducted unless the taxpayer has adequate records or other evidence to substantiate their amount and business purpose, within the meaning of section 274(d).[100] Again, the rules applicable to employees and their employers on the one hand and independent contractors and their clients on the other are about the same. Employers may use certain simplified substantiation methods that are unavailable to clients of independent contractors, however. In particular, they may rely on records maintained by their employees with respect to the use of listed property, and they can avoid any substantiation requirements with respect to the use of vehicles by adopting a policy statement prohibiting personal use and meeting certain other requirements.[101] Presumably, these methods are denied to clients of independent contractors because clients generally do not provide them with the property necessary to perform their jobs, and, in any event, cannot supervise their use of the property very closely.

Finally, business meal expenses generally may not be deducted unless the taxpayer or one of its employees is present. Independent contractors may be treated as employees for this purpose only if they render "significant services" to the taxpayer.[102]

Home office expenses and rental and depreciation expenses associated with listed property (as described above) may be subject to special deduction limits unless they meet certain business

---

[99] Code § 274(e)(1) and (e)(4).

[100] *See* footnotes 95 and 96.

[101] Treas. Reg. §§ 1.274-5T(e)(2) and 1.274-6T. The latter rule applies to both employees and sole-proprietors. Treas. Reg. § 1.274-6T(e)(2)(i). The employer can also shift the burden of compliance to its employees by treating the use of listed property as personal use and including it in the employees' incomes without regard to the working condition fringe benefit rules of section 132.

[102] Code § 274(k); Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986*, 69 (Comm. Print 1987).

use requirements.[103] These limits were significantly tightened in TRA 1986. The limits for employees and independent contractors are generally the same except that, in the case of home office expenses, the employee's business use must also be "for the convenience of the employer",[104] and, in the case of listed property such as home computers, such use must be "for the convenience of the employer and required as a condition of employment."[105] These standards are difficult for many employees to meet.[106]

Fringe Benefits. Independent contractors are generally not taken into account under the employee fringe benefit provisions of the Code. On the one hand, this means that independent contractors' clients generally are not required to include them in any pension or welfare benefit plans they provide for their employees in order to maintain the plans' tax-qualified status, and the independent contractors have correspondingly greater freedom to structure their own benefit arrangements. On the other hand, this means that independent contractors may be unable to participate in such plans even if they want to (and their clients agree), and some of the benefit arrangements they establish for themselves as sole proprietors or partners may not be tax-favored. (Such arrangements may also be more costly, since they usually cannot benefit from the economies that some employers able to achieve through group purchase arrangements.)

The Code provides tax-favored treatment for a wide range of common employee fringe benefits, including pension plans, life insurance and health and accident plans. In many cases, such treatment is not available for benefits provided to highly compensated workers unless the employer also provides comparable benefits to a minimum number of its nonhighly compensated workers. Generally, only an employer's common law employees (and individuals treated as such

---

[103] *See generally* Code §§ 280A and 280F. Generally, in the case of a home office, the space must be used exclusively on a regular basis as the taxpayer's principal place of business. In the case of listed property, the property must be used predominantly (*i.e.*, more than 50 percent of the time) in the taxpayer's trade or business.

[104] *See* Code § 280A(c)(1).

[105] *See* § 280F(d)(3)(A); Treas. Reg. § 1.280F-6T(a)(2).

[106] *See, e.g.*, Rev. Rul. 86-129, 1986-2 C.B. 48. On the other hand, the Tax Court's "focal point" test has made it difficult for independent contractors to establish their home office as their principal place of business if they render services elsewhere. *E.g., Baie v. Commissioner*, 74 T.C. 105 (1980); *but see Soliman v. Commissioner*, 94 T.C. 20 (1990) (apparent abandonment of "focal point" test).

under the Code)[107] are taken into account for this purpose. In addition, these same provisions generally prohibit an employer from offering tax-favored benefits to its independent contractors. A list of tax-favored benefits, and the conditions under which they may be offered to employees and independent contractors, are shown in Table A-1.[108] (The table does not include statutorily-required benefits such as workers' compensation.)

