

# EMPLOYMENT CLASSIFICATION ISSUES

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**HEARINGS**  
BEFORE THE  
SUBCOMMITTEE ON OVERSIGHT  
OF THE  
COMMITTEE ON WAYS AND MEANS  
HOUSE OF REPRESENTATIVES  
ONE HUNDRED FOURTH CONGRESS  
SECOND SESSION

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JUNE 4 AND 20, 1996  
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# **EMPLOYMENT CLASSIFICATION ISSUES**

**TUESDAY, JUNE 4, 1996**

HOUSE OF REPRESENTATIVES,  
COMMITTEE ON WAYS AND MEANS,  
SUBCOMMITTEE ON OVERSIGHT,  
*Washington, DC.*

The Subcommittee met, pursuant to call, at 9:35 a.m., in room 1100, Longworth House Office Building, Hon. Nancy L. Johnson (Chairman of the Subcommittee) presiding.

[The advisories announcing the hearings follow:]

# **ADVISORY**

## **FROM THE COMMITTEE ON WAYS AND MEANS**

### **SUBCOMMITTEE ON OVERSIGHT**

FOR IMMEDIATE RELEASE  
May 23, 1996  
No. OV-13

CONTACT: (202)-225-7601

### **Johnson Announces Hearing on Employment Classification Issues**

Congresswoman Nancy L. Johnson (R-CT), Chairman of the Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a hearing to examine current issues relating to the classification of workers as employees or independent contractors for Federal tax purposes. **The hearing will take place on Tuesday, June 4, 1996, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 9:30 a.m.**

In view of the limited time available to hear witnesses, oral testimony at this hearing will be heard from invited witnesses only. Planned witnesses include officials from the Department of the Treasury and Internal Revenue Service (IRS), numerous small business owners, tax practitioners, and representatives from organized labor. Any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

#### **BACKGROUND:**

The classification of workers as either employees or independent contractors for Federal tax purposes generally is determined under common law (i.e., nonstatutory) rules. Under the common law, if a person engaging the services of another 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," then the relationship of employer and employee exists.

Employment classification issues have long been the subject of considerable controversy between taxpayers and the IRS. In the late 1960s, the IRS significantly increased its employment tax audit activities. In cases when the IRS prevailed in reclassifying workers from independent contractors to employees under the common-law test, the employing business could be assessed significant amounts for Social Security and Medicare taxes (Federal Insurance Contributions Act or "FICA") and Federal Unemployment Tax Act (FUTA) taxes on behalf of the reclassified employees, even though the employees might have fully paid their liabilities for self-employment and income taxes. In many cases, the back-tax liabilities assessed were so large that the companies were forced into bankruptcy.

In response to this problem, Congress enacted section 530 of the Revenue Act of 1978 (P.L. 95-600). This provision generally allows a taxpayer to treat a worker as an independent contractor for employment tax purposes, regardless of the actual status under the common-law test, unless the taxpayer has no reasonable basis for such treatment. Under section 530, a taxpayer is relieved from Federal employment tax liability when it can demonstrate that, in classifying its workers as independent contractors, it reasonably relied upon: (1) a past IRS audit of the taxpayer; (2) published rulings, a private letter ruling, or judicial precedents; (3) a long-standing recognized practice of a significant segment of the taxpayer's industry; or (4) any other reasonable basis.

The section 530 safe harbor was intended to alleviate what the Congress perceived as overly zealous pursuit and assessment of taxes and penalties by the IRS against employers who had, in good faith, misclassified their employees as independent contractors. The legislative history of this provision indicates that the Congress intended for the section 530 safe harbor relief to be liberally construed and applied by the IRS.

In recent years, the IRS has again stepped up its enforcement efforts with regard to employment tax issues, particularly with regard to small businesses with assets of \$3 million or less. The IRS has focused its enforcement resources in this area because its data suggests that such small businesses are the most likely to misclassify the status of workers.

However, many small businesses undergoing employment tax audits do not have the financial resources necessary to litigate adverse determinations by the IRS, even where the IRS's determination was erroneous. Moreover, those who do appeal IRS efforts to reclassify their workers and successfully prevail in litigation may incur hundreds of thousands of dollars in administrative costs, accountant and attorney fees during the examination and administrative appeals phase which may not be fully recovered. Although Internal Revenue Code section 7430 provides for the payment of attorney fees and certain costs by the Federal Government when taxpayers substantially prevail on the merits of their tax disputes with the IRS and the IRS's position was not substantially justified, this provision only applies to litigation costs incurred in connection with a court proceeding.

At last year's White House Conference on Small Business, a legislative solution to the problem of the IRS's aggressiveness in recharacterizing independent contractors as employees was ranked the number one priority among small businesses. Although the Administration has no legislative proposal to address this issue, the IRS has several administrative initiatives underway which attempt to address small businesses' concerns about the IRS's handling of worker classification issues.

First, the IRS has developed a new classification settlement program which will be available for a two-year test period. Under this program, an optional standard settlement agreement will be offered to businesses which filed Form 1099 information returns, but failed to meet all other requirements for relief under section 530. The settlement agreement will require workers to be reclassified prospectively as employees and the taxpayer will pay an assessment not to exceed one year's liability. Second, the IRS has developed a new procedure to allow businesses, at their option, to appeal employment tax issues to the IRS Appeals Office while the examination is still in progress in order to allow quicker resolution of the worker classification issue. Finally, the IRS issued for public comment a draft of new training materials for IRS examiners who handle worker classification issues (comment period closed April 28, 1996), and will examine comments before instituting the training.

Several bills have been introduced in this session of Congress to clarify the rules for classifying workers for Federal tax purposes, including H.R. 1972, the "Independent Contractor Tax Simplification Act of 1996," introduced by Representative Jon Christensen, and H.R. 582, the "Independent Contractor Tax Fairness Act of 1995," introduced by Representative Jay Kim.

In announcing the hearing, Subcommittee Chairman Nancy L. Johnson stated, "Although I am very encouraged by the IRS's worker classification initiatives and Commissioner Richardson's statements that this issue is one of the IRS's top concerns, I question whether these steps alone will be adequate to bring long-needed certainty to this area. I believe the Subcommittee needs to have a complete airing of this issue and to consider legislative proposals to clarify the classification of workers for Federal tax purposes."

**FOCUS OF THE HEARING:**

The Subcommittee will examine current problems with regard to classification of workers for tax purposes, including the IRS's handling of employment tax audit issues and reasons for its failure to liberally construe and administer the safe harbor rules created by section 530 of the Revenue Act of 1978. The Subcommittee will also consider whether the IRS's recent worker classification initiatives (i.e., the settlement program, revised training materials, and appeals policy changes) will adequately address perceived problems in this area. In addition, the Subcommittee will receive testimony on proposed legislation to clarify the tax laws relating to worker classification (e.g., H.R. 1972 and H.R. 582).

The Subcommittee will also examine whether modifications to the section 530 safe harbor rules are desirable. For example, should the section 530 safe harbor be modified to apply for income tax purposes as well as employment tax purposes? Is a statutory clarification of what constitutes a "significant segment" of the taxpayer's industry desirable? Finally, the Subcommittee will also examine independent contractor tax compliance and whether changes to improve compliance (e.g., expanded information reporting requirements or increases in penalties for failure to file Forms 1099) are desirable.

**DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:**

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) legal size copies of their statement, with their address and date of hearing noted, by the close of business, Tuesday, June 18, 1996, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, at least one hour before the hearing begins.

**FORMATTING REQUIREMENTS:**

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages including attachments.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. A witness appearing at a public hearing, or submitting a statement for the record of a public hearing, or submitting written comments in response to a published request for comments by the Committee, must include on his statement or submission a list of all clients, persons, or organizations on whose behalf the witness appears.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and the public during the course of a public hearing may be submitted in other forms.

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# **ADVISORY**

## **FROM THE COMMITTEE ON WAYS AND MEANS**

### **SUBCOMMITTEE ON OVERSIGHT**

FOR IMMEDIATE RELEASE  
June 13, 1996  
No. OV-14

CONTACT: (202) 225-7601

### **Johnson Announces Second Day of Hearings on Employment Classification Issues**

Congresswoman Nancy L. Johnson (R-CT), Chairman of the Subcommittee on Oversight of the Committee on Ways and Means, today announced that the Subcommittee will hold a second day of hearings to examine current issues relating to the classification of workers as employees or independent contractors for Federal tax purposes. **The hearing will take place on Thursday, June 20, 1996, in the main Committee hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m.** The first day of hearings took place on June 4, 1996. (See Subcommittee press release No. OS-13, dated May 23, 1996.)

Oral testimony at this hearing will be heard from invited witnesses only. Planned witnesses include officials from the U.S. Department of the Treasury and Internal Revenue Service, the General Accounting Office, tax practitioners and others. Any individual or organization not scheduled for an oral appearance may submit a written statement for consideration by the Committee and for inclusion in the printed record of the hearing.

#### **DETAILS FOR SUBMISSION OF WRITTEN COMMENTS:**

Any person or organization wishing to submit a written statement for the printed record of the hearing should submit at least six (6) legal size copies of their statement, with their address and date of hearing noted, by the close of business, Monday, July 8, 1996, to Phillip D. Moseley, Chief of Staff, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements wish to have their statements distributed to the press and interested public at the hearing, they may deliver 200 additional copies for this purpose to the Subcommittee on Oversight office, room 1136 Longworth House Office Building, at least one hour before the hearing begins.

#### **FORMATTING REQUIREMENTS:**

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4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

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Chairman JOHNSON. Good morning, everyone. It is a pleasure to have you here this morning.

Welcome to Senator Gramm. Nice to have you on this side. And to my colleagues, Hon. Jon Christensen, and Hon. Jay Kim. Thank you for being with us.

Today the Oversight Subcommittee is going to wander into wild woods where even angels fear to tread, the classification of workers as employees or independent contractors for Federal tax purposes. As you know, the issue has had a long and controversial history, and is one of the major sources of friction between the Internal Revenue Service and taxpayers, particularly small businessmen.

At last year's White House Conference on Small Business, a legislative solution to the problem of the IRS' aggressiveness in re-characterizing individual contractors as employees was ranked the number one concern among small businesses. The determination of whether workers and employees are independent contractors is made under a common law test which looks at whether the person engaging the services of another 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 the result is accomplished.

While this may sound simple, the common law test is anything but simple. Most employment relationships possess elements of both an employer-employee relationship and an employer-independent contractor relationship, and there isn't any bright yellow line which distinguishes the two.

As a result of ambiguity and conflicting interpretations under the common law test, reasonable people have often reached different conclusions as to the proper classification of a worker. Unfortunately, the consequences of even a good-faith mistake about the proper classification of workers for tax purposes can have devastating consequences for small businesses.

In cases where the IRS determines that a company has misclassified its workers as independent contractors, the employer can be assessed significant amounts of Social Security, Medicare and Federal unemployment taxes on behalf of the reclassified employees, even though the employees may have fully paid their liabilities for self-employment and income taxes. In some cases, the back tax liabilities assessed are so large that the companies are forced into bankruptcy.

Further, IRS agents have been known to privately acknowledge the protection offered by section 530 "safe harbor" provisions, but refuse to concede this issue to force a small business that cannot afford to appeal or pay back taxes to prospectively reclassify employees as independent contractors to satisfy the IRS agent. This is abusive, this is blackmail, and this is the kind of thing that poor law allows.

The time to solve this problem is at hand. The process starts today, to identify clear, fair, objective standards to prevent the IRS from abusing taxpayers, while assuring fair share compliance.

Several bills have been introduced in this session to clarify the rules for classifying workers for Federal tax purposes. I am pleased today we will hear from the authors of several of those.

The Subcommittee will hear from several small businesses regarding their experience with the IRS and from a representative with organized labor. Unfortunately, Bob Georgine, president of the Building and Construction Trades Department of the AFL-CIO, who had been scheduled to testify, will not be able to attend because of scheduling changes in today's hearings. He will be represented by written statement and will be heard at later panels.

This is the first of two hearings to examine this issue. On June 20, the Subcommittee will receive testimony from the Treasury, IRS, GAO, taxpayers, and others about whether or not the IRS' recent worker reclassification initiatives are sufficient to address the problems in this area or whether a legislative solution is necessary.

The Subcommittee will also examine whether modifications to the "safe harbor" created by section 530 of the Revenue Act of 1978 rules are desirable. The Subcommittee is going to take a hard look at independent contractor tax compliance and move to fix the problems in this area.

It is my belief that examination will lead to the development of a bipartisan consensus, on actions that can be taken to help clarify this longstanding problem in tax law. At this time when our Nation's economic growth depends on the growth in the small business and medium-sized business sector, it is imperative to support and encourage that growth in every way possible. Clarifying this passage of tax law is one important step we can and must take.

It is my privilege to recognize this morning, first, my colleague, Mr. Matsui, from California, whom I appreciate very much having made the effort to be here today, even though we do not have floor votes, and I would like to welcome my colleague, Representative Greg Laughlin, also, and thank him for being here today on a day when we actually are not going to have to vote.

Mr. Matsui.

Mr. MATSUI. Thank you very much, Chairman Johnson. I want to thank you and commend you for holding these very important hearings, and certainly I commend my colleague Mr. Laughlin for being here as well, given the fact that we do not have any votes today.

To the three gentlemen, Senator Gramm from Texas, Congressman Kim from my home State, and Congressman Christensen from the State of Nebraska, I am going to be very brief in my comments. I think, as Madam Chairman has said, there will be another series of hearings on the June 20, and it would be my hope that individuals will suspend judgment on this issue until they hear from the Treasury Department, the Internal Revenue Service, GAO, and certainly tax practitioners—those particularly in the New York State bar, because they might have a different set of facts, different set of circumstances, and different conclusions drawn from what is going on in terms of the issue of independent contractors.

It is my belief that Representative Johnson and the Members on her side of the aisle and those on our side will probably be able to come up with something bipartisan. Mrs. Johnson and I have worked very closely together over the last year and a half, and we have been able to come up with a number of bipartisan pieces of legislation that passed the House unanimously or close to it. We will certainly try in this particular case, as well.

I remember, as a law student, one of the big issues—I do not know if they teach agency courses any longer in law schools, but when I was going to law school, they taught agency courses. The issue of independent contractors or the employment relationship is a very important relationship. In the cases that I used to read in the late sixties, the issue was whether or not the employee, when he or she committed a tort or the employer was responsible.

Now we have a whole different set of circumstances. That issue no longer, in terms of tort responsibility, is a key one. The key issues today are benefits—pension benefits, health care benefits, benefits that employers often give to employees.

The reason this issue has taken on a life of its own and has become so critical over the last 20-plus years, or so is mainly because of nondiscrimination rules to a large extent. Employers in the past were not required to provide the same benefits to employees as they gave to management or to themselves with the nondiscrimination rules. That has all changed, so many employers are trying to find ways in which they can make employees independent contractors.

Certainly we need a balance. We need to make sure that the rights of the employer are protected, but we also need to make sure that the rights of the employees are protected, because as I indicated, that employment relationship has certain very valuable benefits to it, particularly health care benefits and pension benefits, which I think everyone understands is the cause of a great deal of security in America today.

It would be my hope that this debate does not turn into the debate of extremism that we have seen in the past. It is my hope we are going to be able to deal with this issue in a very rational fashion and make sure that both sides are reasonably protected, but particularly the employee side of the equation is protected.

Let me just conclude by making one further observation. As you know, the Internal Revenue Service, Treasury Department, has a test of 20 different criteria they use at this time. It is cumbersome.

On the other hand, this relationship has developed over a long period of common law in England and certainly the 230-year history of our country in terms of the court decisions. It would be my hope we are not precipitous in passing legislation. The gentlemen before us have different kinds of tests, and we will analyze those tests and see if in fact they work, see if in fact they do damage or help the employment relationship.

So, I look forward to working with the Chair and certainly other Members that are interested in this issue. Thank you.

Chairman JOHNSON. Thank you, Bob.

Representative Laughlin.

Mr. LAUGHLIN. Thank you, Madam Chairman. I thank you very much for calling this hearing.

Certainly we are delving into a murky area that has imposed extreme hardship on the independent contractor and particularly the small business independent contractor. I am hopeful that these hearings will focus on what is best for the small business owner, the small business protector, who is providing jobs in many instances when the very large corporations who have followed the

mandates of government in many areas are laying off thousands of people.

I hope that we look at what is best for those who are picking up the pace, employing those laid-off workers and give a well-informed process to that business operator who is providing much-needed jobs for our economy.

Chairman JOHNSON. Thank you.

Welcome, Senator Gramm. It is a pleasure to hear from you at this time.

**STATEMENT OF HON. PHIL GRAMM, A U.S. SENATOR FROM  
THE STATE OF TEXAS**

Senator GRAMM. Madam Chairman, first of all, let me say I am very happy to be here today. I think you are going to hear a lot about independent contractors today, so I will be brief on that general subject.

I think we have a problem with the 20-rule guideline of IRS, and that the logical way to fix it is to say, by law, who is not an employee. I think we ought to go at it from that direction. This is what we tried to do in the Senate. I think it is very important and I think we ought to be very concerned about anything that endangers independent contractors.

Independent contracting is basically an incubator for small business. A lot of people begin as independent contractors to sort of test their wings in the marketplace, so to speak. Many of our most successful companies, paying the highest wages, providing the best benefits, have ultimately come from people who started out on their own as independent contractors.

I think it is important that we look at independent contracting not just as a method of business organization, but as a stepping stone toward the establishment of successful small, medium-sized, and ultimately big businesses.

I wanted to concentrate today on one little facet of this problem, and that problem has to do with newspapers and with what we call the "paper boy."

Now, I tried this morning, to think of alternatives that would not carry the sexual connotation, because I am positive that there are paper girls, but the term just simply is not one that rings in our ears. So, if I can be forgiven by the Chairman, I will just use the term "paper boy."

I wanted to explain why this form of independent contracting is so vitally important for America. Forget the newspapers, but let's focus in on just paper boys.

When I was in academics, I got off into an area of economic history, and one of the things I discovered was that miraculously in the 19th, 18th, and the 17th centuries, educated people understood the economy and how it worked a lot better than educated people do today. I started racking my brain about how that could be so. And the conclusion I came to was that in the specialized world we live in, being in economic life for most people does not teach you much about the economy.

Most people go to work for a business, they specialize in, say, buying things for the business, but they do not engage in selling things. Or people engage in the production of something, but they

do not engage in the purchasing of the inputs or selling the final product.

It is very seldom in our life in the specialized world we live in that actually living and functioning in our society becomes an educational institution teach us how our great economy works, how prices are determined, and how markets work.

Interestingly enough, the entry level job for literally millions of young people in America is becoming paper boys, it is one job where—at a very early age—people have an opportunity to in essence be in business for themselves.

When I was a paper boy in Columbus, Georgia, I threw the Columbus Ledger-Enquirer. I threw 105 newspapers, which I purchased weekly from the newspaper. I threw the newspaper and then I collected money from the 105 people—well, the ones who actually paid me. And what I earned was the difference between the two. I was, in the language of your debate, an independent contractor.

But the important thing is that as a paper boy, it gave me an insight into how our free enterprise system worked. It was a practical experience of being in business for myself, taking responsibility for myself, learning about the whole end of the business, buying my product, delivering it, collecting the money for it. And my argument for having a correction—and I would like to see us do it this year—is to deal with these lawsuits concerning the independent contractor status of distributors and paper boys.

I think it is very important that we take action to see that we do not turn paper boys into employees of the newspaper. If we do, we are going to exclude young teenagers from that profession. I think we are going to deny our country a great educational experience—experience that most people get at no other point in their lives.

I mean, go out and explain to a paper boy how a minimum wage law is going to help him. Explain to him how government could come in and raise his wages as a paper boy without either affecting the price he pays for the newspaper or the amount he collects when he collects for the paper. And any newspaper boy in America would laugh in your face.

It is that kind of experience and education that we have too little of, Madam Chairman, and I hope that we can take whatever action we need to preserve the institution of the paper boy in America. I think it goes beyond the independent contractor issue, and I think it goes beyond this whole tax debate.

This is an institution in America that needs to be preserved, and that is what I wanted to come over and say this morning.

Chairman JOHNSON. Thank you very much, Senator. I agree that the term “paper girl” somehow does not work very well. On the other hand, there are lots of young women delivering papers. There was a lot of opposition to that. Parents were afraid about young girls being out, and not afraid about young boys being out.

We have overcome that, and I think that is part of the progress women are making, and it is not surprising that more small businesses are being founded by women in today’s America than by men. Very independent-minded. Thank you for your testimony.

Chairman JOHNSON. Representative Christensen.

**STATEMENT OF HON. JON CHRISTENSEN, A REPRESENTATIVE  
IN CONGRESS FROM THE STATE OF NEBRASKA**

Mr. CHRISTENSEN. Thank you, Madam Chairman. Yesterday when I got on the plane, I happened to sit by an IRS official from Omaha. I said we were having a hearing today on this important issue, and he replied, I sure hope you can help us because, he said, the 20-point test that we have to administer is too difficult, and anything you can do in this area would ease our job.

So, I preface my remarks by saying that, because oftentimes we can use the IRS as an excuse or easy to blame, but they are having a difficult time with this 20-point test.

Under the Code, you are either an employee or you are an independent contractor. Some workers are categorized by law as one or the other. Other workers may be classified as independent contractors under the safe harbor of section 530. Those not fortunate enough to fall under these two classes fall under the IRS' infamous 20-point test.

Almost everyone agrees that the 20-point test is far too subjective. It is quite possible to take two seemingly identical situations and find employee status in one and independent contractor status in another.

According to one estimate, this past year the IRS had 439,000 independent contractors that they had to reclassify, and the collection of \$678 million in fines and taxes that were collected just since the mideighties. The IRS' actions have been especially deadly to all small business people, not just paper boys.

Unlike their Fortune 500 counterparts, our Nation's small businesses cannot afford the fancy tax lawyers and litigators needed to defend themselves against the IRS. Consequently, rather than fighting the IRS in the use of its murky 20-point test, many entrepreneurs are forced to close their doors, putting countless industrious Americans out of work.

That is why, as you said earlier, this was the number one issue of the White House Conference on Small Business in 1995. As a result of that conference on June 30th, just 2 weeks after the close of the White House Conference on Small Business, I and 100 original cosponsors introduced H.R. 1972, the Independent Contractor Tax Simplification Act.

Unlike past attempts to resolve this issue, H.R. 1972 defines who is not an employee. It establishes distinct, clear and objective criteria for those seeking to perform services as an independent contractor. These new criteria may only be used if the independent contractor and the business for whom the services are being performed correctly complied with income reporting rules.

Specifically, H.R. 1972 establishes a three-part objective test for determining whether someone is not an employee. To qualify as an independent contractor, you must meet all three parts: Independence, investment, and contract.

Some argue the tests in my bill could make it easier to classify workers as independent contractors. That is neither the purpose nor the effect of my bill. It certainly makes it easier to tell if someone is an independent contractor, but without a substantial degree of independence and investment in business, no one, no one, can meet these tests.

The fact is that my bill would protect workers from the current abuse of designating workers who are clearly employees as independent contractors. One of the purposes of the bill is to clarify the law to such an extent that employers can no longer hide in the shade of the 20-factor test gray areas.

It is also important to note that my bill does not eliminate the 20-factor test, nor section 530. It simply provides for a simpler alternative test that can be used if you comply with all income reporting requirements.

We are in a changing world. No longer will the majority of Americans earn a living in the fields and factories that many of us and our ancestors toiled in. Rather, we are at the brink of the third wave information age. This new era will feature new kinds of employment relationships, where people can work out of their homes and telecommute, where individuals can serve customers all over the world at the push of a button. It will foster the entrepreneurial spirit which has made this country great.

This new era has the potential of bringing enormous improvement into the lives of all Americans. Our laws should encourage, not hinder, this development. That is precisely why we need to adopt a new, clear, objective standard for determining who is self-employed and who is not, a standard based on freedom which allows those who wish to benefit from this new era to do so.

In closing, Madam Chairman, I wanted to thank you for convening these hearings as soon as you did because it is an area we have to act on. And, as Senator Gramm said, it would be nice to be able to act on it this year since the White House Conference on Small Business said this is their number one priority.

Thank you for the opportunity to testify.

[The prepared statement follows:]

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**Testimony of Representative Jon Christensen**  
**Before the Subcommittee on Oversight**  
**of the**  
**Committee on Ways and Means**  
**June 4, 1996**

Madam Chairman, I want to thank you and the other members of the Subcommittee for this opportunity to testify on the importance of clarifying federal tax provisions with respect to independent contractors.

"THE IRS WAGES WAR ON THE SELF-EMPLOYED." "REBUFFING IRS ATTACKS ON WORKERS." "REVENGE OF THE TAX MAN." The headlines go on and on. These are recent articles about how the Internal Revenue Service has used murky, subjective criteria to target honest, self-employed entrepreneurs and reclassify them as employees.

Let me lay out some background on this pervasive problem. Although in today's high-tech world there are many working relationships between businesses and individuals, the Internal Revenue Code classifies all such relationships into just two categories: Either you are an "employee" or an "independent contractor."

Some workers are categorized by law as one or the other. Other workers may be classified as independent contractors, with a reasonable amount of certainty, under the safe harbors enacted in Section 530 of the Internal Revenue Code. Those not fortunate enough to fall under these two classes are carefully scrutinized under the IRS' infamous 20-factor test derived from common law.

What does it matter whether someone is an "employee" or an "independent contractor"? This distinction is important because it determines whether the payor or the payee is responsible for withholding income tax and the payment of FICA and unemployment. In other words, it has little to do with *how much* tax gets paid, but everything to do with *who pays*.

Almost everyone will agree that the 20-factor test is unclear and far too subjective. It is quite possible to take two seemingly identical situations and find employee status in one and independent contractor status in another. Nevertheless, in recent years the IRS has bludgeoned small businesses over the head with the 20-factor test, targeting truckers, florists, travel agents, computer programmers, even ministers.

According to one recent estimate, the IRS' war on our nation's job creators has resulted in the reclassification of 439,000 independent contractors and the collection of \$678 million in fines and taxes since the mid-1980s.

The IRS's actions have been especially deadly to small businesspeople. Unlike their Fortune 500 counterparts, our nation's small businesses cannot afford the fancy tax lawyers and litigators needed to defend themselves against IRS legal hit squads. Consequently, rather than fighting the IRS and its use of the murky 20-factor test, many entrepreneurs are forced to close their doors, putting countless industrious Americans out of work.

America's small businesspeople have finally said enough is enough. Last summer, the White House Conference on Small Business convened in Washington to debate a whole host of issues important to our nation's entrepreneurs. The top vote-getter at the Conference was a proposal to clarify the standards for determining whether an individual is an employee or independent contractor.

Specifically, the delegates recommended that Congress "should recognize the legitimacy of an independent contractor," stating further that the current common law twenty-factor test is "too subjective." The Conference delegates called upon Congress to establish "realistic and consistent guidelines."

Those on the front lines have spoken and we've listened. On June 30th of last year, just two weeks after the Small Business Conference, I and 100 original cosponsors introduced H.R. 1972, The Independent Contractor Tax Simplification Act. Unlike past attempts to resolve this issue, H.R. 1972 defines who is not an employee. It establishes distinct, clear and objective criteria for those seeking to perform services as an independent contractor. These new criteria may only be used if the independent contractor and the business for whom the services are being performed correctly comply with income reporting rules.

Specifically, H.R. 1972 establishes a three-part objective test for determining whether someone is not an employee. To qualify as an independent contractor, you must meet all three parts. Two of the parts contain subparts, but you must only meet one to satisfy that part. Let me go through the criteria briefly.

**Part One: Investment.** Does the individual: (1) have a significant investment in training or assets; or (2) incur significant unreimbursed expenses; or (3) agree to work for a specific time or complete a specific result, and is liable for damages for failure to perform; or (4) receive compensation primarily on a commission basis; or (5) purchase a product for resale? If the individual satisfies any one of these subtests, then Part One is met.

**Part Two: Independence.** Can the individual demonstrate just one of the following subparts: The individual (1) has a principal place of business; or (2) does not primarily provide the service in the service recipient's place of business; or (3) pays a fair market rent for use of the service recipient's place of business; or (4) is not required to perform service exclusively for the service recipient and (a) has performed a significant amount of service for others; or (b) has offered to perform service for others through advertising, individual written or oral solicitations, listing with agencies, brokers, or others; or (c) provides service under a registered business or trade name. Meet any one of these four subtests and you satisfy Part Two.

**Part Three: A Contract.** Is there a written agreement between the parties? This helps clarify each parties responsibility for the payment of taxes thereby aiding compliance.

That's it. Meet all three parts -- independence, investment, and contract -- and you qualify as an independent contractor. But remember the independent contractor and the business for whom the services are being performed must correctly comply with income reporting rules. If they fail to do so, then they are left with the burdensome 20-factor test and all of its traps.

It is important to note that my bill does not eliminate the 20-factor test nor the safe harbors under Section 530. It simply provides for an alternate test that can be used if you comply with all income reporting requirements.

As a matter of public policy our tax laws should not favor employee status over independent contractor status, or vice-versa. Individuals should be free to enter into business arrangements of their own choosing without the IRS pushing them into one category or the other.

Despite a well-documented record of discouraging independent contractor status, the IRS is now on record that it will not discriminate against independent contractors. Margaret Richardson, Commissioner of the Internal Revenue Service, told delegates to the White House Conference on Small Business that the IRS "does not care whether someone is an employee or an independent contractor as long as they properly report their income." H.R. 1972 clearly satisfies her reasonable request and I look forward to working with Mrs. Richardson on this important issue.

We are in a changing world. No longer will the majority of Americans earn a living in the fields and factories that many of us and our ancestors toiled in. Rather, we are at the brink of the Third Wave Information Age. This new era will feature new types of employment relationships, where people can work out of their homes and "telecommute," where individuals can service thousands of customers all over the world through the push of a button. It will foster the entrepreneurial spirit that has made this country great. This new era has the potential of bringing enormous improvement to the lives of all Americans.

Our laws should encourage, not hinder, this development. That's precisely why we need to adopt a new, clear, objective standard for determining who is self-employed and who is not -- a standard based on freedom and which allows those who wish to benefit from this new era to do so.

In closing, I want to again thank you, Madam Chairman, and my colleagues on the Subcommittee for the opportunity to testify before you today.

- end -

Chairman JOHNSON. Thank you, Representative Christensen, for your leadership on this issue.

Representative Kim.

**STATEMENT OF HON. JAY KIM, A REPRESENTATIVE IN  
CONGRESS FROM THE STATE OF CALIFORNIA**

Mr. KIM. Thank you, Madam Chairman. I would like to thank you again for giving me this opportunity.

As my colleagues mentioned, there are a lot of horror stories about this issue. Many times businesses hire someone who they think is legitimately an independent contractor. Later the IRS apologizes and tells them that they should have been employees. The penalty for this honest mistake, is massive fines, back taxes, and legal fees. Many of them just go bankrupt.

IRS does not give businesses the benefit of the doubt. As my colleague mentioned, they have a 20-factor test. If you meet 19 of them only, you can be fined. The IRS is very aggressive about this.

It is not entirely their fault. Congress passed the laws that are causing the problem.

In 1990, the IRS assessed more than \$100 million in fines against small businesses for misclassifying workers. But the reason they could do this is Congress' failure to clarify the law. My bill would try to clarify and correct that madness.

Now, my bill has three sections. One of them is defining what the independent contractor is, which is almost identical to my colleague Mr. Christensen's bill. Very simple.

First of all, you have to have some kind of written agreement. That is common sense. In addition to the written agreement, you have to have one of the following four criteria: One is you have to suffer a profit loss. Come on, if you do not have that, how can you be an independent contractor?

Or, you have to have a separate principal place of business and some kind of investment; or he or she shall be paid exclusively on a commission basis; or offer the same service to other general public.

That is it. As long as you meet the criteria, written agreement plus one of those four criteria, then he or she shall be an independent contractor. There is no question about it; the IRS cannot interpret it otherwise.

Now, what is the difference between the Kim and Christensen bills? Mine goes a little deeper. My bill reforms section 530 and compliance rules. That is what I would like to talk about this morning.

Let me explain quickly what I mean by section 530. As you know, in 1978, Congress passed an amendment called section 530. It was supposed to be temporary, to try to protect the small businesses from the IRS.

Now, let me tell you what my bill would do in terms of changing section 530. Right now, according to the IRS rules, a business can be found in violation of the consistent treatment. The phrase, "consistent treatment," what it is is if you are an employer trying to change one of the independent contractors to a permanent employee, you cannot do that. You are going to be fined by IRS because the phrase, "consistent treatment" is violated. This is ridicu-

lous. It discourages you from hiring an independent contractor as an employee.

My bill changes that. You can go ahead and hire him if you want to, if the two parties agree, and not risk IRS prosecution.

Second, section 530 gives no concrete standard for what constitutes a significant segment of the relevant industry. It is ambiguous. Mine clearly defines what that means. My bill defines "significant segment of industry" as no more than 25 percent of industry.

Where did I get that? We contacted a lot of businesses and industries, and looked at court rulings. They told me 25 percent is a reasonable figure; as long as you have 25 percent or more, that should be considered a significant sector.

Right now it is very ambiguous. My bill changes that.

Third, there is a lot of confusion about certain independent contractors being treated as independent contractors for employment taxes, yet in terms of other federal taxes, they are treated as employees.

Let me give you one example, a real estate agent, for tax purposes, is an independent contractor, yet he/she is treated as an employee when determining who is a qualified individual for a profit-sharing system or stock bonus plan.

There is a contradiction in here. In another example a tax court ruled that Methodist ministers are employees, so they cannot get credit on automobile allowances, yet they are independent contractors for Social Security taxes.

This inconsistency has to be eliminated, and my bill does that. It simply eliminates inconsistencies and qualifies what they mean by this examination of employment and taxes.

Finally, my bill deletes section 1706 of section 530. In 1986, Congress passed another amendment trying to exclude technical services people who work through brokers from section 530 protection. I do not know why they did it. This is ill written, it is not fair. My bill simply eliminates this.

Everybody is equal and fair; as long as they meet the definition tests, they shall also be treated as an independent contractor. They are not going to be excluded from section 530 protection.

Finally, we added compliance reforms so that nobody can call this bill extreme. My bill asks the employer to be more responsible. For example, we asked an employer to line list his or her Form 1099 income. In other words, when a worker files his or her tax return, he or she has to list an independent contractor income, rather than a lump sum, so that the IRS can audit easier.

It is an additional responsibility for the employer to list additional incomes when they file a Form 1099—but it will help greatly. I raised the fines from \$50 to \$75 per offense for businesses who fail to issue Form 1099s, and \$100 to \$125 per offense for doing so intentionally.

In other words, the employer, an independent contractor, takes a little more responsibility; in return, section 530 is clearer and gives businesses more protection. I think it is a fair trade and a very comprehensive reform.

I also support Mr. Christensen's bill. I am an original cosponsor. But, I believe mine is much more comprehensive, and therefore I urge you to pass my independent contractor reform legislation as soon as possible.

Thank you, Madam Chairman.

[The prepared statement follows:]

**Statement of Congressman Jay Kim (R-CA)**  
**House Ways and Means Committee**  
**Subcommittee on Oversight**  
**June 4, 1996**

Madam Chairwoman, members of the Subcommittee, thank you for the opportunity to testify here today. I believe that independent contractor reform is the ultimate small business issue, so I am extremely pleased that you have chosen to have this hearing.

As many of you know, I used to own and operate a business. I ran a small engineering firm in Southern California called JayKim Engineers which, at one point, had 150 employees. Over the years my firm used many independent contractors – accountants, consultants and others. I know from firsthand experience exactly how confusing, ambiguous and arbitrary the current worker classification rules are.

In my short time as a Congressman, I have learned that I was not alone in having difficulties with worker classification rules. I have heard horror story after horror story from my constituents about how they hired someone they thought was a legitimate independent contractor, only to have the IRS swoop in years later, claim that the worker (or workers) should have been an employee, and impose massive fines and back taxes. Often, these businesses are faced with severe financial problems and, in some cases, bankruptcy as a result of an honest mistake in classifying workers.

For this reason, I was not surprised to see that the White House Conference on Small Business identified independent contractor issues as the #1 issue for small businesses. I think that this statement should serve as a clarion call for all of us who care about the future of small businesses in this country.

The independent contractor issue illustrates one of the fundamental truths of our government: Wherever Congress leaves ambiguity in the law, a federal agency will use the ambiguity to usurp as much power as possible.

And that is exactly what the IRS has done with the worker classification rules. There exists an abundance of anecdotal evidence to suggest that the IRS consistently interprets these rules in the most restrictive way possible. The IRS is clearly not "neutral" on whether or not a worker is an employee or an independent contractor. The fact is, the agency has a bias against the independent contractor status, and as a result, puts the burden of proof on the taxpayer to prove that the worker is not an employee.

In short, the IRS has taken an extremely aggressive and hard-line stance on independent contractor issues – and it has gotten more aggressive every year. Between 1987 and 1990, for example, the IRS' Employment Tax Examination Program (ETEP) grew from a small pilot program to a major undertaking which, in 1990, employed 19,000 revenue officers who examined more than 20,000 tax returns. These reclassifications resulted in \$111 million in assessments against small businesses. That's \$111 million dollars that could have been spend to hire more workers, to make capital investments, or to open new businesses. And this cost figure does not even include the tens millions of dollars that small businesses must spend every year on legal fees to defend themselves against IRS prosecution.

Given these facts, it would be easy to blame the IRS for the problems in our worker classification system. But, to be honest, I really think that most of the blame does not lie with the IRS, it lies with Congress.

The fact is, despite the massive heartburn that worker classification rules have caused small businesses over the years, Congress has done almost nothing to clarify the distinction between employees and independent contractors. The passage of Section 530

in 1978 helped, but it was only supposed to be a "stop-gap" measure. When this measure was passed, it was expected that Congress would return to independent contractor issue in short order to fix the problems that necessitated Section 530. Unfortunately, Congress never did, and the problems that small businesses face in dealing with the worker classification rules have gotten much, much worse.

And the unfortunate fact is, these problems will continue to get worse until Congress gets involved with the independent contractor issue. In the absence of a clear definition of who is and who isn't an independent contractor from Congress, the IRS will continue to take advantage of ambiguities in the law to harass honest small business owners.

For this reason, I strongly believe that it is time for Congress to get off of the sidelines and reform the worker classification system. That is why, last January, I introduced H.R. 582, the "Independent Contractor Tax Fairness Act". The idea behind H.R. 582 is simple: It is time for Congress to establish a clear, unambiguous test for what constitutes an independent contractor.

To that end, the core of my bill is a simple test that establishes who is not an employee. The test has four criteria that are based on common-sense requirements for who qualifies as an independent contractor. If a worker meets any one of the four – and has signed a written agreement clearly stating that both parties understand the responsibilities of independent contractor status – then he or she cannot be considered an employee and the IRS is prevented from reclassifying the worker (and assessing associated fines and penalties).

In short, H.R. 582 establishes clear, easily understandable criteria for determining whether a worker is or is not an employee. Instead of having to wade through the current swamp of worker classification rules, most small businesses can look for guidance and protection to the four common-sense criteria established by the bill. In doing so, I believe that H.R. 582 would help small businesses by providing badly needed clarity to the worker classification rules.

At this point, I would like to make a couple of points about H.R. 1972, the independent contractor bill established by our freshman colleague, Mr. Christensen.

Many of you will note that I am an original cosponsor of H.R. 1972. I support this bill because I believe that, at their core, both H.R. 1972 and my bill, H.R. 582, share the same underlying intent: To establish a clear and unambiguous standard for who is not an employee. In fact, the tests established by both bills are extremely similar – although the test in Mr. Christensen's bill is slightly more flexible in its application.

Where our bills differ, however, is in whether and how they address other important problems with our worker classification system. H.R. 582 builds on the same foundation as H.R. 1972, but also contains a more comprehensive attempt to address many of the other underlying problems with the worker classification rules. To put it simply, H.R. 1972 is the minimum we should do; H.R. 582 represents a broader overhaul of the worker classification system.

For example, H.R. 582 makes badly needed changes to the so-called Section 530 rules that help businesses who make honest mistakes in classifying workers. These include: Allowing businesses to convert independent contractors to employees without threat of losing Section 530 protection; clarifying the threshold for what constitutes a "significant segment" of an industry; repealing the section 1706 exemptions for technical workers; extending classification rules to all federal taxes, not just employment taxes; and narrowing the current prior audit safe harbor.

These provisions, I believe, will strengthen Section 530 and provide businesses with additional protection against IRS overzealousness.

Equally importantly, the bill contains strong compliance provisions which would encourage independent contractors to more completely report their income. These most important of these compliance provisions would require independent contractors to "line-list" 1099 income. This would allow the IRS to detect unreported payments and, in doing so, improve income reporting among independent contractors.

In addition, the bill increases the penalty for not issuing 1099's to workers. According to a recent GAO study, issuing a 1099 to a worker dramatically improves the chances that an independent contractor will report their income. H.R. 582 would help ensure that 1099's do indeed get issued. Finally, H.R. 582 requires the IRS to undertake a substantial education campaign to inform businesses about the changes made by the bill.

In short, H.R. 582 takes a balanced approach to the independent contractor issue. It substantially clarifies worker classification rules and gives businesses better protection from being persecuted for honest mistakes – making it easier and less risky for businesses to use independent contractors. In return, however, the bill requires that businesses and the independent contractors they hire are more accountable for the income that is generated as a result of their professional relationship. I believe that this is a very fair trade.

To sum up, I believe that H.R. 582 represents a balanced and comprehensive attempt to address the problems in the worker classification system. I would urge this committee to consider adopting such a comprehensive approach to this issue. Since Congress will probably only have one chance in the near future to deal with independent contractor issues, I believe that we should be as thorough as possible in reforming the system.

Whatever approach we take, however, I believe that the independent contractor issue must be dealt with, and soon. There are few issues which are having more impact on the lives of small business across the country. It is my hope that, with the new Republican Congress, we can act quickly to remove this onerous regulatory burden from the backs of small businesses.

Madam Chairwoman, I would like to thank you again for the opportunity to testify today. I look forward to taking any questions you or the committee may have.

Chairman JOHNSON. Thank you very much, Representative Kim. Your bill does go further in some regards than Representative Christensen's bill, and certainly this issue of the Form 1099 is an important one. Employers have to bear their full responsibility, because in the end a good Tax Code requires everybody to pay their fair share, and the evidence of noncompliance is quite clear.

Mr. KIM. That is where the cheating comes from. Once you identify line by line, it is difficult to cheat, and also, it will be easier for the IRS to audit their books. I think it goes two ways. That is not just one way, it is two ways; it is balance.

Chairman JOHNSON. We will also look very closely at the proposals you made in regard to section 530. There are some problems there.

I was not aware of the problem in section 1706, and we will certainly look at that.

Mr. Christensen, in regard to the compliance issue, would you be interested in working with us to improve the information reporting requirements that are proposed on both independent contractors and businesses?

Mr. CHRISTENSEN. Absolutely. I would be more than happy to work with the Committee and, Congressman Kim, to put together some compliance measures so that we could make sure that that is a part of our bill.

I guess the one thing I want to emphasize though is, I come from a different angle. I think that this legislation is so important. First of all, I do not think we should be looking at people saying that the independent contractors are basically looking for a way to get around the payment of their taxes and for ways to hide or where to hold their income.

Basically, I think that the independent contractors have given this country a large percentage of the new jobs and new growth and new opportunities. So, I look forward, to working with you on some compliance measures.

One of the things I am very concerned about is, there has been some talk about withholding. I want to let the Chairwoman know that this would be disastrous. It would have a disastrous effect for the small business owners, and it would be disastrous for a number of people out there, including direct sellers. I could see it being not only a bureaucratic nightmare with paperwork in that area, but it would also take away the total effect of wanting to go into business for yourself and wanting to be an independent contractor.

I would just like to alert the Chairwoman to that issue, because I believe that would have a disastrous effect. I would strongly urge away from proceeding with my bill if that was even a consideration.

Chairman JOHNSON. What is the logic for retaining the 20-point test if we clarify the law? Anyone on the panel is welcome to comment on this.

Mr. CHRISTENSEN. First of all, under my test—the independence, investment, and contract—if you meet all three, there is no need for the 20-point test. But if you do not meet the three areas under my bill, then the 20-point test still applies. So, that is one of the reasons that I think we should keep that 20-point test there.

We are not looking for a way to get around the law, but just to make it easier and simpler for the IRS to administer.

Chairman JOHNSON. Thank you.

Would your bill repeal or retain section 530?

Mr. CHRISTENSEN. It would keep section 530 as is.

Chairman JOHNSON. Thank you.

Mr. Matsui.

Mr. MATSUI. Thank you, Madam Chairman. I would just like to ask Mr. Christensen a couple questions.

Jon, do you know how many people, employees, currently classified employees in the country today, would be affected by your legislation?

Mr. CHRISTENSEN. I do not have that figure.

Mr. MATSUI. I would imagine that CBO or somebody would have the figures.

Chairman JOHNSON. If the gentleman will yield, did you get a revenue estimate?

Mr. CHRISTENSEN. Yes. It is roughly under \$1 billion.

Chairman JOHNSON. I think we could probably work back from that and find those numbers.

Mr. MATSUI. All right. Do you know what category of jobs are affected by your bill? Can you describe what it might be?

Mr. CHRISTENSEN. I can tell you the general areas. There are over 400 different types of independent contractors in service areas out there, from florists to truckdrivers to paper boys, direct sellers. Over 400.

Mr. MATSUI. What I am trying to find out is, who would actually be affected by your bill? What job classifications? Could you give me a few examples?

Mr. CHRISTENSEN. Well, for example, a truckdriver, an independent contractor, or a florist who owns his or her business.

I am not sure I follow your question.

Mr. MATSUI. OK. So, right now a truckdriver or a florist is considered to be an employee. Maybe; maybe not.

Mr. CHRISTENSEN. Maybe; maybe not. That is the problem with the 20-point test.

Mr. MATSUI. I am trying to understand what your legislation—how the relationship will be impacted. You have three tests. Under test 1, you have 5 possible conditions; you need to satisfy one; if a person has significant investment, assets, or training.

Test 2: A worker must either have a principal place of business, plus five other possible conditions.

Test 3 is an agreement. Anybody can draft an agreement.

So, you basically have two tests. An airline pilot, for example, has significant investment in assets or training. An airline pilot goes to airline pilot training school, whatever that might be. He or she then has a license to fly commercially. That person then has their own principal place of business. That is two tests that are satisfied.

Does that mean that an airline pilot for United Airlines that takes me back to California would necessarily be an independent contractor?

Mr. CHRISTENSEN. Not under that scenario, Congressman.

Take the scenario of a truckdriver who owns or leases his own tractor-trailer rig. He is working with a provider who has given him some of the leads for transportation and loads, pickup loads or delivery, but he has the right to say no or yes on whether he wants to pick that load up. So, he has the control; he has the decisionmaking power. But under this scenario, he has met the significant investment test, as well as the contract test.

Mr. MATSUI. But your test—the three tests that you have here do not talk about control. You satisfy significant investment in asset or training. That is test 1. Test 2: Has a principal place of business. Test 3: Has a contract.

So, tell me why the airline pilot would not qualify as an independent contractor under your test?

Mr. CHRISTENSEN. Under my test, the independence element is your controlling element. It does meet that test. Under an airline pilot, they do not have that independence to decide whether or not they want to fly to Philadelphia or to Florida. There is no independence there. So, arguably, they would not meet that test.