Taken together, these rules tend to encourage employers to admit a new worker into an existing fringe benefit plan if she is classified as an employee, and to discourage (if not actually prohibit) them from doing so if she is classified as an independent contractor. Classification as an independent contractor may, therefore, be beneficial to the client; in cases where the worker would prefer additional cash or a different benefit package to the fringe benefits offered under the employer's plan and can negotiate to receive some or all of the compensation the client would otherwise have spent on the benefits, classification as an independent contractor may also be beneficial to the worker.

An independent contractor who is unable to participate in her client's plans generally can establish her own benefit arrangements in her capacity as a sole proprietor (or as a partner, if she is in business with other individuals).[109] As indicated in Table A-1, the most significant types of fringe benefits may be available on a tax-favored basis. For example, sole proprietors can generally establish their own pension plans, subject to essentially the same rules as

---

[107] These include leased employees subject to section 414(n) and so-called "statutory employees" treated under sections 3121(d) and 7701(a)(20) as employees for purposes of FICA and certain employee benefit provisions of the Code. *Cf.* Staff of the Joint Committee on Taxation, 100th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986*, 1345 (Comm. Print 1987) (section 1706 not to affect application of section 414(n)). Note that, in some cases employees may also be deemed to be self-employed. *See, e.g.*, Code § 1372 (certain S corporation shareholders treated as partners).

[108] Provisions that merely specify the accounting treatment of benefits provided to employees, and do not grant tax-favored treatment, generally also apply to independent contractors. *E.g.*, Code §§ 83, 280G and 457; Treas. Reg. §§ 1.83-1(a)(1) and 1.457-2(d); Prop. Treas. Reg. § 1.280G-1, Q&A-15.

[109] Sole proprietors and partners are proprietors of unincorporated businesses. The treatment of proprietors of incorporated businesses is discussed in section II.C. below.

# Table A-1

## Tax-Favored Benefits Available to Employees and Independent Contractors

| Benefits | Availability: To Employee in Employer's Plan | Availability: To Independent Contractor in Client's Plan | Availability: To Independent Contractor in Own Plan |
|---|---|---|---|
| Employee achievement awards[a] | May be required | | |
| Group-term life insurance[b] | May be required | | |
| Death benefits[c] | Generally optional | | |
| Accident and health insurance[d] | Generally optional | | Limited deduction only |
| Tuition remission[e] | May be required | | |
| Meals and lodging[f] | Optional | | |
| Group legal services[g] | May be required | | Optional |
| Cafeteria plans[h] | May be required | | |
| Educational assistance[i] | May be required | | Optional |
| Dependent care[j] | May be required | | Optional |
| No-additional-cost fringes[k] | May be required | | Optional |
| Qualified employee discounts[l] | May be required | | Optional |
| Working condition fringes[m] | Optional | Optional | Optional |
| *De minimis* fringes[n] | Generally optional | Optional | Optional |
| Free parking[o] | Optional | | Optional |
| On-premises athletic facilities[p] | Optional | | Optional |
| New-product testing[q] | Optional | | Optional |
| Qualified pensions and annuities[r] | May be required | | Optional |
| Tax-sheltered annuities[s] | May be required | | |
| Qualified and incentive stock options[t] | Optional | | |
| Employee stock purchase plans[u] | May be required | | |
| Voluntary employees' beneficiary associations[v] | May be required | | |

Department of the Treasury
Office of Tax Policy

In this table, "optional" means that the benefit is not required to be provided under any minimum coverage or nondiscrimination rules, while "may be required" means that it may have to be provided.