Mr. MATSUI. But you have three tests. I am trying to understand this. Maybe we reached the point where we just cannot resolve this.

If I am not mistaken, you have test 1, a worker must meet one of the five conditions, have significant investment in assets or training, incur significant unreimbursed expense, agree to perform services for a particular amount of time, or to complete a specific result and be liable for damages, to be paid primarily on a commission basis, or purchase products for resale.

Those are the five conditions under test one. The worker must satisfy one of those tests. OK. Assuming that the worker satisfies the test of having a significant investment in assets or training, that is test one. An airline pilot goes to school, as I said, and satisfies that test.

Then you have test 2, six criteria. You only need to satisfy one of the six. Has a principal place of business; OK. That airline pilot has a principal place of business. He declares one.

Then test 3—

Mr. CHRISTENSEN. Congressman, under that scenario, the airline pilot would not pass that test. Under the place of business, because he does not own or lease or put any money into that place of business, he is an employee under your scenario.

Mr. MATSUI. We do not know that. The airline pilot may have leased a facility, may have separated part of his home. The home office rules we are changing right now, that might qualify as an office.

Then obviously an employment contract. United signs a contract with that pilot. All of a sudden, the pilot is an independent contractor.

I am trying to understand what your bill does. I mean, we are trying to come to some conclusion here. You are telling me that the airline pilot would not comply, and I read your rules and give you a scenario, and it appears to me the airline pilot complies as an independent contractor.

You are going to have to help me with this.

Mr. CHRISTENSEN. I would be glad to work with you in that area.

Mr. MATSUI. You are saying there is another element of control.

Mr. CHRISTENSEN. The independence factor is analogous to your control element. The airline pilot would not meet the independent factor. He is taking his orders from a central area. He is taking his orders from the authority on where they need to fly to and where to fly from, versus an independent contractor, a truckdriver.

Mr. MATSUI. That is where our problem is, I guess, because your bill does not talk about control. The bill talks about these three criteria and conditions within it. But you do not have control.

Now, are you suggesting that case law will be part of your legislation? Because if you are, that just could add more complexity.

Mr. CHRISTENSEN. Under the airline pilot scenario, the supervision aspect would definitely control that area. But one of the things about my test that I think is different from Congressman Kim's test is—

Mr. MATSUI. I am not asking about Congressman Kim's test.

Mr. CHRISTENSEN [continuing]. You have to take all three of the areas, the independence, the investment, as well as the written contract.

Senator GRAMM. I was telling the Chairman I have to go.

Mr. MATSUI. I do not have any questions for you.

Chairman JOHNSON. Mr. Laughlin, would you like to ask the Senator any questions?

Mr. LAUGHLIN. No.

Chairman JOHNSON. Thank you very much for being with us, Senator. We appreciate it.

Mr. MATSUI. Jon, are you saying that there is an element of control in your legislation? Because there isn't in your bill.

Mr. CHRISTENSEN. Under the independence factor, you have that control aspect, because you—as I say, a truckdriver, would have the authority to go to New York or to go to Philadelphia, to make that decision for yourself, versus taking the supervisory role and having that decision made for you.

Mr. MATSUI. This is obviously a very important subject.

You will have to give me the forbearance of asking this question. The florist asks a truckdriver to drop flowers off at 2015 K Street, an office. A gentleman calls on Mothers Day and says, "Will you send flowers to my mother?" The florist tells the truckdriver, "I wanted this delivered by a certain time, 11 o'clock in the morning," because that is what the client or customer wanted. "In addition to that, I want to make sure that the flowers are well preserved before they get to the office, because obviously I want to preserve business."

Is that control? Explain to me what control is then.

Mr. CHRISTENSEN. I have to have more information from you. Does the truckdriver own his own rig?

Mr. MATSUI. I am afraid some of the people in the audience are going to be a little unhappy, because then you go right back into this law, complexity. Obviously the service will have some problem. This issue is much more complex than three tests.

If you want to bring control under this thing, there are literally thousands of cases in the United States on what is control, how do you define an independent contractor from an employee. So, this is not just an issue of, you know, significant investment in training.

Obviously, a place of your own business and, third, a contract. This is a very difficult issue to resolve. Once you get into control, what is control?

Mr. CHRISTENSEN. That is—I would agree. That is why the 20-point test has been so hard to interpret and enforce.

Mr. MATSUI. Exactly. We have a lot of work to do on the 20-point test.

Mr. CHRISTENSEN. The commissioner just came out with a training manual that is somewhat simplified, but it is still very murky and hard to administer.

Mr. MATSUI. You are saying in your bill you are willing to put in the element of control?

Mr. CHRISTENSEN. To get that independent contractor, he has to make a decision on whether or not to accept that job.

Mr. MATSUI. OK. I have no further questions.

Chairman JOHNSON. Mr. Laughlin.

Mr. LAUGHLIN. Just to follow up on that, it seems to me there is a real differential in the airline pilot and the truckdriver that Mr. Christensen talked about. The airline pilot does not get on any airline, as I understand it, without authority from the company or direction from the company, and certainly has a lot of other authoritative controls on where he flies and how he flies that the truckdriver may not have.

Mr. MATSUI. If the gentleman is directing that question to me, I agree. The only problem is, it is not in the bill. It is not in the bill. Somebody will have to resolve that issue.

Chairman JOHNSON. If the gentleman will yield.

Mr. Christensen, as I read your bill, to be independent, the service provider cannot just have a principal place of business. The bill reads, "The service provider, A, has a principal place of business; B, does not primarily provide the service in the service recipient's place of business; or." But those first, it would seem to be coupled together.

It does not appear to me from your bill, having a principal place of business is sufficient. The "or" comes after the two are coupled together and goes on to say, "or pays a fair market rent for use of a service recipient's use of business, or", the next section, 2, is quite long and it has many parts to it. I do not think just having a principal place of business under your bill is sufficient.

Mr. CHRISTENSEN. That is correct, Madam Chairman.

Mr. MATSUI. So, you are saying, if I may—

Chairman JOHNSON. No; what I am pointing out is, the "or" comes after B, not after A. A and B are required before you get to the "or."

Mr. MATSUI. You are saying A and B are required? That is not grammatically correct.

Chairman JOHNSON. That is my question.

Mr. MATSUI. That is not how it is construed. It has a principal place of business, does not primarily provide the services in the service or recipient's place of business, or pays fair—A, B, and C.

Chairman JOHNSON. That is why I directed my question to Congressman Christensen.

Mr. CHRISTENSEN. That is correct, Madam Chairman.

Chairman JOHNSON. This is the kind of thing we will pursue in greater detail among us. We have to have the matter cleared up, and the issue Congressman Matsui brought up is worthy of our attention.

Mr. LAUGHLIN. John and Jay, I want to compliment you for getting us started. The discussion points out why we appreciate the spirit in which both of you wanted to cooperate.

I can think of one newspaper in my State that is very concerned about what we do about the newspaper boy. I use that term, since my younger brother and I learned many valuable lessons being newspaper boys. Frankly, I would like to change it to make everyone that works for that company an employee, so it would put them out of business, because they never wrote one kind thing about me. But that is not the approach we need to be taking on this bill and this hearing.

Mr. KIM. Are you referring the question to me?

Mr. LAUGHLIN. I am not even putting a question, Jay. But if you want to respond, I was going to reserve the questions until the opportunity we can work together and go to the next witness. If you want to respond to what I said, Jay, I am happy to hear you on my time.

Mr. KIM. I will await my turn then.

Chairman JOHNSON. I thank the gentlemen very much for your thoughtful proposals in this area.

Mr. Christensen, it is rare that freshmen are assigned to this Committee. You are one of those who was assigned in your freshman year to the Committee on Ways and Means, and you have made a very important contribution in proposing this legislation.

Your experience, Mr. Kim, as a small business man with section 530 will be very helpful to us. Thank you.

Mr. CHRISTENSEN. Thank you, Madam Chairman. I would like to say I look forward to working together with you and Congressman Matsui to clarify this area and make it easier for everybody.

Chairman JOHNSON. Thank you.

The next panel will assemble, please. Sandra Abalos, a certified public accountant from Phoenix, Arizona; David Barbee, president of Hospital Resource Personnel, Inc., Augusta, Georgia; Wayne Kessler from Pennsylvania; Dave Bolt from New Jersey; and Edgar Gee from Tennessee. We have a nice collection of small business representatives on the next panel. We will start with Sandra Abalos.

Ms. Abalos, welcome. If you will proceed.

**STATEMENT OF SANDRA A. ABALOS, CERTIFIED PUBLIC ACCOUNTANT, ABALOS & ASSOCIATES, P.C., PHOENIX, ARIZONA**

Ms. ABALOS. Thank you. I appreciate the opportunity to testify today. Thank you for inviting me.

My name is Sandra Abalos. I am an elected delegate to the White House Conference on Small Business from Arizona and the Region IX Taxation Chair for the Implementation Team. I am a CPA. I hold my master's in accounting, with an emphasis in taxation, and have been a small business owner for the past 17 years. My practice emphasis and expertise is with small business tax

matters, and I testify today on behalf of the small business community.

The 1995 White House Conference on Small Business ranked the need for clarification of the independent contractor definition as the number one concern for small business. I was a cosponsor of that issue recommendation. This is such a critical issue because the 20 common law factors used today in making a status determination do not provide an answer to the question as to whether someone is an employee or an independent contractor. That determination is purely subjective, and even as tax practitioners, we are often unable to analyze the facts and make conclusive determinations with any level of assurance.

In addition, the small business community has been the target of aggressive employment tax audits with inconsistent determinations. From 1988 to 1994, 11,380 employee tax audits have been conducted, resulting in \$751 million of proposed assessments and alleged reclassification of 483,000 workers.

Often the resulting penalties, tax assessments, and interest are so large that bankruptcy becomes the only alternative. In many cases, the cost of litigation exceeds the cost of assessment. If they win the case, they still lose the battle financially.

The Internal Revenue Service recently recognized this undue burden on the small business community, and in response they have adopted two new programs to expedite the examination process, and they have developed new independent contractor training manuals.

I have reviewed the manual in its entirety, and I commend the IRS for their efforts in attempting to provide reasonable guidance in this area. However, the training manual itself is evidence that this issue is in need of legislative clarification.

The manual is over 100 pages long. It focuses on evidence of behavior and financial control and ultimately is a subjective interpretation of the evidence. I do not believe that this will alleviate the problems of inconsistent and incorrect application of standards by IRS examiners. Retraining is just simply not enough. Legislation is needed to provide specific, definitive criteria for determination.

If the IRS puts in this much time and resources to try and resolve their internal understanding of this issue, then I ask you, how can the small business community ever hope to comply with any level of assurance? We do not have those kinds of resources.

All these efforts are aimed at treating the symptoms of this issue. Instead, we need to cure the cause. House bill 1972 provides definitive criteria for determining who is an independent contractor. The requirements are clear, they can be answered definitively, and they do not lend to subjective determination.

The language and testing requirements are such that small business owners and practitioners can make a determination of a worker's status with a reasonable level of assurance, and this is the key issue before you.

The White House Conference delegates' regional tax chairs understand that there is concern that House bill 1972 may prompt a reclassification of workers currently treated as employees. Please understand that the small business community wants clarification of the criteria, not a redefinition of who may be an independent

contractor. We are looking for a workable solution that achieves balance and equity for all that are affected.

In my written testimony, I have made suggestions of ways to deter employee reclassification at the employment level. This concern can be addressed and should not be an effect of clarification.

In closing, I ask Congress on behalf of the small business community to continue the process to provide us with rules we can follow. We believe that consistent criteria will provide a clear line for determination, will create equity among industries, will protect workers from reclassification, and businessowners from redetermination; and, in addition, we believe that consistent criteria will enhance compliance. This can be a positive resolution for everyone.

I sincerely appreciate the opportunity to testify, and I welcome any questions you may have.

[The prepared statement follows:]

**STATEMENT OF  
SANDRA A. ABALOS, CPA  
OF  
ABALOS & ASSOCIATES, P.C.**

The Honorable Nancy L. Johnson, Chair  
Subcommittee on Oversight  
Committee on Ways and Means  
104th Congress of the United States  
House of Representatives  
1136 Longworth House Office Building  
Washington, D.C. 20515

Dear Madam Chair and members of the Subcommittee:

I testify today on behalf of the small business community. I am an elected delegate from Arizona to the 1995 White House Conference on Small Business and the elected Region IX Taxation Chair for the Implementation Team. I am a Certified Public Accountant, hold a Masters degree in accounting with an emphasis in taxation, and own a public accounting firm with eight employees. I began my own small business upon graduation from college seventeen years ago. Our practice emphasis and expertise is with small business and small business tax matters.

The 1995 White House Conference on Small Business ranked the need for clarification of the independent contractor definition as the number one concern for small business. Debra Lessin, CPA and myself were the co-sponsors of this issue recommendation at the Conference.

This is a critical issue for small business because we have been the target of aggressive employment tax audits. From 1988 through 1994, there have been 11,380 employment tax audits resulting in \$751 million of proposed assessments and reclassification of 483,000 workers as employees. Often the resulting tax assessments, penalties and interest charges are so large that bankruptcy becomes the only alternative. Small business simply does not have the financial resources to adequately defend and litigate adverse determinations. The cost of litigation may even outweigh the cost of assessment; if we win the case, we still lose financially. These are real consequences to the small business community despite our best efforts to comply with the criteria as it exists in the 20 common law factor test.

The 20 factors do not provide an answer to the question of whether a worker is an employee or an independent contractor. This lack of a clear and objective standard causes problems for both small business and the Internal Revenue Service. The Internal Revenue Service recently adopted the Classification Settlement Program and the Early Referral Program to expedite the examination process and apply provisions under section 530 of the Revenue Act of 1978 if applicable. In addition, the Internal Revenue Service has produced a new training manual for their auditors on employee or independent contractor classification audits. I have reviewed the new training manual in its entirety and I commend the IRS for their efforts in attempting to provide reasonable guidance in this area. However, the training manual itself is evidence this issue is in need of legislative clarification. The manual is over one hundred pages long, focuses on evidence of behavioral and financial control, and ultimately is a subjective interpretation of the evidence. I believe this is the best that can be done with the 20 common law factors we have today. However, I do not believe this will alleviate the problems of inconsistent and incorrect application of worker classification standards by IRS examiners. Retraining is simply not enough; legislation is needed to provide specific definitive criteria for determination. If the IRS puts in this much time and resources to try and resolve their internal understanding, how can the small business community ever hope to comply with any level of assurance.

HR 1972. The Independent Contractor Tax Simplification Act of 1995, provides definitive criteria for determining who is an independent contractor. The requirements are clear, can be answered definitively, and do not lend to subjective determination. HR 1972 incorporates those points that are at the heart of an independent contractor relationship, requires a written contract, and submission of 1099's to the Internal Revenue Service. If the service recipient fails to comply with IRS reporting requirements, they may not rely upon the definitive criteria and are then subject to the existing 20 common law factors. The language and testing requirements of HR 1972 are such that small business owners and practitioners can make a determination of a worker's status with a reasonable level of assurance; this is the key issue before you.

I believe legislation providing a definitive testing criteria will in fact enhance reporting compliance and create worker classification consistency and equity among industries. As tax and financial advisors, we address worker classification issues more frequently than any other small business tax issue. In practice, this is considered a "gray" area of taxation, meaning that a small business can reach one conclusion based on the facts; yet the Internal Revenue Service may reach an entirely different conclusion considering the exact same facts. We find when an issue is highly subjective or "gray," there is a tendency to justify the more favorable outcome. In making a worker classification determination, business may tend to lean toward independent contractor status whereas the IRS will lean toward employee status. Thus we have the audits, appeals, classification programs, new training manuals, etc. These are all in an attempt to bring definition to who is an independent contractor. If, however, the testing criteria is such that an answer can be determined, then classification becomes a clear line. By removing the subjectivity, you take away the "gray", there is no more "leaning", compliance is enhanced, and industry classifications become consistent. Think of the productive time and energy that could be saved by clarity. Small business will comply with the rules, we simply need to be able to determine what those rules are.

The WHCSB Delegates and Tax Chairs understand the concern that HR 1972 may create reclassification of workers currently treated as employees. Please understand, the small business community wants clarification of the criteria, not a redefinition of who may be an independent contractor. The small business community is unique as we are on "both sides of the fence" with this issue. Small business owners are often independent contractors and small business owners often hire independent contractors as well as employees. We are looking for a workable solution that achieves balance for all who are affected. We are looking for a solution that creates equity and maintains compliance. We do not want a massive reclassification of employees to independent contractor status. If the Committee is concerned about rampant reclassification, perhaps you could exclude designating independent contractor status to those who are currently employees unless the 20 point test and Section 530 safe harbor tests are met.

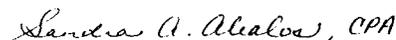
The cost of government compliance enforcement on this issue must be astounding, not to mention the compliance costs to the small business community. With a clear definition, we could shift the focus of IRS efforts from reclassification of independent contractors to compliance with existing tax laws. With the down-sizing of corporate America, we see many more violations of worker classification issues at the large corporate level. I have a client who is an architect and has worked at the same firm for twenty years. Two years ago, the Company changed his classification from an employee to an independent contractor. He does the same job, works in the same office, the same hours, with the same direction; the only difference being the manner in which he is compensated and the benefits he is now eligible to receive. This seems a clear violation of the independent contractor definition and should be pursued by the IRS. Perhaps the IRS could explore an employment referral program where workers who are misclassified can report these cases directly to the IRS and prompt an investigation. If this were available and promoted to the public, such a program in and of itself may deter such tendencies and activities at the employment level.

Congress must provide a simple and uniform definition of independent contractor that we can all rely upon. By this I mean employers, workers, practitioners, and the IRS must all be able to analyze a set of facts and make a reasonably consistent determination. HR 1972 establishes an objective definition of independent contractor that can produce a consistent determination. I ask Congress, on behalf of all small business, to continue the process to provide us all with rules we can follow. We believe consistent criteria will create equity among industries, will provide a clear line for determination, and will protect workers from reclassification and business owners from redetermination. In addition, we believe consistent criteria will promote compliance. This can be a positive resolution for all.

I thank this Subcommittee and the 104th Congress for acknowledging the concerns of the small business community with respect to the independent contractor issue, and for working to create legislation to clarify the definition.

I sincerely appreciate the opportunity to testify and welcome any questions you may have.

Respectfully,

A handwritten signature in cursive script that reads "Sandra A. Abalos, CPA".

**Sandra A. Abalos, CPA**  
**WHCSB Region IX Taxation Chair**

Chairman JOHNSON. Thank you very much for your testimony. We can come back to questions at the end.

Mr. Barbee.

**STATEMENT OF DAVID BARBEE, PRESIDENT, HOSPITAL RESOURCE PERSONNEL, INC., AUGUSTA, GEORGIA**

Mr. BARBEE. Madam Chairman and Members of the Subcommittee, my name is David Barbee. I am the owner-operator of Hospital Resource Personnel, Inc., which is a nurse referral agency based in Augusta, Georgia.

Mr. BARBEE. My business consisted of referring self-employed, independent contractor nurses to hospitals and other institutions that have peak demands for nurses. A nurse who elects to join my company's registry always has the right to accept or decline offers of assignments. The nurses are all State licensed, and my company does not provide them with any training or any instruction on how to perform those services.

During 1990, the Internal Revenue Service audited my company and contended that the company's classification of nurses as independent contractors was wrong. My attorney and I explained to the IRS representative that my company was eligible for protection under section 530 of the Revenue Act of 1978. My attorney provided the IRS representative with the detailed explanation of why my company qualified under the safe harbor.

IRS rejected the claim based on the contention that my company failed to comply with the Form 1099 requirements of section 530. The IRS claimed that for one period the Form 1099 had not been filed when, in fact, all those forms had been filed.

We found the Form 1099 that my company filed for the period in question, we also obtained from many nurses their copy of the forms, that my company had sent to them, and even after showing these to the IRS, the IRS still refused to accept my company's section 530 protection. Ultimately, the IRS assessed my company over \$1 million in back taxes, penalties, and interest. The exact number is \$1.4 million.

Based on the advice of my lawyers, we paid a divisible portion of the tax submitted, submitted a refund claim which was denied, and filed suit against the government's seeking funds.

As you probably know, after the final refund action in district court, my case was transferred from the IRS to the Justice Department. The Department of Justice recognized how preposterous the 1099 issue was and never considered it. Instead, the Department of Justice contested that my company's section 530 claim was based on the contention that my company did not satisfy the substantive requirement of the test.

Shortly after filing for the refund action, the IRS commenced aggressive collection actions against my company and sought to levy all my company's assets. My wife and I were terrified that the IRS collection actions were going to shut down the business that my wife and I spent so much time in building. I would have no resources to fight for my own right to practice, as allowed by the Constitution.

My attorney filed papers with the court to stop the IRS from pursuing the collection activities and a very short time later filed for

motion for summary judgment on the section 530 issue. The court ruled on the summary judgment motion and held, not only was my company qualified under section 530 protection, but it qualified based on three separate reasonable bases; namely, a reasonable reliance on judicial precedent, a reasonable reliance on Revenue Ruling 61-196, and a reasonable reliance on a reasonable interpretation of the common law test.

I am fortunate that my company had the financial resources available to defend me against the IRS attack on my business. The fact that the IRS would not accept the section 530 defense where the court had held that my company was eligible on three separate bases, and the fact that I almost lost my business as a consequence of the IRS' aggressive collection effort to collect the taxes that the court held my company did not owe, it is unconscionable.

Although I understand it is difficult to attain attorney fees under the current interpretation of the tax bill of rights, when my attorney filed for attorney fees, the government never contested. I received a check from the government several weeks ago. The government check did not cover the fees that occurred, however, but the cost was over \$10,000 more than I received.

This \$10,000 that the government had to write—did not have the right to take from me. More important than the money, however, the government had no right to put my wife through the many months of long nightmare, living in daily fear of losing our business, when we did nothing wrong.

As a law-abiding taxpayer who had built a significant business that provided a lot of opportunities for entrepreneur nurses, I to this day cannot fathom why the IRS expended so much effort to drive me out of business. It just does not make any sense to me.

The reason I testified before this Subcommittee today is to ask for your help in reining in the IRS. Although I have heard a lot of testimony today about the problems of the current law, in my opinion, the current law on the books is just fine. The problem is in the enforcement by the IRS. If nothing is done to change the IRS' enforcement, then changing the law will not make any difference.

The court held that under current law my case was clear. I won on three separate reasonable tax bases. This does not stop the IRS from making me go to court to win. I do not understand why one would think that a change in the law would protect taxpayers from having to go through the hell that my wife and I had to go through when this case could hardly be clearer than mine was.

In my opinion, the Congress needs to enact a law that stops the IRS from acting as predators on small businesses. Under the notorious ETEP programs, the IRS has focused its attack on small businesses who, I guess, the IRS assumes cannot afford to fight back. Through intimidation and aggressive collections, the IRS seeks to coerce those businesses to reclassify workers as employee status, with complete disregard for why the worker was actually classified correctly. These practices need to be stopped now.

What I think is needed is a modification of the tax bill rights fee recovery provision that would make it easier for taxpayers to be eligible to recover fees in cases where the taxpayer is held eligible under section 530 protection. Furthermore, in those cases tax-

payers must be made whole. The law should provide that in cases like mine the government is required to bear the total cost of defending against an unjustified IRS attack, not just a portion.

Although I know the Subcommittee considered a proposal that will significantly change the test of independent contractor status, I am not certain whether that is a good approach at this time.

As I indicated earlier, I do not believe there is any problem with the law. Current and new law only add further confusion, and after reviewing a copy of the bill, I am not sure whether my company would qualify, because it would depend on how certain terms of the bill were defined. If the IRS is allowed to define the terms, my guess is that my company would probably not qualify.