### Notes

a. Code §§ 74(c) and 274(j)(3)(B).

b. Code § 79(d); Treas. Reg. § 1.79-0(b).

c. Code § 101(b)(3)(A); Treas. Reg. § 1.101-2(f)(1). Discrimination rules may apply if the benefits are provided under a qualified pension plan, however.

d. Code §§ 105(g), 106, and 162(1)(1); Treas. Reg. § 1.105-1(a). Coverage and discrimination requirements may apply if the plan is self-funded. Code § 105(h).

e. Code § 117(d)(2)(A).

f. Code § 119.

g. Code § 120(c)(1), (c)(2) and (d)(1).

h. Code § 125(b)(1) and (d)(1)(A); Prop. Treas. Reg. § 1.125-1, Q&A-4.

i. Code § 127(b)(2) and (c)(2); Treas. Reg. § 1.127-2(h)(1)(iii).

j. Code § 129(d)(2), (d)(3), (d)(8) and (e)(3).

k. Code § 132(b), (f) and (h)(1); Treas. Reg. § 1.132-1(b)(1) and (3).

l. Code § 132(c), (f) and (h)(1); Treas. Reg. § 1.132-1(b)(1) and (3).

m. Code § 132(d); Treas. Reg. § 1.132-1(b)(2) and (4).

n. Code § 132(e); Treas. Reg. § 1.132-1(b)(2) and (4). Certain nondiscrimination rules apply to eating facilities, however.

o. Code § 132(h)(4); Treas. Reg. § 1.132-(b)(2) (flush language).

p. Code § 132(h)(5); Treas. Reg. § 1.132-1(b)(1) and (3).

q. Treas. Reg. §§ 1.132-1(b)(2) (flush language) and 1.132-5(n).

r. Code §§ 401(a)(4), 401(c) and 410(b); Treas. Reg. §§ 1.72-17(a) and 1.401-10(b).

s. Code § 403(b); Treas. Reg. § 1.403(b)-1(a)(1).

t. Code §§ 421-22A; Treas. Reg. § 1.421-7(h).

u. Code § 423; Treas. Reg. § 1.423-2(e)(2).

v. Code § 501(c)(9); Treas. Reg. § 1.501(c)(9)-2(b).

employer-sponsored plans.[110] In lieu of the exclusion from income for employer-provided accident and health insurance, they can often deduct up to one-quarter of their medical insurance expenses, without regard to the 7.5 percent floor in section 213 (unless they are covered under an employer-sponsored plan directly or through their spouse).[111] They can also provide themselves certain fringe benefits, including working condition and *de minimis* fringes, on a pre-tax basis. Other benefits must generally be purchased out of after-tax income. In addition, as explained in Section II above, the tax benefits for sole proprietor and partnership plans are generally limited to the income tax provisions of the Code, and do not apply for Social Security and Medicare tax purposes.

### C. Determination of Employee Status

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

Background. The common law tests first assumed importance under the employment tax provisions of the Code. The original Social Security Act simply defined an "employee" as including "an officer of a corporation".[112] Treasury regulations issued in 1936 used common law standards to determine employee status.[113] The lower courts, however, applied a variety of different standards, some relying less than others on common law precedents.[114] In 1947

---

[110] In a sense these rules are more favorable: plans of sole proprietors who have no nonhighly compensated employees resemble elective arrangements like IRAs and section 401(k) plans, but are subject to higher dollar limits on contributions.

[111] Code § 162(l)(6), as amended by OBRA 1990 § 11410. This provision is due to expire December 31, 1991, however.

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

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

[114] *See United States v. Webb*, 397 U.S. 179 (1969), for a description of this case law.

the Supreme Court issued a pair of opinions that attempted to clarify the governing standards.[115] In them, the Court applied an "economic reality" test that resembled the common law tests, under which "employees are those who as a matter of economic reality are dependent on the business to which they render services."[116]

The IRS (and the Social Security Administration) proposed amendments to their regulations to incorporate the Court's new economic reality test, but these never took effect: Congress reacted immediately by passing (over President Truman's veto) the so-called Gearhart Resolution, endorsing the use of common law tests.[117]

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

> has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but [also] how it shall be done.[118]

Over the years, the IRS has identified 20 important factors for determining when the common law tests are satisfied.[119] These factors, which are listed in Appendix B, are used in resolving issues raised in rulings and other guidance, including guidance on the status of technical services

---

[115] *Bartles v. Birmingham*, 332 U.S. 126 (1947), and *United States v. Silk*, 331 U.S. 704 (1947). *See also Harrison v. Greyvan Lines*, 331 U.S. 126 (1947).

[116] *Bartles*, 332 U.S. at 130.