The greatest concern I have with the bill is whether its enactment might involve some tradeoff that affects section 530.

My wife and I have spent what is, to us, a great deal of money to endure many sleepless nights and finally to obtain some certainty for my company. I do not think it is worth jeopardizing current law, particularly section 530, as a tradeoff pursuing a new law that presents some of the same type of uncertain terms and definitions that earlier witnesses have explained about under current law. In my view, this is especially so when, based on my experience, the real problem seems to be with the agency that enforces these laws, the IRS. Unless IRS enforcement strategies are changed, I do not believe it makes any difference what the law is.

Thank you for the privilege to testify this morning, and I am sorry I went over time, but thank you so much for your indulgence.

[The prepared statement follows:]

**STATEMENT OF  
DAVID BARBEE  
OF  
HOSPITAL RESOURCE PERSONNEL, INC.**

SUBCOMMITTEE ON OVERSIGHT  
COMMITTEE ON WAYS AND MEANS  
UNITED STATES HOUSE OF REPRESENTATIVES

June 4, 1996

Madam Chairman and Members of the Subcommittee:

My name is David Barbee. I am President of Hospital Resource Personnel, Inc., a nurse referral agency based in Augusta, Georgia. I am also an Advisory Board Member of the Independent Contractor Association of America, Inc. (the "ICAA").

My company's business consists of referring self-employed independent contractor nurses to perform services for hospitals and other institutions that have a peak demand for nurses. We refer only state-licensed nurses, and do not provide any training or instructions concerning the services they perform for clients.

The ICAA is a national association dedicated to the preservation of independent contractor status. ICAA members consist of individuals working as independent contractors and businesses that purchase services from independent contractors. ICAA currently represents over 3,000 independent contractors and businesses that engage independent contractors.

Although I am generally supportive of the *objectives* of the independent contractor reform legislation introduced by Representative Christensen (R-Neb) and the similar bill introduced in the Senate by Senators Nickles (R-Okla) and Bond (R-Mo), I nonetheless, urge the Congress to *proceed with caution and careful deliberation* before enacting any legislation that would affect the *definition* of independent contractor status.

I agree with the proponents of the pending independent contractor reform legislation that the Internal Revenue Service ("IRS") construes the tax laws that distinguish between employees and independent contractors unfairly, with an overemphasis on converting independent contractors — whether bona fide or not — to employee status. The fact that the IRS would include as part of its Employment Tax Examination Program ("EETEP") a component that targets for worker classification challenges businesses with assets of less than \$3 million (who are least financially able to defend against IRS challenges) is utterly unjustifiable.

The basic problem, however, is one of enforcement, not the law.

In my particular case, the court held that under current law, my company's classification of workers as independent contractors qualified for protection under Section 530 of the Revenue Act of 1978 — based on three separate and independent "reasonable bases," namely, reasonable reliance on a judicial decision, reasonable reliance on a revenue ruling and reasonable reliance on the common law test.

To be sure, it is difficult to imagine how a case could be more clear than mine under any law. Notwithstanding the clear application of Section 530 to my case, however, the IRS forced me to bear the financial risk of going to court in order to continue classifying workers as independent contractors.

My case demonstrates that a good law can be made to look bad if the law is subject to perverse enforcement.

I submit that although the pending legislation to establish a new safe harbor provision has been helpful in sensitizing the IRS national office to the harsh treatment that taxpayers are

receiving at the hands of overzealous IRS agents,<sup>1</sup> I am not sure whether the enactment of such a law would actually accomplish much for small business taxpayers.

My case did not arise out of an uncertain application of the law, it arose out of the IRS seeking to coerce my business into reclassifying workers to employee status irrespective of the law. Consequently, I believe that any independent contractor reform should focus on the IRS. The IRS's attack on small businesses that use independent contractors must be stopped.

A starting point for modifying the IRS's enforcement philosophy with respect to small businesses that engage independent contractors would be:

- ♦ to enact a provision that would allow a small business taxpayer that (1) explains to the IRS in writing why it is eligible for Section 530 protection, and (2) is held by a court to qualify for Section 530, to recover from the government *all* the costs incurred in defending against the IRS challenge.

A fee recovery provision along these lines would provide small business taxpayers with the certainty they need to vigorously defend against IRS challenges to their classification of workers as independent contractors when they are confident that their classification is protected under Section 530.

One of the reasons for going slow with *any* new legislation affecting the *definition* of employee or independent contractor is that certain aspects of current law are for many taxpayers — including me — sacrosanct. My concern with *any* law that would affect the determination of a worker's status for federal tax purposes is attributable in part to the fact that the legislative process can be unpredictable. In other words, the law that is introduced might not be the same as the law ultimately enacted. What is more, if the proposed law is determined to cause a loss of tax revenues to the federal government, I am concerned about the type of revenue-raising provision that might be combined with the bill to offset its revenue loss.

Consequently, I respectfully urge the Congress, in its consideration of legislation affecting independent contractor status, to ensure that:

- ♦ The protection currently provided under Section 530 not be displaced;
- ♦ The other statutory independent contractor provisions be preserved;
- ♦ The 20-factor common law test for determining independent contractor status remain as the "fall-back" test for workers who do not satisfy a safe harbor test; and
- ♦ If the proposal results in a revenue loss to the government, the proposal not be "paid for" by imposing withholding — mandatory or optional — on payments made to independent contractors.

If substantive change *is* deemed essential, the change in my opinion should be minor. An appropriate change in the definitional rules at this juncture should build on current law. I submit that the Congress should consider fine-tuning Section 530 in a way that would limit the IRS's ability to seek to impose on taxpayers strained interpretations of Section 530. Fine-tuning changes might include:

- ♦ Imposing a *de minimis* exception to the consistency requirement of Section 530, and requiring the consistency requirement to be met only with respect to the three consecutive years next preceding the year at issue; and

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<sup>1</sup> Recent developments at the IRS — that arguably resulted from the pending legislation — include (1) a set of draft Training Guidelines for IRS agents concerning the independent contractor issue, (2) Announcement 96-13, which allows certain employment tax issues, including worker classification disputes, to be eligible for an early referral during audit for IRS Appeals consideration, and (3) an IRS Fact sheet that announced a new worker classification settlement program ("CSP") that might be advantageous to some businesses.

- Defining by statute the percentage of an industry that constitutes a "significant segment" for purposes of the industry practice safe harbor of Section 530.

According to the Small Business Administration, there are five million independent contractors in America. Almost one-third of all companies use independent contractors to some degree. Independent contractor status gives both service providers and service recipients the flexibility needed to be competitive in today's economic environment. It is submitted that the fact that so many independent contractors currently exist demonstrates that the existing laws, while perhaps not perfect, are *not* altogether flawed.

#### **Liberalize Fee Recovery Provision For Small Businesses that Qualify for Section 530 Protection**

Currently, a taxpayer must show that the IRS's position is not substantially justified in order to qualify for reimbursement of the attorney fees incurred in defending against an IRS challenge to its classification of workers as independent contractors. The only fees that are subject to recovery are those incurred in connection with actual litigation. The provision also imposes a cap on the hourly rate that can be recovered.

Although a proposed revision of the fee recovery provision is contained in legislation that passed the House of Representatives and is pending before the Senate, those provisions would shift the burden of proof to require the IRS to demonstrate that its position in a case in which the taxpayer prevailed was substantially justified.<sup>2</sup> In my judgment, those provisions, while appropriate for many cases, should be expanded for Section 530 cases.

I suggest that a taxpayer that explains to the IRS in writing why it is eligible for protection under Section 530, but is nonetheless forced to litigate the case, should be entitled to recover *all* its costs incurred in connection with the dispute, provided that the court holds that the taxpayer is eligible for protection under Section 530 based substantially on the rationale that the taxpayer provided the IRS in its written explanation.

#### **Preserve Section 530**

Section 530 was enacted in reaction to overzealous efforts by the IRS in seeking reclassifications of workers to employee status. During the past several years, the IRS has been pursuing a worker reclassification program with similar aggression. Many businesses that engage independent contractors currently do so with great fear of having to possibly defend against an IRS worker reclassification challenge in a lengthy — and expensive — court battle. Section 530 provides a valuable refuge for such businesses. Section 530 provides businesses with a means of engaging independent contractors with some degree of security that the IRS will leave them alone. Each of the safe harbors of Section 530 are important for a specific reason.

Reasonable reliance on administrative or judicial precedent is important, because it protects businesses that have sought to properly classify workers based on a good-faith interpretation of applicable precedent. The subjective nature of the common law test in many cases defies a precise conclusion as to a worker's status. This safe harbor is needed, therefore, to enable businesses to enter into business relationships with contractors, based on a reasonable interpretation of case law and certain IRS administrative guidance, without fear that the IRS will later interpret that precedent differently and force the business to litigate the matter in court.

The prior IRS audit safe harbor is also important because it protects businesses from repeated IRS audits, year after year, concerning the same workers. The safe harbor was enacted precisely because the IRS was harassing businesses with recurrent audits concerning the very same workers. The criticism sometimes made about this safe harbor — that it would apply to a business that had been audited by the IRS on an unrelated issue — is simply unfounded. The requirement that reliance on the safe harbor be "reasonable" would prohibit that possibility. To eliminate this valuable safe harbor would subject businesses, once again, to repeated harassment by the IRS concerning workers who the IRS has previously determined to be properly classified.

<sup>2</sup> Under current law, the taxpayer must demonstrate that the government's position was not substantially justified.

The industry practice safe harbor is a critical safe harbor for those industries where a type of worker had always been classified as an independent contractor, but no administrative or judicial precedent has been established to confirm the appropriateness of that classification. It is submitted that where an industry practice has been followed year after year with respect to the classification of a type of worker, there is no plausible rationale for disrupting that practice — especially when the compensation paid such workers is reported on Forms 1099, as Section 530 requires.

The "other reasonable basis" safe harbor is valuable to those businesses that have a reasonable basis for classifying workers as independent contractors but do not qualify for one of the statutorily-prescribed safe harbors. Courts have provided a constrained interpretation of this safe harbor, and current law in this area should not be disturbed.

Overall, Section 530 provides a safe haven protection to businesses that, since the law's enactment, have assiduously complied with its requirements. Tens of thousands of business arrangements have been structured in reliance on Section 530. To abandon any of the safe havens offered under Section 530 would significantly disrupt the market for freelance talent, and produce no offsetting benefit. The Form 1099 requirement contained in Section 530 already requires that the compensation paid an independent contractor that is covered by Section 530 be reported to both the worker and the government. Thus, there would be no revenue gain to be derived from such a disruptive action (actually there would likely be a revenue loss as a consequence of existing business relationships that produce taxable income being severed).

Section 530 was enacted to stop repeated audits and ensure fairness. The fairness established by Section 530 should not be eliminated.

For the foregoing reasons, I strongly urge the Congress, in its consideration of alternative proposals to reform the independent contractor laws, to not disturb the protection currently provided under Section 530.

#### **Retain the Common Law Test**

No matter what the Congress decides with respect to the establishment of additional safe harbor protection for independent contractor status, it is submitted that the common law test *must* be preserved for those workers who might not qualify for a safe harbor.

The nation's economy is dynamic and unpredictable. Individuals are currently providing services that merely a decade ago could not have been fathomed. Thus, while a safe harbor could be devised that covers all types of services that are provided in today's economy, there is simply no way to ascertain whether the safe harbor would also cover new types of services that might be performed five years from now, or even two or three years hence. For this reason, the common law test — as a test of last resort — must remain sacrosanct.

#### **No Withholding**

Proposals have been offered to impose withholding on payments made to independent contractors. The proposals have been offered either as a "trade-off" for certainty in a worker's independent contractor status, or as a means to "pay for" the revenue loss that would be attributable to a proposal that modifies the worker classification rules in a way favorable to independent contractors.

I submit that any withholding proposal — mandatory or optional — would be devastating to the viability of independent contractor status.

To single out the independent contractor sole proprietorship for withholding — while exempting other forms of business — would place independent contractors at an unfair disadvantage relative to their competition. Current law recognizes several forms of business, e.g., corporation, partnership, proprietorship, LLC and LLP. A company that contracts with a firm to provide services currently has no duty to withhold on the fees paid the firm, irrespective of the

form of entity through which the firm operates. To single out proprietorships for imposing withholding would impede their ability to attract and retain clients, inasmuch as the clients and potential clients of a proprietorship subject to withholding would be burdened with administrative withholding duties that they would avoid by contracting instead with the proprietorship's competitors that operate through a different form of business.

Furthermore, to impose withholding on payments made to independent contractors would create competitive imbalances within and among industries. The actual financial impact on a business of, for example, a 5-percent withholding rate would depend on the business's net profit as a percentage of gross revenues. A business with a net profit margin of 10 percent of gross revenues would be much more affected by 5 percent being withheld from their fees than a business with a net profit margin of 50 percent of gross revenues. In the former case, the government would be withholding 50 percent of net income for the year (5% / 10%), whereas in the second case the government would be withholding 10 percent (5% / 50%). Such variances of net income as a percentage of gross revenues exist both within and among industries.

The reason why withholding is not problematic as applied to employees is that an employee's net income from a job is generally equal to or very near 100 percent of wages paid. Employees are not required, for example, to advertise their services, to purchase the equipment and supplies needed to perform their services or to pay the expenses otherwise incurred in running a business. Their employer assumes those burdens. And, their employer is *not* subject to withholding with respect to its revenues.

For the foregoing reasons, I urge the Congress to remain steadfast against any effort to impose withholding in any form on payments made to independent contractors.

#### **Modify Consistency Requirement of Section 530**

A common argument made against Section 530 is that it creates unfair competitive distinctions between businesses that are eligible for Section 530 — who are free from harassment by the IRS, and those that are *not* eligible — who remain vulnerable to recurring IRS challenges to their classification of workers as independent contractors.

One of the most onerous and unforgiving requirements of Section 530 is its consistency requirement — which requires that a taxpayer *always* classify *all* substantially similar workers as independent contractors. A company that has treated one type of worker as an employee is forever precluded from obtaining Section 530 protection with respect to that type of worker.

Although the objective of the consistency requirement is meritorious, its application in some cases can produce harsh and undesirable outcomes. For example, consider two businesses, one started during 1980 and the other in 1990. The business started in 1980 was a pioneer in its industry and originally classified a certain type of worker as employees, but almost immediately converted them to independent contractor status. The other business started in 1990 and classifies its work force the same as the first business currently does.

In this scenario, the pioneer business that effectively showed the rest of its industry that a certain type of worker is more suitably classified as independent contractors would be precluded from ever obtaining protection under Section 530 with respect to those workers. Its competitors, however — that emulated its business structure and that learned from its early mistakes — can qualify for Section 530 protection.

It is submitted that such a result is unjust. It is further submitted that the inequitable result just described could be avoided if the consistency requirement were modified so that it did not operate as an absolute perennial bar.

We urge the Congress to consider modifying the consistency requirement so that:

- ♦ *A de minimis* violation of the requirement not be taken into account, and

- ♦ A taxpayer that violates the requirement not be forever barred from eligibility, but only be deemed ineligible for a specified period of time, such as three years. After the expiration of the specified period of time, the earlier violation would be disregarded.

These suggested modifications of the consistency requirement are minor, and they would preserve the general objective of the requirement by requiring consistent treatment of substantially similar workers. At the same time, however, the suggested modifications would eliminate the perceived competitive imbalances that can be created by Section 530.

#### **Clarify Industry Practice Safe Harbor**

A frequently litigated issue involving the industry practice safe harbor provision of Section 530 involves determining what percentage of an industry constitutes a significant segment of the industry. Although IRS Commissioner Margaret Richardson confirmed in a letter to Subcommittee Chairman Nancy Johnson (R-Ct) that the IRS does not interpret the term as requiring between 65 and 90 percent, that letter has not been accorded appropriate deference by IRS representatives in "the field."

It is submitted that the controversy over this issue has created needless uncertainty for taxpayers and should be resolved. The means for resolution is apparent; the Congress should specify by statute a minimum percentage that is deemed to constitute a significant segment.

#### **Conclusion**

For the foregoing reasons, I respectfully urge the Congress to approach new legislative proposals for addressing the perennial issue of worker classification cautiously, and that protections that are contained under current law not be sacrificed as a price to be paid for a new approach.

I appreciate the opportunity to present this statement and to testify today. If you have any questions or would like additional information concerning the foregoing comments, please let me know.

Respectfully submitted,

David Barbee  
President, Hospital Resource Personnel, Inc.  
Advisory Board Member, ICAA

Chairman JOHNSON. Thank you so much for sharing your testimony with us. I appreciate that the witnesses have come from some distance to be here, and I appreciate your thoughts.

Mr. Kessler.

**STATEMENT OF WAYNE KESSLER, PRESIDENT, LDW, INC.,  
BENSALEM, PENNSYLVANIA**

Mr. KESSLER. Thank you.

My name is Wayne Kessler, and I am president of LDW, Inc. I want to thank all of you for the opportunity to address an issue that has been described by the business community as the single most important problem for small business.

There are only two things you can do when the heavy hand of government places their regulatory mitts on your shoulders; fight or capitulate. I and several others decided to fight. I knew my decision to fight City Hall would be a long, lonely, and costly battle, but I believed in my cause and hoped that somewhere in our government my voice would be heard. Today is that day.

My company, LDW, Inc., located in Bensalem, Pennsylvania, was founded 15 years ago after the company I was employed with closed. I was 38 years old at the time and decided to strike out on my own. With about \$3,000 in my hand, hard work, and a belief that opportunities abound in this country, I took my shot and have had many successful years as a small business owner.

As part of our normal course of business, LDW contracts with many other small businessmen and women to service the cable television industry, constructing and installing the cable services that we all enjoy in our homes today. In so doing, I feel that I accomplish something for the community, the subcontractors, and for my family.

When I started the business, I believed that I could be successful. I believed in myself and my country. This is America, the land of opportunity for those with a little luck and a little moxie.

In 1989, LDW was audited by the IRS, during which time the use of our independent contractors was examined. At the conclusion of the investigation, the IRS informed us that no change was necessary in our reported taxes or our business operation.

During the audit, the IRS agent carefully scrutinized our use of subcontractors. The agent checked all the pertinent facts—contracts, invoicing, training, historical treatment of the workers, and so on. As far as the auditors were concerned, we were conducting our business in a proper manner.

Last year, we were notified by the IRS that LDW was going to be audited once again. We were told that there was a special project within the IRS targeting the cable installation industry. Unfortunately, our encounters with IRS auditors this time have resulted in threats and intimidation.

During this audit, we were advised that our use of independent contractors was in error, although our business practices and use of the independent contractors remained unchanged since the 1989 audit when we were given a clean bill of health. However, we were told that a prior audit could easily be overturned. In addition, the auditor did not consider industrywide practice or legal precedent as claim to section 530 relief.

We have asked the IRS, under the Freedom of Information Act, to give us the working papers of the 1989 audit. We requested this information in September 1995, and the IRS has yet to supply the documents. In the meantime, however, the IRS auditor wants to deny LDW section 530 relief.

We have the letter that the IRS sent to us at the conclusion of the 1989 audit indicating we were indeed operating appropriately. However, this does not seem to be enough for them either. It is clear the IRS is treating their previous finding of "no change" as irrelevant and incorrect.

In May, 1996, LDW was notified by the IRS auditor that they would like us to settle the matter of claims against LDW. I am not certain at this time what the specific details of the settlement would involve. However, it seems clear that the IRS wants LDW to comply with vague guidelines that most certainly will be rewritten.

Nothing has changed in our mode of operation since 1989, much less since the company was started, either within the industry or the IRS guidelines, that would warrant reclassification or substantiate treating the previous IRS findings as incorrect.

If we continue to fight the IRS' arbitrary and capricious demands, hefty assessments will be levied against us which will put LDW out of business. This is particularly egregious because the IRS has already determined in a previous audit that our contractors are independent and not employees. I am in the unenviable position of being regulated out of business this year and legislated back into business next year, an impossibility for me.

If this is allowed to happen, what message are we sending the small business community and entrepreneurs who, through sweat and hard work, have created many jobs and helped people build their lives and their communities? To paraphrase Mr. Wilson, what is good for small business is good for America.

Thank you for your time, and I will be happy to answer any questions that you may have.

[The prepared statement follows:]

TESTIMONY OF WAYNE KESSLER  
PRESIDENT  
LDW, INC.

BEFORE THE  
SUBCOMMITTEE ON OVERSIGHT  
COMMITTEE ON WAYS AND MEANS

UNITED STATES HOUSE OF REPRESENTATIVES

JUNE 4, 1996

I want to thank all of you for the opportunity to address an issue that has been described by the business community as the single most important problem for small business.

There are only two things you can do when the heavy hand of the government places their regulatory mitts on your shoulder, fight or capitulate. I and several others decided to fight.

I knew my decision to fight "City Hall" would be a long, lonely and costly battle, but I believed in my cause and hoped that somewhere in our government my voice would be heard.

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As part of our normal course of business, LDW contracts with many other small businessmen and women to service the cable television industry constructing and installing the cable services that we all enjoy in our homes today. In so doing, I feel that I accomplish something for the community, the subcontractors, and for my family. When I started the business I really believed that I could be successful. I believed in myself and my country. This is America, a land of opportunity for those with a little luck and a little moxie.

In 1989, LDW was audited by the IRS during which time our use of independent contractors was examined. At the conclusion of the investigation, the IRS informed us that no change was necessary in our reported taxes or our business operation. During the audit, the IRS agent carefully scrutinized our use of subcontractors. The agent checked all the pertinent facts - contracts, invoicing, training, historical treatment of the workers and so on. As far as the auditors were concerned we were conducting our business in a proper manner.

Last year, we were notified by the IRS that LDW was going to be audited once again. We were told that there was an "unofficial" special project within the IRS targeting the cable installation industry. Unfortunately, our encounters with the IRS auditors this time around have resulted in threats and intimidation. During this audit, we were advised that our use of independent contractors was in error, although our business practices and use of independent contractors remained unchanged since the 1989 audit - when we were essentially given a clean bill of health. However, we were told that a prior audit could easily be overturned.

In addition, the auditor did not even consider industry-wide practice or historical precedent as claim to Section 530 relief. We have asked the IRS, under the Freedom of Information Act, to give us the working papers of the 1989 audit. We requested this information at the beginning of this year and the IRS has yet to comply. In the meantime, however, an IRS auditor wants to deny

LDW Section 530 relief. We have the letter that the IRS sent to us at the conclusion of the 1989 audit indicating we were indeed operating appropriately, however, this does not seem to be enough for the them. It is clear the IRS is treating their previous findings of "no change" as irrelevant and incorrect.

Earlier this month, LDW was notified by the IRS auditor that they would like us to settle the matter of claims against LDW. I am not certain at this time what the specific details of the settlement would involve, however, it seems clear that the IRS wants LDW to comply with vague guidelines that most certainly will be rewritten. Nothing has changed in our mode of operation since 1989, much less since the company was started, either within the industry or in IRS guidelines, that would warrant reclassification or substantiate treating the previous IRS findings as incorrect. If we continue to fight the IRS' arbitrary and capricious demands, hefty assessments will be levied against us, which will put LDW out of business. This is particularly egregious because the IRS has already determined in a previous audit that our contractors are independent and not employees. I am in the unenviable position of being regulated out of business this year and being legislated back into business next year, an impossibility for me.

If this is allowed to happen, what message are we sending to the small business community and the entrepreneurs who, through sweat and hard work, have created many jobs and helped people to build their lives and their communities? To paraphrase Mr. Wilson, "What's good for small business is good for America."

Thank you for your time. I would be happy to answer any questions that you might have.

Chairman JOHNSON. Thank you, Mr. Kessler, for sharing your experience with us.

Mr. Bolt.

**STATEMENT OF MIKE MCCARTY, PRESIDENT, DC WIRING, INC.;  
AS PRESENTED BY DAVID BOLT, VICE PRESIDENT, DC WIRING, INC., SWEDESBORO, NEW JERSEY**

Mr. BOLT. Madam Chairman.