[117] H.R.J. Res. 296, Pub. L. No. 642, 62 Stat. 438 (1948).

[118] Treas. Reg. §§ 31.3121(d)-1(a)(2), 31.3306(i)-1(b) and 31.3401(c)-1(b).

[119] Internal Revenue Manual 4600 (Employment Tax Procedures), Exhibit 4640-1; *see also* Rev. Rul. 87-41, 1987-1 C.B. 296. These factors were originally compiled by the Social Security Administration in determining entitlement to benefits.

workers issued after the enactment of section 1706.[120] No one factor on this list is determinative, though some are more important than others.

Congress and the courts have overridden the common law tests in some situations. For example, certain occupations generally performed by employees are nevertheless treated as performed by independent contractors under the Code; these include certain door-to-door salesmen and real estate agents.[121] Conversely, certain occupations generally performed by independent contractors are nevertheless treated as performed by employees for employment tax purposes. These "statutory employees" include certain full-time life insurance salesmen, agent-drivers and commission-drivers engaged in the distribution of specific kinds of products, homeworkers and traveling or city salesmen.[122]

Relevance of Incorporation. An employee generally cannot change her status for Federal tax purposes to that of an independent contractor via incorporation. The common law tests focus on the relationship between the individual performing the services and the service-recipient; if an employment relationship exists, it is generally irrelevant whether payments are made directly or through a corporation controlled by the individual.[123] The legislative history of section 1706 reiterates this point.[124]

---

[120] *See* Rev. Rul. 87-41, 1987-1 C.B. 296. *See also* Moore, *Defining the Employee: Common-Law Rules*, Direction, February, 1988, at 13. Mr. Moore is the technical assistant for Federal employment tax in the Office of the Assistant Chief Counsel (Employee Benefits and Exempt Organizations) of the IRS. *See generally* Annotation, *Determination of Employer-Employee Relationship for Social Security Contribution and Unemployment Tax Purposes*, 37 A.L.R. Fed. 95 (1978), and Annotation, *What Constitutes Employer-Employee Relationship for Purposes of Federal Income Tax Withholding*, 51 A.L.R. Fed. 59 (1981).

[121] *See* Code § 3508; *see also* Code § 1372.

[122] *See* Code § 3121(d); Treas. Reg. § 31.3121(d)-1(d); Rev. Rul. 90-93, 1990-45 I.R.B. 4. Full-time life insurance salesmen may also be treated as employees for certain fringe benefit purposes. Code § 7701(a)(20).

[123] *E.g., Sargent v. Commissioner*, 93 T.C. 572 (1989); Rev. Rul. 87-41, 1987-1 C.B. 296; and Rev. Rul. 74-330, 1974-2 C.B. 278 (examples (1) and (2)).

[124] H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-835 (1986); 132 Cong. Rec. S8088-89 (June 20, 1986); *see* Rev. Rul. 87-41, 1987-1 C.B. 296; and Private Letter Ruling 9002017 (October 12, 1989).

An independent contractor also generally cannot change her status for Federal tax purposes to that of an employee *of her client* via incorporation; she may, however, be treated as an employee of her own personal service corporation for certain purposes, and derive certain tax benefits as a result. The effect depends on whether the personal service corporation elects to be taxed as a Subchapter S corporation under section 1362 of the Code. If it does not, the individual will generally be treated as an employee of the corporation for tax purposes, and can thus take advantage, *inter alia*, of various employee benefit provisions of the Code. She will, moreover, not be subject to the two-percent floor on itemized deductions or other limits on employee trade or business expense deductions to the extent she causes such expenses to be deducted at the corporate level. Although any income received and retained by the corporation will be taxed at (usually higher) corporate rates, in practice this problem can be minimized by distributing as much income as possible in the form of compensation.

If the personal service corporation *does* elect to be taxed as an S corporation, the individual will also generally be treated as an employee of the corporation for tax purposes,[125] but with one important exception: assuming her ownership interest exceeds two percent, she will not be treated as a employee for purposes of the employee benefit provisions of the Code.[126] The treatment of trade or business expenses is roughly the same as for a C corporation.[127]

## III. OTHER LAWS

### A. Federal Labor Laws

Most Federal labor laws apply only to employees and do not protect independent contractors. This is generally beneficial to the independent contractors' clients, who may save the direct costs of providing additional benefits to the individuals plus any associated administrative costs, but may not be beneficial to the independent contractors unless they do not need the protection and can share in their clients' cost savings.

---

[125] *See Spicer Accounting, Inc. v. United States*, 918 F.2d 90 (9th Cir. 1990).

[126] Code § 1372.

[127] Code § 67(c); Temp. Treas. Reg. § 1.67-2T(b).

COBRA. Employers must generally give their employees and the employees' beneficiaries the right to continue coverage under an employer-sponsored health plan after their coverage has ceased, if coverage ceases on account of certain qualifying events.[128] This requirement applies to employees and independent contractors (provided the plan covers at least some common law employees).[129]

ERISA. Pension and welfare benefit plans are subject to various coverage, funding, fiduciary, reporting, and other requirements under the Employee Retirement Income Security Act of 1974.[130] These labor provisions of ERISA do not apply to plans benefiting self-employed individuals (including independent contractors) unless they also cover employees, and many of the specific protections provided under ERISA extend only to employee-participants.[131] The tax provisions of ERISA are included in the Code.

Other Labor Laws. Independent contractors are generally not covered by the National Labor Relations Act, and therefore generally may not engage in collective bargaining or similar protected activities.[132] They also receive no protection under the nondiscrimination requirements of the Age Discrimination in Employment Act[133] or Title VII of the Civil Rights Act

---

[128] Code § 4980B, as added by the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA), Pub. L. No. 99-272, Title X, 100 Stat. 222 (1986), and amended by TAMRA § 3011.

[129] Code § 4980B(f)(7); Prop. Treas. Reg. § 1.162-26, Q&A-16(b).

[130] Pub. L. No. 93-406, 88 Stat. 829 (1974), *codified at* 29 U.S.C. §§ 1001 *et seq.*

[131] ERISA §§ 3(3) and (6), 4(a) and 4021(a), 29 U.S.C. §§ 1002(3) and (6), 1003(a) and 1321(a); 29 C.F.R. § 2510.3-3.

[132] NLRA § 7, 29 U.S.C. § 157. *See North American Van Lines, Inc. v. NLRB*, 869 F.2d 596 (2d Cir. 1989).

[133] ADEA §§ 4(a) and (11), 29 U.S.C. §§ 623(a) and 630(f). *See Hyland v. New Haven Radiology Assocs., P.C.*, 794 F.2d 793 (2d Cir. 1986).

of 1964,[134] the safety requirements of the Occupational Safety and Health Act,[135] or the minimum wage and overtime requirements of the Fair Labor Standards Act,[136] among others.

### B. Patent and Copyright Laws

An employer is generally considered the author of any work prepared during the course of an employee's employment for purposes of the Federal copyright laws; no such presumption exists with respect to work prepared by independent contractors.[137] By contrast, generally no legal distinction is drawn between employees and independent contractors under the Federal patent laws.[138] In practice, however, independent contractors may find it somewhat easier to secure patent protection for on-the-job creations than employees, since this issue often turns on a court's analysis of the implicit bargain struck between the parties.[139]

### C. State Laws

Many State laws also impose different requirements on employers and employees on the one hand and independent contractors and their clients on the other. In particular, employers are generally required to contribute a portion of the wages paid to each of their employees to

---

[134] Civil Rights Act (1964) § 701(f), 42 U.S.C. §§ 2000e(f). *See Wheeler v. Hurdman*, 825 F.2d 257 (10th Cir.), *cert. denied*, 484 U.S. 986 (1987).

[135] OSHA §§ 3(6) and 5(a)(1), 29 U.S.C. §§ 652(6) and 654(a)(1).

[136] FLSA §§ 3(e)(1), 6 and 7, 29 U.S.C. §§ 203(e)(1), 206 and 207. *See Walling v. Portland Terminal Co.*, 330 U.S. 148 (1947). Recent legislation has created an exemption from FLSA for technical services workers who are employees. Pub. L. No. 101-583, 104 Stat. 2781 (1990).