Chairman JOHNSON. Before you begin, I would like to express my condolences to Mr. McCarthy. I regret he cannot be here with us, and I am pleased you are with us.

Please proceed.

Mr. BOLT. My name is David Bolt, vice president of DC Wiring. I am appearing here—

Chairman JOHNSON. If you could get a little closer to the microphone, we can hear better. Thank you.

Mr. BOLT. I am appearing here today substituting for the president of our company, Mike McCarthy. Mr. McCarthy very much wanted to be here to deliver his testimony. Unfortunately, his mother passed away and he is attending her funeral. He asked me to appear today and read his testimony.

I appreciate the opportunity to testify about my experience in dealing with the worker classification issue. Unfortunately, my experience has been one of great adversity, involving years of burdensome accusations and costly legal bills. I am at the point now where I will lose my business imminently if something is not done to curb the erratic and unfair application of the worker classification standard.

By way of background, in our business, cable TV operators contract with companies such as mine, otherwise known as cable installation-related services companies, to obtain installers for the installation services to the customer. Cable installation-related services companies, in turn, contract with independent contractors, who use their own transportation, tools, and techniques to perform the cable installation.

Mike and I met while we were independent contractors doing work for another larger cable installation company 16 years ago. Ironically, our former company has not been targeted by the IRS or the Department of Labor. We both dreamed, as young boys, of one day owning our own business. That dream became a reality 11 years ago when we started DC Wiring.

It was a real struggle the first 5 years, but finally we felt we had faced every obstacle imaginable and that we were on our way. Then we received a visit from the IRS and the U.S. Department of Labor. From then until now, the pressure has been unrelenting, both emotionally and financially. We have seriously considered closing our doors on more than one occasion. Instead, we have decided to fight to change the unfairness and unwieldiness of the worker classification issue, not only for ourselves, but for other small businesses that have come under IRS scrutiny.

Cable installation-related services companies have used independent contractors since the inception of this industry more than 40 years ago. For the IRS to now arbitrarily decide that some workers are independent contractors while others are employees is

unfair and absurd. The industry has operated the same way since 1952.

The vast majority of companies in the industry, including broadcast companies, utilize independent contractors to perform the actual cable installation. The IRS is concerned that they are not collecting all of the taxes due them and is making American small businesses and workers suffer the consequences.

Big government should not be making small business a tax collector and, in so doing, putting small business out of business and workers on the street. We understand the need for the IRS to collect tax revenue. However, this is not a reason to force small businesses to become tax collectors.

It is important to understand that this is not a situation where we are reclassifying workers from employees to independent contractors. They have always been independent contractors, and now, at great economic cost to us and other companies and contractors, the IRS and the U.S. Department of Labor want them classified as employees.

In the cable industry, independent contractors provide the necessary skills and expertise to complete the installation in an efficient and timely manner. The flexibility provided by an independent contractor offers numerous advantages for the cable TV company, the cable installation-related services company, and the independent contractor. It is imperative that a businessowner have the opportunity to make sound economic decisions in the operation of their company.

Because independent contractors play a vital role in the industry, clarification of the standards that determine this status is critical. There is an overwhelming consensus that the IRS' 20-factor test, a common law test for determining worker classification, is a whimsical and completely subjective process. The uncertainty surrounding the test leads to litigation and large assessments levied against businesses, like mine, that are devastating, if not fatal. These assessments are unjust and accomplish nothing.

It is unreasonable that an industry which has been conducting business for more than 40 years now be told that its business practices are inappropriate and that it is subject to hefty retroactive assessments. This is entirely unfair and causes substantial economic drain.

These assessments and the costs associated with defending such erratic decisions will force DC Wiring out of business. This will have a profound effect not only on me and my family, but also on office employees, their families, and the community as a whole.

It is also important to note that classifying workers as employees or contractors affects more than just one government entity. If the IRS classifies certain workers as employees, for all intents and purposes, other government agencies will need to do so as well. That includes the U.S. Department of Labor and State agencies. This is a never-ending cycle, and we need some clarification of this issue.

I thank the Subcommittee for inviting me here today, and I urge you to take quick action to resolve this important issue.

Chairman JOHNSON. Thank you very much, Mr. Bolt.

Mr. Gee, my colleague and friend, Rep. John Duncan, mentioned to me last week that you were going to be joining us, and it is a pleasure to have you.

**STATEMENT OF EDGAR H. GEE, JR., CERTIFIED PUBLIC  
ACCOUNTANT, KNOXVILLE, TENNESSEE**

Mr. GEE. Thank you very much.

My name is Edgar Gee. I am a CPA from Knoxville, Tennessee. It is an honor and a privilege for me to be here. I appreciate this opportunity.

I am a member of the AICPA and TSCPA. I have had my own practice for about 20 years. I am here today to speak with you about the reality of dealing with the independent contractor issue firsthand.

Beginning in December 1991, the IRS initiated an examination of a client of mine on this issue. My client was Smoky Mountain Secrets. This took place in the Eastern District of the Federal District Court of Tennessee. You have an opinion attached to that. I was the initial and primary witness in this case.

The court handed down its opinion September 29, 1995, about three and a half years later, and ruled in favor of my client, and it saved my client \$4 million. I believe that ruling makes this case one of the largest independent contractor cases in the history of the country.

It is significant that this particular case is the first case litigated under code section 3508 and code section 530, and we prevailed in both of these code sections. I think paragraph 16—page 16, paragraph 9, of the court's opinion is particularly relevant because it did away with any possibility of appeal the Service might have, and we have a petition for fees pending in court at this time.

The rest of what I wanted to tell you today is what happened in the case. We asked the IRS at every level—the agent level, the agent supervisor level, the appeals conferee level, the district counsel level, and the Justice Department level—to simply answer these questions: What part of the section 3508 did they think we did not meet? Even if we didn't meet section 3508, how did they possibly think we didn't meet section 530?

We never got an answer from the government ever, and in fact at trial the government presented no witnesses and no evidence at all.

The rest of what I am going to tell you here today I am telling you because I think you, as Members of the Committee, need to know what took place in this case.

In the spring of 1993, I got a call from the employment tax specialists in Chattanooga, the gentleman and I met for lunch in Knoxville, during which he told me that his solution for resolving this case was a prospective reclassification of all of my client's people that were working for them.

I asked him why did he think I would consider doing that. He indicated that if we did not do it, they were going to sue us and make us litigate the case.

I indicated to him that it sounded a little bit like blackmail and extortion to me. He said call it whatever you want, but he said they

treated everybody this way. I asked him who in the world tells him to do things like this. He said the national office instructs him.

I made a comment to him that I knew he had seen the case file and I said, "You have to know we have a very strong case." He said, "You have a very strong case. You are going to win if you go to court. We already know that."

Sometime after that, I obtained some internal IRS documents under the Freedom of Information Act, and they are attached to my report that you have. Those documents clearly show that as early as 1992 the government was actually writing memos to each other indicating that they knew they had no case. I have some suggestions that I think that we need to consider.

Chairman JOHNSON. Excuse me, Mr. Gee. Did I understand you clearly that you have copies of memos that the IRS wrote showing that they knew they had no case?

Mr. GEE. Yes, ma'am. They are attached to my remarks.

Chairman JOHNSON. They are attached to your remarks.

Mr. GEE. Internal memos that I got under the Freedom of Information Act.

Chairman JOHNSON. Thank you.

Mr. GEE. In concluding, let me say this. I do have some solution here. Taxpayers need to be issued 1099s and they need to have written contracts. But the bottom line is this: My client should never have had to spend a dime having to litigate this case. Second, no taxpayer or citizen should ever be subjected to this kind of abuse at the hand of the Internal Revenue Service.

I thank you for letting me be here today, and I will answer any questions you have.

Thank you very much.

[The prepared statement and attachments follow:]

**STATEMENT OF  
EDGER H. GEE, JR., CPA, MBA**

## I. INTRODUCTION

My name is Edgar H. Gee, Jr. and I am a CPA from Knoxville, Tennessee. It is an honor and a privilege for me to address this committee today and I appreciate this opportunity. I am a member of the AICPA and TSCPA and I have had my own practice for 20 years.

I am here today to speak to you about the Internal Revenue Service and the continuing controversy relating to independent contractors. I am speaking from my own experience - the reality of dealing with this firsthand.

## II. THE CASE

Beginning in December 1991, the IRS initiated an examination of a client of mine which involved the issue of employees v. independent contractors. This issue culminated on July 20, 1995 when the case was tried in Federal Court - the Eastern District of Tennessee. (Court opinion attached)

I was the initial and primary witness in the case, representing my client Smoky Mountain Secrets, Inc., headquartered in Alcoa, Tn.

The Court handed down its opinion on September 29, 1995. With the Court's opinion in my clients favor and against the government, we prevailed in what I believe is the largest independent contractor case litigated in the history of the United States. This saved my client almost four (4) million dollars for years 1989 and 1990 - the two years under examination. Had we lost the case, there were open years where the taxes assessed by the IRS would have tripled this amount making it somewhere between a \$15 - \$20 million case.

This appears to be the first case ever litigated involving both IRC Sec 3508 (TEFRA '82) - the direct sellers exemption and Revenue Act '78 Section 530, the safe harbor relief provisions. As you can see from the court's opinion on page 16, paragraph 9, we prevailed under **BOTH** sections.

This ended any reasonable possibility the Service had for an appeal. This paragraph also provided a basis for our petition to the court for recovery of attorney fees and other costs related to this litigation. This petition is pending in Federal District Court.

## III. IRS ACTIONS

The rest of what I am going to tell you all here today are not the observations of some disinterested third party. They are not what I think happened. They are in fact what did happen.

From the revenue agent level, to the agent's manager, to district chiefs, to appeals conferees, to IRS district counsel, to the Department of Justice's lawyer, we could never get an answer to two (2) basic questions. Those simple questions were:

1. What part of IRC Sec 3508 did the government think my client did not meet?
2. And most importantly **even if** we did not meet IRC Sec 3508 how could the government even begin to think we did not meet Sec 530?

In fact, there never was an answer ever from the government (even at trial the government presented no evidence and called no witnesses). This amounts to institutional breakdown at each and every level in the existing system and cries out for major change in the way these cases are handled. If the IRS has been willing to focus on these questions at any level, both the taxpayer and the Government would have been spared years of litigation and thousands of dollars in fees and costs.

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What I am going to tell you next, I am going to tell you out of a sense of duty because the members of this committee need to know what transpired in this case. Hopefully this will help this committee to develop legislation which will prevent such institutional breakdowns in the future. I believe that is in the best interest of both the Government and its taxpayers.

While this case was before the appeals conferee in Nashville, I received a phone call from the districts chief employment tax specialist. He told me he had a way to resolve this case. He said he wanted to come up to Knoxville and meet with me. I arranged for lunch at Regas Restaurant in Knoxville.

His solution to resolve the case was for my client to reclassify his independent contractors to employees on a prospective basis and he said IRS would drop the case if we did that. I asked why did he think I would even consider this proposal of his? His response was if we didn't agree, the Service was going to sue us and make us litigate the case. I said but you have seen the case file. You have to know I have a strong case. His response was that we did have a strong case and were probably going to win anyway if we went to court. I was incredulous. I said who in the world tells you all to do this - to conduct a case this way - to cause taxpayers to be put to this expense even though the Government expects to lose? His response was National Office.

At this point I realized the utter futility of continuing any dialogue and that court was the only logical alternative. Some months after this luncheon, I discovered (under the Freedom of Information Act) internal IRS memos written in late 1992 (prior to this Regas luncheon meeting) where the IRS memos actually stated that "...the Government would have absolutely no case."(Exhibits attached).

#### IV. SUGGESTED CHANGES OR STRONG RECOMMENDATIONS

- A) IRS should undertake a comprehensive training program to insure that all IRS employees who deal with this problem in any manner understand the laws and intent of the Congress.
- B) Have these simple rules:
  - a. If Taxpayer
    - 1. Issues 1099's
    - 2. Has written IC contracts
    - 3. Uses performance based pay (e.g. commission per each etc.)
  - b. Then IC status is automatic and not subject to any IRS whim.
- C) Failing both A and B - change the law so that IC status will be respected if 10% is withheld by the payor at the source - much like backup withholding now done on pensions, bank interest, etc. In addition, there would be a provision prohibiting businesses from engaging to reclassify former current employees as IC's.
- D) As the WHCSB recommends, set up a task force or joint committee of one CPA, one tax lawyer, one small businessperson and two (2) members of your subcommittee to review cases like this and initiate legislation to effect changes.
- E) If the IRS pursues a case like this and loses, give the courts authority to make the award of attorney fees and costs to the taxpayer effective beginning at the agent level and make the award automatic and mandatory. This will stop the IRS's relentless blind pursuit of these type cases.

#### V. CONCLUSION

*Ladies and gentlemen the bottom line is this* My client should never have had to spend the first dime on this case. No taxpayer should ever again be subjected to this kind of abuse at the hands of an agency of the Federal Government.

Thank you. I will be happy to answer any questions which members of the Committee might wish to ask.

*Authenticity*

Internal Revenue Service  
MEMORANDUM

Date: November 24, 1932

To: Gene Boon, Group Mgr 1310

From: Gary Watkins, Employment Tax Specialist

subject: Employment Tax Case

Per your request, I have reviewed the Revenue Agents Report as well as the Protest submitted by the Corporations PDA. It would appear that the Taxpayer is relying on essentially two avenues in which to defeat the Agents initial determination. The first defense presented, is that of the workers meeting the criteria of statutory non-employees under the category of Direct Sellers. The PDA states that the workers "...meet both criteria in subsection 2(A) when they could meet either or and still fit under the definition." The criteria being described is that of IRC Section 3508(b)(2)(A). It states that the term "direct seller" means any person who:

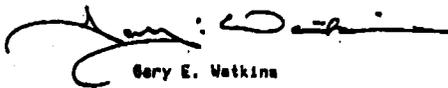
- (i) "is engaged in the trade or business of selling (or soliciting the sale of) consumer products to any buyer on a buy-sell basis, a deposit-commission basis, or any similar basis which the Secretary prescribes by regulations, for resale (by the buyer or any other person) in the home or otherwise than in a permanent retail establishment, or"
- (ii) "is engaged in the trade or business of selling (or soliciting the sale of) consumer products in the home or otherwise than in a permanent retail establishment."

The prevailing question would clearly be, do telephone solicitors working under what would appear to be direct and immediate supervision, in an office complex, qualify as direct sellers under this Section. The answer to that question would be no. The intent of Congress in defining direct sellers as statutory non-employees was to ensure that door-to-door, person-to-person sellers such as individuals working for such companies as Fuller Brush, Avon, Mary Kay, etc. would not be challenged as to the common law criteria of an employee. In the present case, the telephone solicitors perform their duties in an established office location and not at the home of potential customers or some other location in which the customer would be required to travel to. Therefore, since the telephone solicitors could not be properly classified as direct sellers, one must now look at the common law factors to determine if an employer-employee relationship does exist. Indeed, the facts would tend to indicate that significant control and direction is being exerted on the telephone solicitors, not only as to the results to be

accomplished but also to the means by which that result is accomplished.

The second defense that is being presented in the Protest centers around the safe havens as established by Section 530. The POA contends that the Corporation has been consistent in its treatment of the workers, i.e. treating them as independent contractors and issuing them 1099's. He goes on to say that the Corp. has reasonable basis in its treatment of the workers based on the fact that his client had been examined (years prior to his incorporation of this business) previously where IRS allowed commission only individuals to be nonemployees. If indeed this fact can be substantiated, the Government would have absolutely no case. Rev. Rul. 83-152 clearly states a past examination would provide the Taxpayer a "reasonable basis" for its treatment of the workers, and therefore, a safe haven under Section 530. The fact that the past audits were conducted while the business was a sole proprietorship or other type of entity would be immaterial, assuming the nature of the business remained unchanged. It would seem clear that this statement represents the Government's most serious challenge to the employment tax issue.

Per your suggestion, I contacted the POA to obtain more specific information concerning the past IRS examination. The CPA, Edgar Gee, was extremely vague and very elusive when discussing this particular issue. However, he did say that he would contact his client and attempt to provide further information concerning the past audit. Additionally, I contacted Rudy Broughton, Employment Tax Specialist in Birmingham, he agreed completely with my analysis of the Corporations direct seller defense. I will give you a call when additional information is received from Mr. Gee.

  
Gary E. Watkins

cc: Manager, Group 1317

Internal Revenue Service  
MEMORANDUM

date: November 28, 1982

to: Gene Boon, Group Mgr 1210

from: Gary Watkins, Employment Tax Specialist

subject: Employment Tax Case

On this date, a discussion was held with Edgar Gee, CPA, concerning the ongoing employment tax case being worked by Susan Elmore. He stated that information has been received as to the past audits of entities similar to the one under examination which would qualify his client for Section 530 safe haven treatment under the "past IRS Audit Rule". Affidavits were faxed (see attached) indicating that three different corporations were audited in the 1970's with no challenge being made as to the sales personal receiving non-employee compensation. The entities which were audited included (1) Saco, Inc., (2) Thoroughbred Films, Inc., and (3) Phylben Village, Inc. The corporate entities are currently defunct and no EIN's were available. He was uncertain as to the exact business activities conducted by the entities. However, he did state emphatically that the sales people working for the corporations performed duties involving direct selling to the public, both on the telephone and person-to-person, and they were paid on a commission basis. Mr. Gee maintains that Section 530 makes no stipulation as to "substantial similarity", but in fact the Section merely states that a safe haven is provided where a taxpayer is treated as having satisfied the test by showing reasonable reliance on a past Internal Revenue Service audit.

It should be noted that the court case referred to by the CPA in his protest is the case of Lambert's Nursery & Landscaping, Inc. v. United States, No. 88-4298 (5th Cir. 2-12-90) 85 A.F.T.R. 2d 90-673. In this particular case the taxpayer, operating a nursery and landscaping business, hired landscape workers on a job-by-job basis and treated them as independent contractors. In 1976 the IRS audited Lambert's 1974 returns and an eventual determination was made that the workers were indeed independent contractors. In 1989, Mr. Lambert started a new business of janitorial services. He employed the janitorial workers on a job-by-job basis and treated them as independent contractors. The IRS subsequently audited the Corporate returns and determined that the janitorial workers were employees. The district court registrars was of the opinion that, as a matter of law, both the landscape workers and the janitors were actually employees. However, because the two sets of employees were "substantially similar" in their relationship to Lambert, the

magistrate held that Lambert had reasonably relied on the result of an earlier audit in treating the janitorial workers as independent contractors.

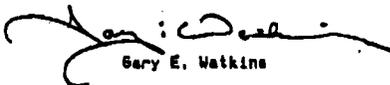
The Service's position as to Lambert's Nursery & Landscaping, Inc. supra, is that this case should not be followed in situations where a prior audit has occurred but the taxpayer has begun a new line of business, and workers (determined to be employees) are performing different services. Indeed, the Service's standing position has been that reliance on a past Internal Revenue Service audit would qualify only if the audit entailed no assessment attributable to the taxpayer's treatment of individuals holding positions substantially similar to that held by the individual whose treatment is at issue.

It should also be noted that the courts have taken an extremely liberal view when it comes to applying the safe havens of Section

530. Clearly, in this case, dissimilarities exist between the Corporation's present business of telephone solicitation and that of prior business activities of the shareholder. The extent of the dissimilarities is uncertain based upon the sketchy information available. At this point, the CPA is attempting to make the case that any nature of sales activities which occurred in the past and previously judged by virtue of an audit to be non-employee activities, would be sufficient to satisfy Section 530 requirements.

This is not the view of the IRS. However, if the taxpayer could reasonable show that the workers had telephone solicitation \*

\* responsibilities, then indeed the weight of the case would shift in the favor of the taxpayer.

  
Gary E. Watkins

LAST  
Sentin  
Delet

cc: Manager, Group 1315

## Full Text:

IN THE UNITED STATES DISTRICT COURT  
FOR THE EASTERN DISTRICT OF TENNESSEE  
AT KNOXVILLE  
No. 3:94-cv-121

SMOKY MOUNTAIN SECRETS, INC.,  
Plaintiff

UNITED STATES OF AMERICA,  
Defendant

## MEMORANDUM OPINION

This is a tax refund action brought by the plaintiff-taxpayer, Smoky Mountain Secrets, Inc. (SMS), pursuant to 28 U.S.C. §1346(a)(1). Plaintiff seeks a refund of Form 941, Federal Insurance Contribution Act (FICA) taxes and Form 940, Federal Unemployment Tax Act (FUTA) taxes, which plaintiff contends were assessed erroneously by the United States Department of the Treasury through the Internal Revenue Service (IRS). The total amount of taxes assessed is approximately \$3,888,918. This does not include interest on the assessments. The jurisdiction of this court is not disputed. This matter was tried before the undersigned without intervention of a jury on July 20, 1995. The parties were given additional time within which to file post-trial briefs. After consideration of the pleadings, the testimony of witnesses, the depositions and exhibits introduced at trial, the parties' briefs and the applicable law, the court makes the following findings of fact and conclusions of law. See Rule 52(a), Federal Rules of Civil Procedure.

## Findings of Fact

1. SMS, a Tennessee corporation, markets gourmet foods and condiments, including mustards, salad dressings, jellies and preserves. SMS sells its gourmet foods to consumers; it does not package and sell its products to other businesses for resale.
2. Something during late 1991 or early 1992, defendant, through the IRS, initiated an audit of SMS which included a review of whether SMS's telemarketers and delivery persons were properly treated as independent contractors for federal tax purposes.
3. During the tax years in question, the bulk of SMS's sales orders were solicited through telephone calls made by plaintiff's telemarketers, although some sales were made through mail orders received from repeat customers and through on-the-spot sales by delivery persons. The product orders solicited by the telemarketers were delivered to the customer's home by delivery persons who collected the amount due.
4. In addition to the telemarketers and delivery persons, all of whom were treated other than as employees for federal tax purposes during the 1989 and 1990 tax years, SMS employed workers who were and still are treated as employees for federal tax purposes. These employees include home office staff, warehouse workers, office managers, regional managers, and the officers of the corporation.
5. The telemarketers and delivery persons worked out of sales offices in various locations in approximately 14 different states during the tax years in question. No walk-in sales were made from these offices. Sales were only made through telephone solicitation and delivery of the package. For each package sold, which SMS defined as requiring

actual delivery to and receipt of payment from the customer, the telemarketer received a specific commission, the amount of which depended upon the size of the package sold and the year in which the transaction took place.

6. SMS's delivery persons were an integral part of SMS's sales force; their services did not consist of merely driving to the customer's home and handing over the package. The delivery person had to collect the amount due, which often meant that he or she had to close the sale. Neither the delivery person nor the telemarketer would be paid unless the package was accepted and paid for by the consumer. Thus, the reason SMS's own delivery persons were used instead of common carrier was to obtain the opportunity to close the sale face-to-face if a delivery was refused. Two of plaintiff's managers, Terry P. Goodall and Barbara Jean Thomas, each of whom had previously worked for SMS as delivery persons, testified that the person delivering the packages was often called upon to close sales, such as when a customer has changed his or her mind, did not know the terms of the sale, or when an unknowledgeable spouse refused to accept the package. Mr. Goodall and Ms. Thomas further testified that delivery persons also made sales on a "show-me" basis, in which additional packages are shown and sold to customers and to their neighbors. Consequently, I find that closing the sale was as much an art as was obtaining the order over the telephone in the first place.