[137] Copyright Act §§ 101 and 201(b), 17 U.S.C. §§ 101 and 201(b) (work-for-hire). *See, e.g., CCNV v. Reid*, 104 L.Ed.2d 831 (1989); and *Aldon Accessories Ltd. v. Speigel, Inc.*, 738 F.2d 548, 552 (2d Cir.), *cert. denied*, 469 U.S. 982 (1984).

[138] *See, e.g., Francklyn v. Guilford Packing Co.*, 695 F.2d 1158, 1160-61 (9th Cir. 1983); and *B.F. Gladding & Co. v. Scientific Anglers, Inc.*, 248 F.2d 483 (6th Cir. 1957).

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

State workers' compensation and unemployment funds.[140] Clients of independent contractors generally are not required to do so, and, as a consequence, independent contractors generally are not eligible for benefits under these systems. Employee wages may also be protected under State wage payment laws, while payments to independent contractors are not.[141] As with Federal labor laws, this exclusion is generally beneficial to the clients of independent contractors, but may not be beneficial to the independent contractors themselves unless they do not need the protection and can share in their clients' cost savings.

### D. Determination of Employee Status

The status of an individual as an employee or independent contractor for purposes of Federal and State labor and other laws is generally determined under standards that resemble the control-based common law standards applied under the Code.[142] Depending on the purpose of the law involved, however, different factors are often emphasized in making this determination.[143] Thus, IRS determinations of employee status are generally persuasive but not

---

[140] *See, e.g.*, N.Y. Workmen's Compensation Law § 210 (McKinney 1965), and N.Y. Labor Law §§ 560 and 570 (McKinney 1988) (unemployment insurance). *See also* text accompanying footnote 80 above.

[141] *See, e.g.*, N.Y. Workmen's Compensation Law § 50 (McKinney 1965) (requirement that employer provide security for payment of wage compensation).

[142] *See generally* Annotation, *Trucker as Independent Contractor or Employee Under § 2(3) of the National Labor Relations Act (29 U.S.C.S. § 152(3))*, 55 A.L.R. Fed. 20 (1990); Annotation, *Determination of "Independent Contractor" and "Employee" Status for Purposes of § 3(e)(1) of the Fair Labor Standards Act (29 U.S.C.S. § 203(e)(1))*, 51 A.L.R. Fed. 702 (1990); Annotation, *Who is "Employee" Within the Meaning of Age Discrimination in Employment Act (29 U.S.C.S. §§ 621-634)*, 69 A.L.R. Fed. 700 (1990); Annotation, *Who is "Employee" as Defined in § 701(f) of the Civil Rights Act of 1964, 42 U.S.C.S. § 2000e(f)*, 72 A.L.R. Fed. 522 (1990); and Annotation, *Right to unemployment compensation or social security of one working on his own projects or activities*, 65 A.L.R.2d 1182 (1990).

[143] Federal law: *see, e.g., Darden v. Nationwide Mutual Ins. Co.*, 796 F.2d 701 (4th Cir. 1986) (ERISA); *Weisel v. Singapore Joint Venture, Inc.*, 602 F.2d 1185 (5th Cir. 1979); *Dunlop v. Dr. Pepper-Pepsi Cola Bottling Co.*, 529 F.2d 298 (6th Cir. 1976) (NLRA); *Brennan v. Gilles & Cotting, Inc.*, 504 F.2d 1255 (4th Cir. 1974) (OSHA); *Spirides v. Reinhardt*, 613 F.2d 826 (D.C. Cir. 1979) (Title VII); and *EEOC v. Zippo Mfg. Co.*, 713 F.2d 32 (3d Cir. 1983) (ADEA).

State law: *see, e.g., Taylor v. Employment Division*, 597 P.2d 780 (Or. 1978); *Starinieri, v. Unemployment Compensation Board of Review*, 289 A.2d 726 (Pa. 1972); and

determinative, and, in some cases, a worker can simultaneously be an employee for some purposes and an independent contractor for others.