7. Before going to work for SMS, each telemarketer and delivery person was required to sign a written contract. SMS's company president, CHARLES T. ALLEN, who along with his wife, Lois Allen, own 100% of the issued and outstanding stock of SMS, testified that it was corporate policy that all salespersons sign a contract before beginning work. The evidence establishes that the contracts clearly set forth that each telemarketer or delivery person would be paid on a commission basis, would not be treated as an employee for federal tax purposes, and that no federal, state or local income or payroll taxes would be withheld. The earlier forms of the contracts also stated that because the telemarketer or delivery person was not an employee, a Form 1099 would be issued and filed if the individual earned over \$600 during that year. The parties stipulated that SMS issued a Form 1099, as required by federal tax law, to every telemarketer and delivery person who earned \$600 or more during the 1989 and 1990 tax years.

8. These written contracts further provided that each telemarketer's delivery person's remuneration was directly related to the number of sales delivered and for which they were paid. Each year SMS corporate policy required every telemarketer and delivery person to sign a new contract. It was the responsibility of the manager of each sales office to obtain those documents. And, in fact, the contracts were signed by every telemarketer and delivery person before they started work.

9. Copies of form contracts between SMS and its telemarketers and delivery persons which were used during the years following the 1989 and 1990 tax years were admitted in evidence. As the undisputed testimony confirms, the contracts used in prior years were, in all relevant provisions, substantially the same as those in evidence. The contracts used in the 1989 and 1990 tax years provided that the service provider — i.e., the telemarketer or delivery person — would be paid on a per-package-sold basis and that the service provider would not be treated as an employer for federal tax purposes. The parties stipulated, however, that SMS has been unable to produce and does not have in its possession originals or copies of the written contracts for the tax years in question, even though SMS diligently

searched for them and even sought to obtain copies or originals from numerous third parties. The reason SMS was unable to obtain the contracts is that its certified public account (CPA), Edgar H. Gee, Jr., advised Mr. Allen, SMS's president, that it would be unnecessary to retain copies after the corporate books had been closed and the required tax returns, including Forms 1099, had been filed for the year. Mr. Gee did not consider it important to keep copies of the contracts between SMS and its sales force because 26 U.S.C. §3508 does not address retention of contracts in any respect. Nonetheless, because it was SMS's corporate policy that every telemarketer and delivery person sign a new contract each year, and since the undisputed proof at trial indicated that contracts were, in fact, executed by all telemarketers and delivery persons during the tax years at issue, I find that SMS convincingly proved the existence of the contracts and their contents pursuant to Rule 1004(1), Federal Rules of Evidence.

10. Mr. Allen first sought Mr. Gee's advice in 1983, after having read a statement in a business publication which reported the addition of §3508 to the Internal Revenue Code (the Code). Because he realized that it possibly applied to businesses such as his, which utilized the services of "direct sellers" treated them as independent contractors, Mr. Allen sought the advice of Mr. Gee as to whether the new Code provision would apply to SMS's relationship with its telemarketers and delivery persons. Mr. Gee is a CPA who has been licensed and in practice for more than 20 years. He received his undergraduate degree in accounting from Western Kentucky University and a masters in Business Administration from the University of Tennessee at Knoxville. Mr. Gee started his professional career with what was then one of the Big Eight accounting firms. He has had his own practice since 1977. Mr. Gee maintains a general accounting practice, concentrating on small businesses, the most significant of which is SMS. He testified at trial that probably one-half of his practice is related to tax accounting and tax advice.

11. Mr. Gee testified that when Mr. Allen first inquired about §3508 he was initially unfamiliar with the statute's requirements. The reason is that the statute had only recently been enacted. He therefore obtained a copy of the new statute prior to Mr. Allen's initial appointment, found that there were no regulations regarding §3508, and analyzed the Code section with Mr. Allen, asking him pertinent questions regarding each of the elements set forth in the statute. Based on the information gleaned from Mr. Allen, Mr. Gee opined that SMS's telemarketers and delivery persons were direct sellers as contemplated by §3508. Mr. Gee testified that his opinion was based upon Mr. Allen's description of the relevant facts about SMS's business, the manner in which the telemarketers and delivery persons would be compensated, and the fact that plaintiff had a written contract with its sales force providing that the telemarketers and delivery persons would not be treated as employees for federal tax purposes. Shortly after his meeting with Mr. Allen, Mr. Gee researched §3508's legislative history, obtaining copies of the Senate and House committee reports as well as the conference committee report. He gave copies of these reports to Mr. Allen, advising him that he remained of the opinion that SMS's sales force qualified as direct sellers under the statute. Mr. Gee was hired that same year as SMS's CPA with responsibility for closing the books at year-end, preparing financial statements as needed, and filing all tax returns, including employment tax and information returns.

12. Unknown to Mr. Gee, Mr. Allen also consulted with the CPA who regularly prepared Mr. Allen's personal tax re-

turns, Jerry Lee Sharpe of Middlesboro, Kentucky. Mr. Allen asked Mr. Sharpe the same question regarding the proper tax classification of SMS's telemarketers and delivery persons. Mr. Sharpe, now semi-retired, has been a CPA since 1963. When he began his career, he worked for the IRS as a revenue agent for almost two years. While with the IRS, Mr. Sharpe worked on a number of independent contractor cases. As a CPA in private practice, the vast majority of his time has been spent on tax-related issues, including some work, primarily related to the coal industry, regarding the issue of independent contractors.

13. Like Mr. Gee, Mr. Sharpe advised Mr. Allen that he believed that SMS's telemarketers and delivery persons were properly classified as independent contractors and not employees. He based this advice, however, upon his prior experience and knowledge of common law factors. Mr. Sharpe was not familiar with and did not discuss with Mr. Allen the application of §3508. Some years later, Mr. Sharpe called Mr. Allen regarding this issue after he had attended a three-day continuing professional education course, which was sponsored by the University of Kentucky and taught by IRS instructors. Mr. Sharpe advised Mr. Allen that the course's primary subject involved the IRS's new 20-factor analysis for determining whether workers are employees or independent contractors for federal tax purposes. After again analyzing SMS's sales force in the context of these 20 factors, Mr. Sharpe advised Mr. Allen that the telemarketers and delivery persons were properly characterized as independent contractors.

14. Mr. Gee has continued to perform certain accounting services for SMS since 1983. In addition to the specific advice he gave regarding §3508, Mr. Gee has represented SMS in state unemployment tax investigations involving the issue of the proper classification of SMS's telemarketers and delivery persons. A number of such investigations took place over the years and, consistent with his initial advice to Mr. Allen, Mr. Gee have taken the position with the states that the telemarketers and delivery persons were statutorily classified as independent contractors. Mr. Gee testified that most, if not all, of these investigations resulted in findings by the states that SMS's telemarketers and delivery persons were indeed properly treated as independent contractors rather than employees.

15. Based upon the undisputed evidence at trial, I find that SMS has, since its inception, treated all of its telemarketers and delivery persons as independent contractors. No telemarketer or delivery person has been treated as an employee for federal tax purposes.

#### Conclusions of Law

##### A. Section 3508 — Statutory Independent Contractors

1. This court has subject matter jurisdiction over this case pursuant to 28 U.S.C. §§1340 and 1346(a)(1), and 28 U.S.C. §7422. Because this is a tax refund suit in which the IRS counterclaims for the unpaid balance of assessments of divisible taxes, the IRS need only show that a timely assessment was made in order to establish a prima facie case. See *Sinder v. United States*, 655 F.2d 729, 731 (6th Cir. 1981). Thus, the assessment is initially presumed to be correct, and the taxpayer has the burden of proving that the assessment was wrong. *Id.* See also *United States v. Besase*, 623 F.2d 463, 465 (6th Cir.), cert. denied, 449 U.S. 1062 (1980).

2. Prior to 1982, the question of whether a worker was an independent contractor or an employee for federal tax purposes was a question that was answered almost exclusively under common law. See *Cleveland Institute of*

*Electronics, Inc. v. United States*, 787 F.Supp. 741 (N.D. Ohio 1992); H.R. Rep. No. 1748, 95th Cong., 2d Sess. 5, 1978-3 C.B. (Vol. 1) 629 (House Report discussing the enactment of the employment tax relief provisions of §350 of the Revenue Act of 1978). After enacting §350 of the Revenue Act of 1978 as an interim solution for employment tax controversies, Congress in 1982 made §350 relief permanent and, to further alleviate the problem for direct sellers and real estate sales persons, enacted 26 U.S.C. §3508. According to the legislative history, congress added §3508 to the Code as a response to the "problems arising from increased employment tax status controversies," and to provide "a statutory scheme for assuring the status of certain direct sellers and real estate sales people as independent contractors [for federal tax purposes]." *Staff of Joint Comm. on Taxation*, 97th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982*, at 382 (Comm. Print 1982). Importantly, the "statute did not supplant the common law; rather, it merely guaranteed independent contractor status for those taxpayers who met its conditions." *Cleveland Institute of Electronics*, 787 F.Supp. at 743-44.

3. Section 3508 thus establishes two categories of statutory non-employees: (1) qualified real estate agents and (2) direct sellers. The statute sets forth the general rule that an individual performing services as a "direct seller" shall not be treated as an employee and the person for whom the services are performed shall not be treated as an employer. §3508(a)(1) and (2).

4. The term "direct seller" is defined in pertinent part in §3508(b)(2) as any person:

(A) [who]

(i) is engaged in the trade or business of selling (or soliciting the sale of) consumer products in the home or otherwise than in a permanent retail establishment.

(B) substantially all the remuneration (whether or not paid in cash) for the performance of the services described in subparagraph (A) is directly related to sales or other output (including the performance of services) rather than to the number of hours worked, and

(C) the services performed by the person are performed pursuant to a written contract between such person and the person for whom the services are performed and such contract provides that the person will not be treated as an employee with respect to such services for Federal tax purposes.

The parties have stipulated that SMS's sales (the delivery of its gourmet foods and condiments and receipt of payment) and the solicitation of its sales (by the telemarketers over the telephone) were made either in the home or from other than a "permanent retail establishment" as required by §3508. The parties further stipulated that SMS's telemarketers were engaged in the business of "soliciting the sale" of plaintiff's product as required by the statute. However, the parties dispute whether or not SMS's delivery persons were engaged in the business of soliciting the sale of plaintiff's products. I am of the opinion that they were. In fact, SMS's delivery persons were an indispensable part of selling SMS's products. Delivery persons had to be able to and did "close" sales on a regular basis. Indeed, the extent to which they received remuneration for their services was very often dependent on their success in closing sales. The telemarketers and delivery persons thus both clearly meet the first prong of the definition of "direct sellers;" they were engaged in the trade or business of selling or soliciting the

sale of consumer products in the home or otherwise than in a permanent retail establishment.

5. The next criterion which must be satisfied under §3508 is that "substantially all the remuneration" paid to the worker be directly related to sales or other output rather than the number of hours worked. SMS compensated its telemarketers and delivery persons on a commission basis — only if a package was delivered to a customer and the sales price actually collected, were the telemarketer and delivery person to be paid. Thus, substantially all of the remuneration of the telemarketers who received a Form 1099 for the 1989 and 1990 tax years was directly related to sales. Similarly, substantially all the remuneration of SMS's delivery persons during the 1989 and 1990 tax years was directly related to sales. SMS has thus met the second prong of §3508's test.

6. The third requirement of §3508 is that the services must have been performed pursuant to a written contract providing that the service provider would not be treated as an employee for federal tax purposes. Although the IRS vigorously contends that SMS has failed to satisfy the written contract requirement of §3508(b)(2)(C), its argument is unavailing. The IRS would require plaintiff to actually produce the written contracts for the years 1989 and 1990. However, this argument ignores Federal Rule of Evidence 1004(1), which clearly allows other evidence of the contents of an original writing to be introduced assuming all originals have been lost or destroyed. While Congress could have required something more within the terms of §3508, it did not. The IRS has failed to cite any authority for the proposition that copies of the original contracts must be produced in order for the taxpayer to meet the third prong of §3508. SMS introduced into evidence copies of form contracts similar in every material respect to those used in the tax years at issue. The contracts specifically provide that SMS's telemarketers and delivery person to sign these contracts and the evidence clearly reflects that the contracts were, in fact, signed by each telemarketer and delivery person in each of the tax years at issue. Therefore, the third requirement of the statute has been met; the services were performed under a written contract providing that the service provide would not be treated as an employee for federal tax purposes.

7. The IRS also contends that the court may reasonably infer from the existence of written contracts for years subsequent to 1989 and 1990, and the failure of SMS to produce the written contracts for the years at issue, that either no written contracts ever existed for such years or that, if they did exist, the written contracts did not contain the express provisions required by §3508. Indeed, the IRS goes so far as to argue that the court may properly draw an analogy between the established principle that an adverse inference may be drawn from the failure of a non-hostile witness with direct knowledge of important facts to testify on a party's behalf. While the court could draw such an inference is SMS had adduced no proof on this issue, that is not the case here. The government itself stipulated that any and all persons whom SMS could call at trial on this issue would testify, as did Mr. Goodall and Ms. Thomas, that each telemarketer and delivery person signed written contracts as a matter of corporate policy. As noted in the leading case of *Cleveland Institute of Electronics, Inc.*, 787 F.Supp. at 749, the legislative purpose underlying enactment of §3508 was to reduce the number of controversies regarding employment and income tax status of direct sellers and real estate agents. The court therefore must interpret the requirements of §3508 in a fashion which will further the statute's purpose. Therefore, because SMS has clearly dem-

onstrated that its telemarketers and delivery persons meet the requirements set forth in §3508, the court concludes that SMS's sales force were "direct sellers" as that term is used in §3508 for the tax years 1989 and 1990.

**B. Section 530 of the Revenue Act of 1978 — Professional Advice**

8. Section 530 of the Revenue Act of 1978 (the 1978 Act) was enacted by Congress to provide interim relief to certain taxpayers involved in employment tax status controversies with the IRS. *Donovan v. Tastee Freez (Puerto Rico)*, Inc., 520 F.Supp. 899, 903 (D.P.R. 1981). Section 530 of the 1978 Act is codified as a footnote to 26 U.S.C. §3401. Congress intended that §530 would serve as a shelter for taxpayers who had acted in good faith from the potentially harsh retroactive tax liabilities resulting from IRS reclassification of independent contractors as employees. See *United States v. MacKenzie*, 777 F.2d 811, 815 (2d Cir. 1985), cert. denied, 476 U.S. 1169 (1986) (citing *Ridgewell's Inc. v. United States*, 228 Cl. Ct. 393, 655 F.2d 1098, 1101 (1981)). As previously noted, §530 was later extended indefinitely by the Tax Equity and Fiscal Responsibility Act of 1982.

9. Although the court has previously concluded that the members of SMS's sale staff are properly classified as direct sellers under §3508, I further conclude that SMS has demonstrated that it is entitled to relief under §530 even if the telemarketers and delivery persons do not qualify as direct sellers.

10. The government has stipulated and the court finds that SMS has met the first two tests under §530: that SMS has consistently treated its telemarketers and delivery persons, as well as all individuals holding similar positions, as independent contractors for federal tax purposes; and that SMS filed all required tax returns, including information returns, in a manner consistent with having treated the telemarketers and delivery persons as independent contractors. The term "reasonable basis" is to be construed liberally in favor of the taxpayer. See H.R. Rep. No. 1748, 95th Cong., 2d Sess. 5, 1978-3 C.B. (Vol. 1) 629, 633. See also *Lambert's Nursery and Landscaping, Inc. v. United States*, 894 F.2d 154, 157 (5th Cir. 1990); *General Inv. Corp. v. United States*, 823 F.2d 337, 340 (9th Cir. 1987).

11. Section 530 provides three non-exclusive methods by which taxpayers can demonstrate a reasonable basis for having treated individuals as independent contractors rather than employees. The first of these statutory safe harbors is reliance on judicial precedent or published rulings. The second of the statutory safe harbors is reliance on a past IRS audit of the taxpayer in which there was no assessment attributable to the treatment, for employment tax purposes, of individual holding positions substantially similar to those held by the workers at issue. The third statutory safe harbor is reliance on the long-standing recognized practice of the worker's industry. See §530(a)(2). However, the language of §530(a)(2) refers to the three statutory safe harbors as merely "one method of satisfying the requirements [of the reasonable basis test]." Based upon that language, both the IRS in its procedural guidelines and the courts have held that "[a] taxpayer who fails to meet any of the three [statutory] safe havens" may nevertheless be entitled to relief if the taxpayer can demonstrate, in some other manner, a reasonable basis for not treating the individual as an "employee." Rev. Proc. 85-18, 1985-1 C.B. 518. See also *In Re Rasbury*, 130 B.R. 990 (Bankr. N.D. Ala. 1991), aff'd, *United States v. Rasbury (In re Rasbury)*, 141 B.R. 752 (V.D. Ala. 1992).

12. SMS claims that its reliance on the advice of two professional tax advisors is sufficient to demonstrate a reasonable basis under §530 for not treating its telemarketers and delivery person as employees. I agree. Under the circumstances of this case, reliance upon the professional advice rendered by two CPAs — Mr. Gee and Mr. Sharpe — constitutes a reasonable basis for SMS having treated its telemarketers and delivery persons as independent contractors. It is undisputed that Mr. Gee explored with SMS's President, Mr. Allen, the facts about SMS's business relevant to the requirements found in §3508. Mr. Gee testified that he discussed with Mr. Allen that SMS's compensation structure would meet the "substantially all remuneration" requirement, that a written contract was required, and that one existed which met the requirements found in the statute. After determining that the telemarketers and delivery persons would only be compensated on a commission basis and that a written contract meeting the requirements of the statute existed, Mr. Gee advised Mr. Allen that he believed §3508 applied and that the telemarketers and delivery persons could and should be treated as independent contractors. Thus, not only has Mr. Gee consistently filed all appropriate federal documents related to this status under §3508, he has also represented SMS in various state unemployment tax investigations and has consistently taken the successful position with those agencies that the telemarketers and delivery persons qualified as "direct sellers" under §3508.

13. The IRS attacks SMS's reliance upon Mr. Gee's advice based on the fact that Mr. Gee was unaware of the existence of §3508 at the time Mr. Allen inquired of him. Because at that time the statute had just been enacted, and based on Mr. Gee's conduct in researching the matter, I am of the opinion that it was reasonable for Mr. Allen to rely upon the advice of his advice of his CPA. Only after he had examined the statute line-by-line in the context of the information provided by Mr. Allen did Mr. Gee opine that SMS had met the essential elements of §3508.

14. I further conclude that SMS's reliance upon the advice of Mr. Sharpe, who examined the information provided by Mr. Allen in the context of the common law factors governing independent contractor status, was reasonable, thereby further entitling SMS to the protection of §530. As did Mr. Gee, Mr. Sharpe testified as to his education and experience in similar tax matters and indicated that his advice was based upon the information provided by Mr. Allen. The IRS's reliance on *In re McAtee*, 115 B.R. 180 (N.D. Iowa 1990), is thus misplaced. In that case, the taxpayer's accountant did not testify, nor was his identity disclosed on the record. Moreover, there was no evidence in the record as to exactly what advice the accountant gave the taxpayer or what information the taxpayer gave to the accountant. *Id.* at 184-85. By contrast, the undisputed testimony in this case indicates that, so far as Mr. Allen knew, Mr. Gee and Mr. Sharpe were fully capable and qualified to render advice on the question asked of them. It is also undisputed that Mr. Allen fully disclosed all pertinent information necessary for his accountants to render that advice.

15. Although the term "reasonable basis" is not defined in the Code or regulations, an analogy may be drawn from those cases interpreting the term "reasonable cause" as it governs the determination of whether income tax penalties should be imposed upon a taxpayer. In determining if reasonable cause exists, the courts and IRS regulations generally look to see whether the taxpayer "exercised ordinary business care or prudence." See, e.g., 26 C.F.R. §301.6651-(c)(1). Generally, the courts have found that reasonable cause exists where the taxpayer relied on the advice

of a trusted attorney or accountant. See, e.g., *Vorsheck v. Commissioner*, 933 F.2d 757 (9th Cir.), cert. denied, 502 U.S. 984 (1991). Indeed, in this regard, the Supreme Court has stated that:

When an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a "second opinion," or to try to monitor counsel on the provisions of the Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place. "Ordinary business care and prudence" do not demand such actions.

*United States v. Boyle*, 469 U.S. 241, 251 (1985) (emphasis added and citation omitted). Under the circumstances of this case, then, I conclude that SMS's reliance on the advice of two CPAs is a reasonable basis for treating its telemarketers and delivery persons as independent contractors, entitling it to the protection of §530.

**C. Section 530 of the Revenue Act of 1978 — Prior Audit Safe Harbor.**

16. The leading case involving the prior and audit safe harbor provision under §530(a)(2)(B) is *Lambert's Nursery and Landscaping, Inc. v. United States*, 894 F.2d 154 (5th Cir. 1990). The Fifth Circuit set forth the requirements the taxpayer must satisfy to meet the prior audit safe harbor defense. The taxpayer must establish (1) that the IRS conducted a prior audit of the taxpayer for a particular tax year; (2) that the IRS determined in the prior audit that the taxpayer's workers were independent contractors; (3) that the workers who were the subject of the prior audit are "substantially similar" to the workers at issue; and (4) that the taxpayer treated the two groups of workers in a "substantially similar" fashion. Unlike the taxpayer in *Lambert's Nursery*, SMS failed to establish the existence of a past IRS audit of SMS. It did establish, however, that Mr. Allen individually, as well as three corporations he owned in the early 1970's, were audited by the IRS. Mr. Allen nevertheless admitted that he did not know for certain what year the purported audits took place, or for what tax years the audits were conducted. He also admitted that he has no records reflecting that audits were conducted, or to what tax years the audits pertained. Although he testified generally that no adverse independent contractor determination was made by the IRS, he was not able to testify about the precise results of the audits.

17. Accordingly, while there was evidence that Mr. Allen treated SMS's sales force in the same manner as he had treated his sales force in his prior businesses, the evidence is insufficient for the court to conclude that SMS was entitled to rely on the results of the prior audit.

**Conclusion**

Therefore, because SMS's telemarketers and delivery persons are direct sellers under 26 U.S.C. §5308 or alternatively, because SMS is entitled to the protection of §530 on account of its reasonable reliance on professional advice, SMS shall be awarded judgment in its favor and against the United States in the amount of \$400, which represents the total amount of employment taxes paid for the tax years at issue.

Order accordingly.

/s/ James H. Jarvis  
UNITED STATES DISTRICT JUDGE

\*Smoky Mountain Secrets has not actually paid the amounts assessed. Rather, it has for each assessment paid an amount equal to the employment taxes for one employee and immediately sought a refund of that amount. There were a total of 10 assessments beginning with the first quarter of 1989 and ending with the last quarter of 1992. This procedure is in full compliance with the IRS' divisible tax rule. Each claim for refund has been disallowed by the IRS. These and other facts are included in written stipulations [Doc. No. 25] filed by the parties.

The parties stipulated that the testimony given by Mr. Goodall and Ms. Thomas is consistent with that of all office managers, telemarketers and/or delivery persons working with SMS during the tax years in question, both with regard to SMS's corporate policies and the work of telemarketers and delivery persons.

Unlike §530's reasonable basis standard, the reasonable cause test is not liberally construed in favor of the taxpayer.

**End of Text**

**LIST OF RECENT TAX DECISIONS**

Tax decisions received recently by BNA from various courts are listed below with a brief description of their subject matter. Copies can be purchased from BNA PLUS toll-free (800) 452-7773 nationwide; (202) 452-4323 in Washington, D.C.

► *Whitten v. Commissioner*, US TC. No. 19965-94, T.C. Memo. 1995-508, 10/25/95 (on issue of proper characterization of expenses incurred by taxpayer Stanley Whitten in attending and participating in television game show "Wheel of Fortune" the court holds that expenses incurred are at best expenses, deductible as a miscellaneous itemized deduction under Section 67, rather than wagering losses under Section 165(d)).

► *Wolfe v. Commissioner*, US TC. No. 16773-93, T.C. Memo. 1995-509, 10/25/95 (court finds that taxpayers' argument of a loan is not only unsupported by the record, but is clearly contrary to the record, and that IRS' determination with respect to unreported income is sustained).