## IV. SUMMARY

Current law does not consistently favor employee or independent contractor status. Independent contractors and their clients are treated somewhat more favorably with respect to employment taxes, and significantly more favorably with respect to their trade or business expense deductions. On the other hand, employees and employers are treated more favorably with respect to the taxation of some fringe benefits. Similarly, clients of independent contractors do not bear as great a burden as employers under Federal and State labor laws, but independent contractors also do not enjoy the same benefits or protections under those laws as do employees.

---

*Laeng v. Workmen's Compensation Appeals Board*, 494 P.2d 1100 (Cal. 1972); *cf. Cumming v. District Unemployment Compensation Board*, 382 A.2d 1010 (D.C. 1977) (self-employed status does not *per se* disqualify claimant).

## APPENDIX B

## COMMON LAW FACTORS USED TO DETERMINE EMPLOYEE STATUS

Workers are generally considered employees for Federal tax purposes if they:

1. Must comply with employer's instructions about the work.
2. Receive training from or at the direction of the employer.
3. Provide services that are integrated into the business.
4. Provide services that must be rendered personally.
5. Hire, supervise, and pay assistants for the employer.
6. Have a continuing working relationship with the employer.
7. Must follow set hours of work.
8. Work full-time for an employer.
9. Do their work on the employer's premises.
10. Must do their work in a sequence set by the employer.
11. Must submit regular reports to the employer.
12. Receive payments of regular amounts at set intervals.
13. Receive payments for business and/or travelling expenses.
14. Rely on the employer to furnish tools and materials.
15. Lack a major investment in facilities used to perform the service.
16. Cannot make a profit or suffer a loss from their services.
17. Work for one employer at a time.
18. Do not offer their services to the general public.
19. Can be fired by the employer.
20. May quit work at any time without incurring liability.

Source: Exhibit 4640-1, Internal Revenue Manual 4600 (Employment Tax Procedures), and Rev. Rul. 87-41, 1987-1 C.B. 296.

## APPENDIX C

## ADDITIONAL BACKGROUND TO TCMP AND SVC-1

### I. TCMP

The definition of "technical services worker" for purposes of Table 5-2 is based on the occupation of the primary taxpayer determined in the course of the TCMP audit. Unweighted frequencies for the occupations included in the analysis are as follows:

| Frequency | Occupation |
|---|---|
| 102 | Architects |
| 1,327 | Engineers |
| 27 | Surveyors and Mapping Scientists |
| 79 | Computer Scientists |
| 204 | Operations and Systems Researchers and Analysts |
| 8 | Mathematical Scientists |
| 182 | Physical Scientists |
| 27 | Life Scientists |
| 176 | Engineering Technologists and Technicians |
| 94 | Drafting Occupations |
| 11 | Survey and Mapping Technicians |
| 8 | Biological Technologists and Technicians (Except Health) |
| 39 | Chemical and Nuclear Technologists and Technicians |
| 4 | Mathematical Technicians |
| 47 | Science Technologists and Technicians, Not Elsewhere Classified |
| 12 | Air Traffic Controllers |
| 13 | Radio and Related Operators |
| 6 | Legal Technicians |
| 98 | Programmers |
| 4 | Technical Writers |
| 216 | Technicians, Not Elsewhere Classified |
| 2,684 | Total |

## II. SVC-1

Unweighted frequencies for the "technical services" occupations included in the SVC-1 survey are as follows:

| Frequency | Occupation |
|---|---|
| 1 | Architects |
| 8 | Engineers |
| 4 | Physical Scientists |
| 10 | Engineering Technologists and Technicians |
| 5 | Air and Ship Officers and Technicians |
| 15 | Technicians, *e.g.*, Embalmer/Morticians, Radio Operator, Computer Programmer |
| 43 | Total |

The following occupations were included in the TCMP analysis, but did not appear in the SVC-1 sample of misclassified employees:

Computer Scientists and Specialists;
Operations and System Researchers and Analysts;
Mathematical Scientists including Mathematicians, Actuaries and Statisticians,
Life Scientists;
Science Technologists and Mathematical Technicians.

Department of the Treasury
Washington, D.C. 20220

Official Business
Penalty for Private Use, $300