► *Lauckner v. U.S.*, CA 3, No. 94-5747, 10/23/95 (because IRS' penalty assessment against counterclaim defendant Umberto J. Guido Jr. under Section 6672 was made more than three years after the relevant returns were deemed to have been filed, district court properly held that IRS' assessment was time-barred; court rejects IRS contention that no statute of limitations, including the one contained in Section 6501(a), applies to IRS assessments under Section 6672).

► *Algie v. RC-A Global Communications Inc.*, DC SNY, No. 89 Civ. 3471 (MJL/MHD), 10/12/95 (severance benefits payments that defendant is required to make this year to plaintiffs pursuant to judgment, as a consequence of plaintiff's termination in 1988, are subject to withholding of FICA taxes and Medicare hospitalization insurance tax at the rates and on the basis of formulas provided in the law as currently in effect this year, rather than the rates and formulas in effect in 1988).

► *Cardozo v. U.S.*, DC ECalif, No. CV-F 94-5339 REC, 9/27/95 (action against IRS for negligence, wrongful collection of taxes and punitive damages and against Wells Fargo and Standard Mortgage Co. for breach of contract, breach of fiduciary duty and punitive damages in suit involving four tax liens is concluded as Wells Fargo agrees to provide plaintiff with a check in exchange for a general release; plaintiff claimed that Wells Fargo lost a check which in turn caused him a number of financial problems).

► *Toys "R" Us Inc. v. P.F.S.I. Inc.*, Mass Super Ct, No. 93B-01825, 9/8/95 (IRS may attach funds that Toys "R" Us Inc. admits it owes to taxpayer P.F.S.I. Inc., which acted as Toys "R" Us' agent in obtaining transportation services for Toys "R" Us from independent carriers, notwithstanding

Chairman JOHNSON. Thank you very much, Mr. Gee.

I would like to go back to Ms. Abalos. I was interested in your comments that you said you have read the new training manual.

Ms. ABALOS. Yes.

Chairman JOHNSON. And you believe it to be subjective. Could you enlarge on that?

Ms. ABALOS. The training manual, when you read through it, first, it is 100 pages long, you have a 100-page manual.

Chairman JOHNSON. I thought that was a very good point you made.

Ms. ABALOS. To give some definition to this issue, it expands; it talks to the IRS auditors about looking for elements of behavioral and financial control. But again, it works within the common law factors we have today. It still does not give any kind of a test or a checkoff or specific elements to look for that would say yes, you are an independent contractor, or no, you are not. It is just an accumulation of data, and, again, it is a look at the overall facts and situation, and you look and you make a determination.

But as we all know, that is the difficulty about the 20 common law factors. We may interpret it one way, the Service Center may interpret it another way. Ultimately, it goes to the courts, and we have heard testimony from the other witnesses that the courts have in many instances sided with the small business and that the IRS has been abusive in this determination.

Chairman JOHNSON. As a CPA and one with a master's in accounting, do you think there is a simple test?

Ms. ABALOS. I think the criteria established in H.R. 1972 is a good start and it is a good beginning in the direction that we need to go.

What we are looking for is just something that a small business owner or practitioner can look at and have a reasonable assurance. With the 20 common-law factors we have no clue.

Chairman JOHNSON. Do you think the criteria in H.R. 1972 need to be strengthened?

Ms. ABALOS. Perhaps.

And in response to the question with the airline pilot, he would not be an independent contractor because under his situation he would not have a principal place of business. His principal place of business would be in the airplane itself. That is where he is conducting his service.

Chairman JOHNSON. Under the law, he would not have a principal place of business other than the cockpit?

Ms. ABALOS. That is correct.

Chairman JOHNSON. Thank you.

I will let my colleague pursue that. I am sure that he will want to.

You implied perhaps one way to strengthen the Christensen bill is to use "and" instead of "or." Would it become too cumbersome if we were to do that?

Ms. ABALOS. I think we need to look at the criteria. We are not interested in just throwing something out that lends to a whole other set of difficulties. It does need to be examined. Every little "and" and "or" needs to be thought through and looked at with spe-

cific industries and situations in mind. So, I cannot just say I think "and" should be here instead of "or," but—

Chairman JOHNSON. Anyone on the panel who wants to comment, we do not have clear data on what money we are losing in this area. We do not know whether we are losing money because people are able to duck the system and not pay their taxes or whether we are losing money because as an independent contractor you can deduct costs that the prime employer could not deduct in such great volume, that every independent contractor can deduct overhead and the total amount of deduction is greater than the single employer, whether that is the cause of loss of income.

What would be your evaluation of the tax liability of the independent contractor as opposed to that person's tax contribution? Were they an employee? Are you paying more or less taxes if you are an employer? Are you paying more or less taxes if the same person is an independent contractor? Is there any rule of thumb?

Ms. ABALOS. I have two comments. One I think specific criteria will enhance compliance, and the reason I say that is when you have a ruling or a set of facts that is subjective, then when we do an analysis of those, we tend to lean more toward our—what favors our position. And I think you probably have more people classed as independent contractors that may come under the criteria of an employee if we had clear determination.

And then to a certain degree people are out there playing an audit lottery and then they do not file a 1099 because they perceive that the filing of 1099s is a target or trigger of an investigation or an audit. If you have clear criteria and someone can say, yes, I am, and, no, I am not, and if I am, I had better file 1099s or I do not get to come under this testing criteria. I think you will see better reporting by the small business community with this issue overall.

And to answer your question as to whether somebody pays more or less tax depending on their classification, it depends on what kind of business expenses they are incurring independently. If they are an employee and have unreimbursed business expense, those are often not deductible because they go into miscellaneous itemized deductions and they are phased out and they do not have the same impact as business expenses from a self-employed viewpoint. So, it is—I do not know that I can make a very clear analysis of that. It is just a different treatment of those unreimbursed expenses whether an employee or an independent contractor.

Chairman JOHNSON. Does anyone else on the panel have a comment particularly on the issue of do you pay more or less as an independent contractor? It is very important because if this sort of tax gap, as they call it, is the result of legitimate deductions of independent contractors then government has no right to the money. If the tax gap is the result of evasion then it is a fair share, fair burden issue.

We do not at this point, at least I am not aware at this point, and I will ask the IRS this when they come before us in a couple of weeks that we understand what the tax gap does represent, but it is true that the problem of compliance in the independent contractor sector is a real one. I hear you saying, Ms. Abalos, that you think clear definitions will make it easier for the public to comply, and easier for us to enforce the law.

Ms. ABALOS. That is my opinion, yes.

Chairman JOHNSON. Mr. Barbee.

Mr. BARBEE. One thing that offsets when you are self-employed you pay both sides of your FICA taxes. The only advantage that an independent contractor picks up in some cases is the legitimate expense of them doing business. Go back at least to what it cost them to do their trade or do their work. They do get hit with the double side of the employer-employee FICA taxes so the wash out is about the same.

Chairman JOHNSON. Thank you. Before I yield to Mr. Matsui a number of you are from the cable industry. I was interested in, Mr. Bolt, your testimony that the cable industry has since its inception operated through independent contractors. Is that true?

Mr. BOLT. Yes, that is correct. At least in the interpretation.

Chairman JOHNSON. So, the IRS is imposing this standard. Would it represent a clear break with the past for the entire industry of cable installation?

Mr. BOLT. Yes, I believe so.

Chairman JOHNSON. And why is it important to have your installers be independent? Is there a business reason why it is better if they are independent rather than your employees?

Mr. BOLT. Most of them prefer to be independent. They can change companies that they work for at will. They can go where they want. Since I have been in the business, that is the way I learned it, and everyone that works for me wants to be an independent contractor.

Chairman JOHNSON. Do some of the people who work for you work for other cable companies, too?

Mr. BOLT. Yes, some of them do.

Chairman JOHNSON. Depending on the volume and demand.

Mr. BOLT. That is correct.

Chairman JOHNSON. So, it gives them and you flexibility?

Mr. BOLT. Yes, that is also correct.

Chairman JOHNSON. Thank you.

Mr. Matsui.

Mr. MATSUI. Thank you, Madam Chairman.

Mr. Bolt, I would just like to follow up. I understand that installers for cable companies, there are some ambiguities. And what are they in terms of the company that you work with, what are installers?

Mr. BOLT. They are independent contractors.

Chairman JOHNSON. They are independent contractors at this particular time. And do you know of any case where that might be different in other cable jurisdictions?

Mr. BOLT. The installers that work directly for the cable systems themselves they do have some employee relationships, but all the contracting companies that I work with all use independent contractors.

Mr. MATSUI. Because it would seem to me that there is a lot of ambiguity in this part of the law. What is an employee and the issue of control and independence and all of that. Obviously, it is a major concern of yours as well; is that correct, because you do not want to be hit with a significant liability if all of a sudden

these independent contractors come into question and become, or the service interprets them as employees; is that your concern?

Mr. BOLT. Yes, of course.

Mr. MATSUI. Obviously. That is an area we obviously have to get into and that is an area that is a very difficult one. Everybody is trying to grapple with. Senator Gramm raised the issue of the newspaper delivery boys and right now the issue of distributorships that come into play, as you well know. It is so complex and there is no question that there is a lot of discretion involved in this particular area by the service and obviously Treasury and others as well, so it does have to be further clarified. The issue is how we clarify it.

I was very interested in your comments, Mr. Barbee, because you indicated both here today and in your testimony that you felt it was an issue of enforcement, not to a large extent, not so much an issue of whether legislation is needed. Perhaps you can elaborate on that somewhat because that very likely could be the situation though obviously Treasury and IRS particularly will have to come up with stronger and more accurate regulation.

Mr. BARBEE. I feel that the law works. The law—the section 530 of the law is good, it works. My case proves it. There are a lot of cases out there that prove this issue. The problem is that the Internal Revenue Service snubs their nose at the very people that pass the laws, to the very people that protect us, not take care of us, but protect us. You were elected by the people to protect us.

And then you pass this law. And it is very clear. It says, “liberally construed in favor of the taxpayer,” emphasis added. How much clearer does it need to be? And then we throw in words like, “significant.” What does significant mean?

Now, \$29,000 in legal fees, to me, is a significant number, but in Washington, DC it is not a significant number. Five percent of the Coca-Cola empire is a significant market share dollarwise. But it is a small market share for Coca-Cola. So what does the word, “significant,” mean?

It is almost like normal. What is normal on Broadway is not necessarily normal in Augusta, Georgia. So, we have to watch that. That is what scared me more than anything else. If we start tinkering with the law and adding little fuzzies to it, it is not as clear, but more unfocused.

Mr. MATSUI. I appreciate that comment. You know, I sympathized with Mr. Bolt in what might happen, if you will. All of a sudden the Service goes in and reinterprets that employment relationship or that relationship between the company and also the installer. And it is an issue we have been trying to grapple with for 20 years. I have been here 18 years now.

I remember when Congressman Pickle, who was chair of the Subcommittee in early 1980, had some Committees on this. I was not on the Subcommittee at that time, but the same issues were being raised. The real problem that is being faced today isn't your problem. The real problem is if we pass legislation that is so narrow, all of a sudden it could be abusive and employees could be redefined as independent contractors to lose valuable benefits such as pension benefits, health care benefits, that is what we need to be sure we do not do.

I think, Ms. Abalos, you, in your testimony talked about a horror story where an architect friend of yours working for the same company for 20 years was declared an independent contractor by his employer losing valuable benefits and we do not want to see that situation occur as well. So, we have to be very narrow in how we deal with this issue or very balanced, I should say, as to how we deal with this issue.

I have read Mr. Christensen's bill three times now. I read it last night, this morning, and I read it again because I wanted to be sure of the interpretation. The problem is you talked about the airline pilot. Ms. Abalos, you mentioned it would not happen because the principal place of business problem.

Airline pilots obviously do not provide the service at United Airlines headquarters. They provide it in the air in an air craft. That individual could be interpreted as an independent contractor under this legislation.

What you need to do is you need to read this in the disjunctive not the conjunctive. If you read it in the disjunctive, you will find that all you need to do is satisfy, one of the six or one of the seven. If you read it that way you will find a whole different interpretation.

I assure you that the legislative counsel's office and the courts will interpret it, and I believe that is what the intent of the bill was. The intent of the bill was to make it easier to declare an employee an independent contractor and that is why millions of people could be declared independent contractors.

Frankly, that will save the employer a great deal. The pension benefits, health care benefits, and many things that create insecurity in America today. There is no question that is what this bill does. That is why the NFIB supports this bill. But the fact of the matter is do not mix your problem, which is a legitimate problem, with the problem of this bill because this bill addresses a totally different issue than the issues that you have concerns about.

I think Mr. Bolt, Mr. Barbee, all of you have raised very legitimate concerns, but do not be seduced by this legislation because this legislation will put you in a position where even a reporter can be declared an independent contractor through the interpretation under this bill.

And that is all I would request is that as you pursue this issue, and you legitimately pursue this issue, because it has to be addressed, we do not want to create ambiguities and problems for all of you in the future. Just do not be misled by legislation that might have a different interpretation ultimately than you think it does. Thank you.

Mr. GEE. Madam Chairman, if I could just have one further comment.

Chairman JOHNSON. Yes, Mr. Gee.

Mr. GEE. I think it is important to remember that you have people sitting in front of you who believe the problem is not so much clarification, the problem is we need a change of heart, a change of mind, a change of attitude at the Internal Revenue Service.

I would remind you that my particular case was litigated under sections 3508 and 530, the two laws that the Congress specifically enacted years ago to avoid the very problems we are sitting here

telling you about. You can have a law as clear as spring water in east Tennessee. If you do not have a change in attitude at the national level, at the Internal Revenue Service, none of this is going to work.

Thank you very much.

Chairman JOHNSON. Mr. Gee, we appreciate that, but we wrote as clear a law in 530 as we possibly could, and you heard Congressman Kim's proposals for dealing with that law, for instance, is a significant portion of your work force, 90 percent of your employee work force, 90 percent or should it be 20 percent? Clearly, the IRS is incapable of dealing with defining "significant" fairly. They define it whatever way they want if they need it. That is unfortunately the evidence.

So, we have to do something. This Committee isn't into behavioral modification. We do not have the ability to modify the behavior of the bureaucracy. We do have the ability to change the law. We tried it, and when we passed section 530 we made it absolutely as clear as possible how the law should be construed, and it did not work. You are living proof of it and the continued problems in this area are living proof of it.

Now, I think that while I hear what you are saying, Mr. Barbee, about, "I am evidence that it works." You didn't have to close shop before you could get to the point of going to the court and not everybody has those resources. So, I cannot just assume that because you won in court you are living evidence. Also, I would ask Mr. Gee, with your experience, or any of you, what procedural changes would you make in the existing rules to ensure that taxpayers get a fair shot?

Mr. GEE. Here is what I would do, if I might. I would do one of the things that's been suggested already; that at the agent level that as soon as the issue is raised that you break that out and you get some clarification, opinion, or ruling, or something like that where the taxpayer can put in writing the fact that they meet section 530 or 3508 or whatever the reasons they think they are independent contractors. Then, what I would do is you have that in writing.

Chairman JOHNSON. That is to require the IRS to put in writing why you do not comply?

Mr. GEE. And the taxpayer would put in writing why they thought they did.

Chairman JOHNSON. At the very beginning of the process?

Mr. GEE. At the very beginning as soon as the issue is raised. Then what I would do is if the IRS pursues the case as they did in my case and loses, I would make the IRS pay attorneys' fees from the agent level forward, the CPA fees—

Chairman JOHNSON. Excuse me, I didn't understand the second. The IRS pay the attorneys fees and what?

Mr. GEE. CPA fees from the agent level forward. That will stop egregious abuses of behavior.

Chairman JOHNSON. What do you mean by that, from the agent level forward?

Mr. GEE. I will give you an example. This gentleman over here. I think he said he spent \$29,000 on lawyers' fees or something. My client spent almost \$300,000. He cannot even recover half of those

because you do not get to recover your attorneys' fees until the deficiency notice is issued and that is usually about halfway through the cases, so if the Service knew they were looking at refunding all of your attorneys' fees, not just a fraction, they might have a little different attitude about the hazards of litigation.

Thank you.

Chairman JOHNSON. Thank you, Mr. Barbee.

Mr. BARBEE. I want to say section 530 worked. The process that took place I had to go to work to stop the IRS from seizing the assets from our company. I had to get a Federal judge to issue a temporary restraining order against the Internal Revenue Service to enjoin them collecting the money. Taking the money away from me where I couldn't even fight them. I would not have had a chance at all, and the issue was to get a temporary restraining order to stop collection, which is as strong as a garlic milkshake to do. It is very difficult to do.

The Supreme Court has made that emphasis—a very strong emphasis to do. I had to have a temporary restraining order before it could get the hearing about my case. But it was an over zealous Internal Revenue Service. It was an action on their part, and I felt it was driven from Washington. It was not some renegade out here on a reservation, so to speak, in the country. It was directed strictly or straight out of the halls of Washington. And that is the part. But again, I cannot emphasize enough how clear Congress wrote the law. It is how flagrantly the IRS ignored the law; that is the problem doesn't anyone know how to control the IRS.

Chairman JOHNSON. Part of that would be greater accountability throughout the process.

Mr. BARBEE. That is correct.

Chairman JOHNSON. Producing specific information. It is an outrage that you should get to court and never even in court have gotten sufficient documentation of their case; no testimony and so on. So, that is something we can look at, and the issue of penalties you are raising is a very valid one. We have been joined by my colleague, Mr. Collins. It is a pleasure to have you with us.

Mr. COLLINS. Thank you, Madam Chairman. I just dropped by briefly. Mr. Barbee came by our office early this morning. We were reviewing this particular case.

As we were discussing it, when you get down to simplification, it is much easier for the IRS to focus in on one person for the purpose of collection of revenues than it is to go through the broad range of the independent contractors out there and wait to year-end to collect from them. That is the reason why the IRS objects to the independent contractor law. I think it is a shame.

I think we would have a lot more small jobs, small businesses created if we had a different interpretation by the IRS. It is a hinderance, it is a discouragement, a disincentive to get into business. It's not very profitable to get into business, and have the IRS come in and do as they have done to Mr. Barbee. Hopefully, we will be able to straighten out the language that pertains to independent contractors and maybe when we actually reach down and our Chairman of the main Committee says pull the IRS by the roots, we will get their full attention. There will only be a few over there to audit the amount of money that comes in from the States from

the consumption tax or the flat tax and we will not need quite as many of those people out there intimidating the small business people and small taxpayer of this country.

Thank you, Madam Chairman.

Chairman JOHNSON. Thank you, Congressman Collins. Before I dismiss this panel and invite the next panel to come forward, I do want to clarify an aspect of your testimony, Mr. Kessler. I had asked Mr. Bolt earlier to restate for the record the fact that installers in the cable industry have been treated as independent contractors since the inception of their industry in 1952 or thereabouts. It is interesting that in your first audit in 1989, the IRS treated your employees as independent contractors.

Mr. KESSLER. Yes, they did.

Chairman JOHNSON. Is it your experience that throughout the industry the installers were treated as independent contractors in 1989?

Mr. KESSLER. To the best of my knowledge, yes, especially in the State of New Jersey where we do most of our work. The audit I did have was a general audit. It was not specifically to examine these subcontracting areas so we got a clean bill of health on the normal business procedures that we had in terms of paying our taxes and so forth, but they also ruled on the way we treated subcontractors.

Chairman JOHNSON. You say in your testimony they carefully scrutinized your use of subcontractors.

Mr. KESSLER. Yes, I helped my accountant prepare for the audit, and I pretty well know what they looked at.

Chairman JOHNSON. Six years later in 1995, last year, they came in with a very different idea of what an independent contractor was and who was an employee and who was an independent contractor; is that your testimony?

Mr. KESSLER. Yes, it is ma'am.

Chairman JOHNSON. You also testified there were threats and intimidation. What do you mean by that?

Mr. KESSLER. What I think I mean by that is that when I know I am being offered some sort of deal, they called at the end of May and usually the way it works is they may say if you pay this and comply, we will only charge you this or else we can go back 5, 7 years, whatever the case may be. That is rather intimidating for a company my size. I could end up maybe spending, lets say, \$100,000 in fines, if that is what the deal is. Or, in 7 years I am out of business, I am not anywhere at all.

Chairman JOHNSON. And did they ever in this most recent audit discuss with you the issue of industrywide practice or historic precedent or did you ever raise it with them?

Mr. KESSLER. I think we raised it in our section 530 prior audit. We always thought that a prior audit was a slam dunk. I am pretty sure my accountant brought up industrywide practice in particular in the State of New Jersey.

Chairman JOHNSON. What was IRS' response to the fact that section 530 should clearly have covered you, particularly in light of an earlier audit?

Mr. KESSLER. I do not think they respected what happened in 1989. He seemed to believe that—

Chairman JOHNSON. Did they give any answers when you asked questions?

Mr. KESSLER. I will be honest with you, Madam Chairman, I just helped prepare the audit. I was not there. If you want a statement from someone, I will give it to you.

Chairman JOHNSON. We may pursue that, but I think it is very clear in this instance the IRS is moving against an industry where the precedents are so clear that they should automatically be a section 530 case and that concerns me very much. It concerns me that you have been forced to cover extensive costs. It concerns me, Mr. Bolt, that your company is on the verge of folding as a result of this, and this is an issue that we will pursue.

I thank the panel very much for your testimony today. It is very helpful.

I would like to call forward the next panel: Sam Meek of Talbot County, Maryland; Scott Bryan of Anaheim, California; John Budzinski, Milwaukee, Wisconsin; Raymond Kane, New York, New York; Lauraday Kelley from Harrisburg, Pennsylvania.

Thank you for being with us today.

We will start with Mr. Meek, the superintendent of the Talbot County Schools, Talbot County, Maryland.

Thank you. Nice to have you, Mr. Meek.

**STATEMENT OF J. SAM MEEK, ED.D., SUPERINTENDENT,  
TALBOT COUNTY PUBLIC SCHOOLS, TALBOT COUNTY,  
MARYLAND**

Mr. MEEK. Madam Chairman, Members of the Subcommittee, I appreciate having the opportunity of addressing this Subcommittee. My name is Dr. Sam Meek. I am the superintendent of Talbot County Public Schools. Talbot County is located on the Eastern Shore of Maryland. As superintendent, I am responsible for all of the public elementary, middle and high schools located in Talbot County.

In early 1994, the IRS conducted an employment tax audit of my school system. In particular, the IRS examined the school board's treatment of the school bus contractors who are contracted with us to provide bus transportation to our students.

These bus contractors own their own buses. The contractors may or may not drive their buses. Rather, they are free to hire qualified drivers to drive their buses in the performance of these services. These schoolbus contractors have been treated by the board as independent contractors for employment tax purposes for decades. The board issues 1099s to these contractors reporting the payments made to them, and we transmit the 1099 information to the IRS.

In addition to the contractors, the board employs drivers to drive buses owned by the school system. In general, these buses are for the transportation of students needing special attention, such as handicapped or special education students. These buses which are owned by the school system are specially equipped. The buses which are owned by the contractors are not.

The IRS agent who conducted the audit concluded that the schoolbus contractors should be treated as employees of the school system. Recognizing that we issued 1099s to the contractors, he applied the relief provisions of IRC section 3509. Nevertheless, he de-

veloped a deficiency of about \$160,000 for a 2-year period of time. He also determined that relief under section 530 was not available to us because we employed drivers to drive buses owned by the school system. He did not believe that the differences between a contractor who owns his own bus and who is not required to drive the bus, compared to an employee driver who drives a school system bus, were sufficient to allow for the application of section 530.

We proceeded to take an appeal from the IRS agent's report to the Appeals Office of the IRS. Because of our concern over the potential tax liability that could be developed by the IRS and the potential costs of litigation, we engaged in settlement discussions with the Appeals Office. After the appeals officer determined that there was a significantly high degree of compliance by the contractors in their reporting of the income paid by the school system to them, for which we were given credit for settlement purposes, the tax deficiency was substantially reduced from approximately \$160,000 to \$12,000.

We have submitted a closing agreement to the IRS in which we would agree to pay the \$12,000 deficiency and also agree to start treating the bus contractors as employees starting in September 1997 if no substantial changes are made in the relationship between the board and the contractors in the interim. This was an agreement that was worked out with Appeals over the course of several months. The signed closing agreement is now being held by the Appeals Office, and we expect to receive a fully executed copy of the agreement from the IRS very shortly.

Four other county boards of education within Maryland also have been audited by the IRS and have taken appeals. It remains unclear what will happen with the remaining county boards within the State. While we were hoping that whatever result occurred from the IRS audit would be handled in a uniform manner among all of the boards within the State, the sequential auditing of the school boards followed by the taking of appeals from each audit and the uncertainty of further audits of other boards may result in different treatment by the IRS of otherwise similarly situated boards within Maryland.

This entire process has been extremely time consuming, costly and disconcerting. It has caused a tremendous amount of concern within my school board and the other four boards that have been audited, concern among the taxpayers of each of the affected school boards as well as for the schoolbus contractors not only with the particular boards that have been audited, but throughout the State. In addition, schoolbus contractors located throughout the country are focusing their attention on this situation in Maryland.

Administratively, section 530 was of no relief to us. Even though we dispute the lack of "substantive consistency" because we believe there is a substantial difference in position between contractors who own their own buses and are not required to drive their buses, from school employees who drive school-owned buses, we did not want to face the risks and costs associated with litigating this issue.

Although the settlement negotiated with the Appeals Office was, in certain respects, similar to a settlement that could be achieved under the classification settlement program, the settlement does

have material differences. As I understand it, the classification settlement program requires prospective compliance starting in the next quarter. As a public body, budgeting for school board expenses has to be done several months in advance of the school year. Contracts for schoolbus contractors are entered into prior to the beginning of each school year. A board does not have the flexibility of rearranging its relationship with its contractors during a school year. Rather, a substantial lag time is needed in order to rearrange relationships with contractors to the board. The classification settlement program does not allow for this.

If we are forced to treat the contractors as employees starting in September 1997, this will greatly alter the relationship between the school board and the contractors. Aside from shifting employment tax responsibility from the contractors to the board, there are additional issues that need to be considered, such as the inclusion of contractors within retirement plans, fringe benefits, employee grievance procedures and so forth.

Neither the contractors nor the board want their contractual relationship changed. These are relationships that have been in effect for over 40 years. For this reason, I urge the enactment of legislation that would permit us to continue treating schoolbus contractors having a significant investment in their own buses as independent contractors. Should such legislation not be enacted, we will need to consider our options. Although one option would be to bring the contractors in as employees as required by the IRS, other options would include hiring a large private bus contractor, who may or may not use the buses and services of the existing contractors.

Schoolbus contractors are small businessmen. They want to continue operating as small businessmen. Legislation that would recognize bus contractors as independent contractors, where they have a substantial investment, a written agreement with the school board, and do not perform services on the premises of the board would accomplish this.

The collateral benefits and rights that may be associated with employee reclassification represent substantial additional administrative and financial burdens for all local school boards across the Nation. This is not something that either my board or the contractors in my district want. The IRS should not be in a position to require such a costly rearrangement of business transactions between parties where it is of little or no tax consequence to the IRS.

I thank you for this opportunity to bring this situation to your attention, and I would be pleased to entertain your questions.

[The prepared statement follows:]

STATEMENT OF J. SAM MEEK, Ed.D.,  
SUPERINTENDENT OF SCHOOLS  
TALBOT COUNTY PUBLIC SCHOOLS  
TALBOT COUNTY, MARYLAND

BEFORE THE HOUSE COMMITTEE ON WAYS AND MEANS  
SUBCOMMITTEE ON OVERSIGHT  
JUNE 4, 1996

Chairman Johnson and Ladies and Gentlemen of the Subcommittee:

I appreciate having the opportunity of addressing this Subcommittee. My name is Dr. Sam Meek. I am the Superintendent of Talbot County Public Schools. Talbot County is located on the Eastern Shore of Maryland. As Superintendent, I am responsible for all of the public elementary, middle and high schools located in Talbot County.

In early 1994, the IRS conducted an employment tax audit of my school system. In particular, the IRS examined the school Board's treatment of the school bus contractors who are contracted with to provide bus transportation to our students. These bus contractors own their own buses. The contractors may or may not drive their buses. Rather, they are free to hire qualified drivers to drive their buses in the performance of these services. These school bus contractors have been treated by the Board as independent contractors for employment tax purposes for decades. The Board issues 1099s to these contractors reporting the payments made to them and we transmit the 1099 information to the IRS.

In addition to the contractors, the Board employs drivers to drive buses owned by the school system. In general, these buses are for the transportation of students needing special attention, such as handicapped or special education students. These buses which are owned by the school system are specially equipped. The buses which are owned by the contractors are not.

The IRS agent who conducted the audit concluded that the school bus contractors should be treated as employees of the school system. Recognizing that we issued 1099s to the contractors, he applied the relief provisions of IRC §3509. Nevertheless, he developed a deficiency of about \$160,000 for a two-year period of time. He also determined that relief under Section 530 was not available to us because we employed drivers to drive buses owned by the school system. He did not believe that the differences between a contractor who owns his own bus and who is not required to drive the bus, compared to an employee driver who drives a school system bus, were sufficient to allow for the application of Section 530.

We proceeded to take an appeal from the IRS agent's report to the Appeals Office of the IRS. Because of our concern over the potential tax liability that could be developed by the IRS and the potential costs of litigation, we engaged in settlement discussions with the Appeals Office. After the Appeals Officer determined that there was a significantly high degree of compliance by the Contractors in their reporting of the income paid by the school system to them, for which we were given credit for settlement purposes, the tax deficiency was substantially reduced from approximately \$160,000 to \$12,000. We have submitted a Closing Agreement to the IRS in which we would agree to pay the \$12,000 deficiency and also agree to start treating the bus contractors as employees starting in September 1997 if no substantial changes are made in the relationship between the Board and the Contractors in the interim. This was an agreement that was worked out with Appeals over the course of several months. The signed Closing Agreement is now being held by the Appeals Office and we expect to receive a fully executed copy of the Agreement from the IRS very shortly.

Four other county Boards of Education within Maryland also have been audited by the IRS and have taken appeals. It remains unclear what will happen with the remaining county Boards within the state. While we were hoping that whatever result occurred from the IRS audit would be handled in a uniform manner among all of the Boards within the State, the sequential auditing of the School Boards followed by the taking of appeals from each audit and

the uncertainty of further audits of other Boards, may result in different treatment by the IRS of otherwise similarly situated Boards within Maryland.

This entire process has been extremely time-consuming, costly and disconcerting. It has caused a tremendous amount of concern within my School Board and the other four Boards that have been audited, concern among the taxpayers of each of the affected School Boards as well as for the school bus contractors not only with the particular Boards that have been audited, but throughout the State. In addition, school bus contractors located throughout the country are focusing their attention on this situation in Maryland.

Administratively, Section 530 was of no relief to us. Even though we dispute the lack of "substantive consistency" (because we believe there is a substantial difference in position between contractors who own their own buses and are not required to drive their buses from school employees who drive school-owned buses), we did not want to face the risks and costs associated with litigating this issue.

Although the settlement negotiated with the Appeals Office was, in certain respects, similar to a settlement that could be achieved under the classification settlement program, the settlement does have material differences. As I understand it, the classification settlement program requires prospective compliance starting in the next quarter. As a public body, budgeting for School Board expenses has to be done several months in advance of the school year. Contracts for school bus contractors are entered into prior to the beginning of each school year. A Board does not have the flexibility of rearranging its relationship with its contractors during a school year. Rather, a substantial lag time is needed in order to rearrange relationships with contractors to the Board. The classification settlement program does not allow for this.

If we are forced to start treating the contractors as employees in September 1997, this will greatly alter the relationship between the School Boards and the contractors. Aside from shifting employment tax responsibilities from the contractors to the Board, there are additional issues that need to be considered such as inclusion of the contractors within retirement plans, fringe benefits, employee grievance procedures, etc. Neither the contractors nor the School Boards want their contractual relationship to be changed. These are relationships that have been in effect for over forty years.

We do not want to alter the long established relationship between the school system and the contractors. For this reason, I would urge the enactment of legislation that would permit us to continue treating school bus contractors, having a significant investment in their school buses, as independent contractors. Should such legislation not be enacted, we will need to consider our options. Although one option could be to bring the contractors in as employees as required by the IRS, other options would include hiring a large private school bus contractor who may or may not use the buses and services of the existing contractors. The potential loss that may be suffered by the existing contractors if this occurs represents a substantial risk now being faced by the existing contractors. This alone is a factor pointing to the magnitude of the investment maintained by the contractors in their buses that distinguishes them from mere employees.

The school bus contractors are small businessmen. They want to continue operating as small businessmen. Legislation that would recognize contractors as independent contractors where they maintain a substantial investment in assets, have a written agreement with the School Board and do not perform services on the premises of the service recipient would accomplish this.

Through the Appeals process and the negotiation of the Closing Agreement, it was determined that compliance by the Contractors in reporting payments made to them on their tax returns has been very high, ranging from about 85% to 100% among the five boards that have taken appeals. Other measures can also be considered so as to ensure a continued high level of reporting compliance by all of the contractors. For example, requiring the service recipient to obtain a Fact of Filing Authorization from contractors pursuant to which the service recipient

would be permitted to confirm that a tax return was filed with the IRS would achieve this purpose.

From the IRS' perspective, an insubstantial amount of additional revenue will be raised as a result of these audits. Prospectively, requiring employee treatment has a potential to significantly alter the relationship between the school system and the contractors. The additional costs associated with this are not revenue raisers for the IRS. Rather, the collateral benefits and rights that may be associated with employee reclassification represent potential substantial additional administrative and financial burdens for the School Board that may be the result of this rearrangement. This is not something that either the Board or the Contractors want. The IRS should not be in a position to require such a costly rearrangement of business transactions between parties where it is of no, or of relatively de minimus tax consequence to the IRS.

Thank you very much.

Chairman JOHNSON. Thank you very much.  
Mr. Bryan.

**STATEMENT OF SCOTT BRYAN, PRESIDENT, PACIFIC  
DECORATING CENTERS, ANAHEIM, CALIFORNIA**

Mr. BRYAN. Madam Chairman, my name is Scott Bryan. I am president of the Pacific Decorating Centers, a retail business with two locations in Orange County, California.

It is common knowledge that the floor covering industry has been a target of limited IRS employment audits, and, frankly, these audits are not pleasant experiences. I would like to tell you about my own experience.

In 1988, as an immediate past president of our trade association, I volunteered, as an industry expert, to assist an IRS employment tax specialist working on a project in the State of California to determine what common worker classification practices were being used in our industry regarding installation.

Because the California EDD, Employment Development Department, had been treating unlicensed installers as statutory employees for State taxing purposes, there was enormous concern that the disparate treatment of these individuals would cause us to become targets for IRS employment tax audits. I shared with the IRS specialist at that time my method of managing this issue and was encouraged to find that my business system of contracts and consistent approach was likely to place me in a very defensive position if, and when, an audit of my business occurred. In retrospect, I was naive in my assumption about this defensible position.

In January 1994, I was notified by the IRS that a full employment audit would be conducted for tax year 1992. We submitted documentation to support our position that State law created this disparate treatment of installers for State and Federal tax treatment. In the alternative, we also submitted a brief to support relief under section 530.

The result, in December 1994, Christmas never came. Instead, \$447,000 of independent contractor payments on our 1992 forms 1099 were reclassified, leaving us with an approximate \$80,000 tax liability.

If this formula were applied to the 3 years of operations which the Internal Revenue Code permits, our total tax liability would have been over \$200,000, at that time almost two-thirds of my net worth.

We immediately filed a letter challenging the IRS action, and we received no response to our challenge, but 8 months later, in August 1995, a new IRS agent requested a meeting. I was advised that a second investigation of the same audit period was warranted to review potential problems with the initial findings.

Again, a field survey of our installers was conducted, and at that time I refused to go along with an IRS request to sign a consent to extend time for their audit. I made the argument that from that point on, an additional 8 months should be sufficient for the IRS to come to a conclusion. Meanwhile, I continued to maintain no workers were misclassified.

I should not have to tell this Committee that having this open-ended audit liability created a negative climate for me to conduct

my business, and certainly put a pall on any future business expansion plans.

The IRS examiner called me in December 1995, again requesting me to sign a consent to extend time and telling me my failure to do so would force the Agency to act summarily and in all likelihood to my detriment. I relented and signed a consent, on the condition that I have the opportunity to meet with the agent's supervisor before any final judgment would be made.

In February, 1996, the auditor and supervisor visited my office. I was presented with a newly calculated amount for the individuals IRS claimed were misclassified for 1992, which was now \$390,000, and the approximate tax liability had been reduced to around \$42,000. I advised I would still not accept the findings and would appeal. They said it would be 4 to 6 weeks before I would receive their formal assessment, at which time I would be given my appeal rights.

Sometime in April, 1996, I received a call from the IRS examiner requesting a meeting to explain a new classification settlement program. Based on the new program, I received a letter reducing the misclassification payments for 1992 to \$246,000, and assessment of \$10,004. The IRS would also agree not to seek further taxes for 1993 through the current 1996 quarter, so long as I reclassified any unlicensed installers as employees for the future.

After conferring with counsel, I notified the IRS that I would accept the offer, thus ending what I will charitably call a difficult and anxious time for me.

No taxpayer should be put through the ordeal I just experienced. In truth, if I had deep pockets and unlimited patience, I would have taken my case through the appeal process. But, after all, I am just one small business man and simply cannot afford the time nor the continued expense to fight for a principle. My legal and financial costs and personal time spent in this matter far exceeds the IRS' settlement offer. For that matter, the settlement amount in all likelihood exceeds the government's cost in pursuing the matter.

It is time for Congress to resolve the problems surrounding business' use of independent contractors. H.R. 1972 is a good start. Instead of a myriad of subjective judgments, both the private sector and the IRS would benefit from a more objective standard.

In my case, reflect on how different agents kept coming up with different audit amounts. How just could that system be? As long as you allow it to continue, this issue will be the number one complaint of small business in America. For these reasons we urge support of H.R. 1972. Thank you very much.

[The prepared statement follows:]

**STATEMENT OF SCOTT BRYAN  
OF PACIFIC DECORATING CENTERS**

Mr. Chairman:

I am Scott Bryan, President of Pacific Decorating Centers, a retail business with two locations in Orange County, California.

I appear today on behalf of the World Floor Covering Association ("WFCA"), which is the largest trade association representing retail floor specialty firms in America. I am a past President and current member of the Board of WFCA.

I welcome this opportunity to come before the Committee to present the views of the WFCA on a public policy issue that our members consider their number one priority.

Among our member firms, an overwhelming number rely on independent contractors to install floorcovering products sold in our members' stores. This has been an industry practice for as long as there has been an industry. Indeed, during the original debate over Section 530, our industry was active in the campaign to recognize such industry practices.

It is common knowledge that our industry has been a target of limited IRS "employment" audits, and, frankly, these audits are not pleasant experiences. They are made worse because the classification issue is an area of the law that is very subjective and where back tax liabilities and penalties can be overwhelming.

Independent contractors play a crucial role in the American entrepreneurial system. Having acknowledged the legitimacy of the independent contractor role in the U.S. economy and specifically in our floorcovering businesses, we will be the first to condemn the tax evasion among independent contractors, which the IRS has documented. Further, to the extent individuals are misclassified as independent contractors, we deplore the lessening of their rightful employee benefits.

The challenge is to produce a workable formula to assure the payment of Federal tax to the U.S. Treasury, to protect the rightful employee benefits of employees, and to ensure the opportunity for businesses to have independent contractor services available.

Let those of us who play by the rules have the peace of mind and the certainty that we are not at risk when the IRS agent walks through our doors. We deserve no less than that.

Let me tell you about my own experiences, and, then, I think you will understand why I am here today to advocate meaningful reform.

In 1988, I volunteered as an "industry" expert to assist an IRS employment tax specialist working on a project in the state of California to determine what common worker classification practices were being used in our industry regarding installation.

Because the California Employment Development Department had begun treating unlicensed installers as "statutory employees" for state tax purposes, there was enormous concern that disparate treatment of these individuals would become a target for IRS employment tax audits. Accordingly, I participated in a number of industry panels and shared with the IRS specialist my method of managing this issue and was encouraged to find that my business system of contracts and consistent approach was likely to place me in a very defensible position if, and when, an audit of my business occurred.

In retrospect, I was naive. The first challenge to my business practice was an IRS unilateral assessment in 1992 for additional 1989 taxes because the wages being reported to the state of California were higher than those reported to the IRS.

I successfully explained how workers could hold independent contractor status for Federal reporting, but because of state fiat we were required to withhold income taxes if these individuals did not possess a valid State Contractor License. I did prevail in this dispute, citing a joint IRS and Employment Development Department letter in which the agencies conceded that "a worker may be an employee for state employment tax purposes, but not for federal employment tax purposes and vice versa. (November 1990 letter signed by the Director of the California Employment Development Department and the Regional Commissioner of the Internal Revenue Service.)

In January 1994, I was notified by the IRS that an employment audit would be conducted for 1992. At the first conference with the IRS auditor I took the position that our procedures were based upon the professional advice of legal counsel and accountants, and that I had reviewed our procedures with an IRS agent at an earlier time. Following a field survey of our installers by the IRS, the agency formally notified me of an audit in September and requested all employment records, billings, contracts, state and federal tax filings, etc.

We submitted documentation to buttress our position that state law created the disparate treatment of installers for state and federal tax treatment. In the alternative, we submitted a brief to support relief under Section 530.

In December 1994, Christmas never came. Instead, \$447,614 of independent contractor payments on our 1992 Forms 1099 were reclassified, leaving us with an \$80,000 tax liability. If this formula were applied to three years of operations, which the Internal Revenue Code permits, the total tax liability would have been \$200,000 or two-thirds of our net worth.

We immediately filed a letter challenging the IRS action. We received no response to our letter, but eight months later in August 1995, a new IRS agent requested a meeting. I was advised that a second investigation of the same audit period was warranted to review potential problems with the initial findings. Again, a field survey of our installers was conducted. I refused to go along with an IRS request to sign a "Consent to Extend Time" for their audit. I made the argument that eight months should be sufficient for the IRS to come to a conclusion. Meanwhile, I maintained that no workers were misclassified. I don't have to remind this Committee that having this open-ended audit liability created a negative climate for me to conduct business, and certainly put a pall on any future business expansion plans.

The IRS examiner called me in December 1995, again requesting me to sign a "Consent to Extend Time," and telling me my failure to do so, would force the agency to act summarily, and in all likelihood to my detriment. I relented and signed the Consent on the condition that I have the opportunity to meet with the agent's supervisor.

When the agent called on me again in February 1996, he came without a supervisor, which was a condition for my continued cooperation. Later that month, we did have a meeting with the IRS examiner and his Audit Supervisor in our offices. I was presented with a newly calculated amount for the individuals the IRS claimed were misclassified, which was now \$390,865. The approximate tax liability had been reduced to approximately \$40,000. I advised them I would not accept the findings, and would appeal. They advised that it would be 4-6 weeks before I would receive their formal assessment, at which time I would be advised of my appeal rights.

Sometime in April, I received a call from the IRS examiner requesting a meeting to explain a new classification settlement program. Later that month, I received a letter reducing the misclassification payments for 1992 to \$246,483 and an assessment of \$10,004. The IRS would also agree not to seek further taxes for 1993 through the current 1996 quarter, so long as I reclassified any unlicensed installers as employees in the future.

After conferring with counsel, I notified the IRS that I would accept the offer, thus ending what I will charitably call a difficult and anxious time for me.

Members of the Committee. No taxpayer should be put through the ordeal that I have just experienced. In truth, if I had a deep pocket and unlimited patience, I would have taken my case through the appeal process. But, after all, I am a retailer and simply cannot afford the time nor the continued expense to fight for a principle. My legal costs and the financial costs of my personal time spent in this matter far exceed the IRS settlement offer. For that matter, the settlement amount, in all likelihood, exceeds the government's costs in pursuing the matter.

I believe my own experience reflects the industry experience. There really is no such thing as running a business by a textbook. Business life is full of gray areas. To survive, one has to adjust to realities in the market place. For example, personal security is a consideration if you are dealing with a service provided in the consumer's home. This was not the case a

decade ago. It is important to provide some assurance to the consumer through identification, such as uniforms. Yet, providing such identification is frequently a factor cited in audits in our industry.

The result, in the case of compliance with the so-called 20-point common law test, is that no business can meet all 20 points. And while everyone acknowledges that we are not expected to, there is no real way for the IRS, or us, to figure out which points are the most important, and which are the most relevant to a given situation. It is frustrating for both us and the IRS. In many cases, the 20-point common law test actually requires me to "prove the negative," that is, that I do not control the individual, I do not have the right to fire, and so forth. From the IRS perspective, they are forced to focus on the "tangible" evidence of an employee relationship, although that evidence is hardly a significant indicia of independence.

That is why our organization supports the legislation, H.R. 1972, introduced by Representative Jon Christensen. Its sets forth a simple, three-part test. Instead of "proving the negative," the bill allows me to present affirming evidence to demonstrate the relationship is truly one in which the service provider is an independent contractor.

While I am certain the committee is familiar with it, the key provisions are as follows.

Under part one, the independent contractor must meet just *one* of the following criteria:

1. Have a significant investment in assets and/or training;
2. Incur significant unreimbursed expenses;
3. Agree to work for a specific time or complete a specific result, and is liable for damages for failure to perform;
4. Be paid on a commission basis; or
5. Purchase a product for resale.

Under part two, the independent contractor must meet just *one* of the following:

1. Have a principal place of business;
2. Does not primarily provide the service in the service recipient's place of business;
3. Pay a fair market rent for use of the service recipient's place of business; or
4. Is not required to perform service exclusively for the service recipient and a) has performed a significant amount of service for other persons; b) has offered to perform service for other persons through advertising individual written or oral solicitations such as listing with registries, agencies, brokers, and other persons in the business of providing referrals to other service recipients; or c) provides service under a business name which is registered with or for which a license has been obtained from an appropriate jurisdiction.

Under part three, there must be a written agreement between the parties.

I would also like to address the issue of why Section 530 has not been particularly helpful in our industry. As the Committee knows, Section 530 was a temporary solution. As such, no one anticipated it would have to withstand the test of time.

If there was ever an industry in which the practice of using independent contractors was a long-standing practice of a significant segment of the industry, you would think it would be ours. But yet, we debate this in every audit. What constitutes a significant segment? How do you prove it? There are no bright lines. And, when we ask how to exercise our Section 530 rights, we usually get shrugs from the IRS.

Section 530 has two consistency requirements - that the individual must have never been an employee, and that none of the individuals have performed similar work as employees since 1978. There is no rational reason to maintain these permanent consistency requirements. It is a difficult threshold to meet on a permanent basis, and just as many cases fail on the consistency test as on the substantive industry practice test.

It is time for Congress to resolve the problem surrounding business' use of independent contractors. H.R. 1972, if enacted, would eliminate the problem for my industry. It will clearly level the competitive playing field so that well-run businesses trying to pay their fair share of taxes will not be discriminated against by attempting to meet higher compliance levels than those who operate on the fringe with relatively little fear of a compliance audit. Instead of a myriad of subjective judgments, both the private sector and the IRS would benefit from a more objective standard as in H.R. 1972. Just reflect on how different agents came up with different amounts in my case over the two years that the IRS audited my business. As long as you allow that present system to exist, it will continue to be the number one complaint of small business in America.

I hope you will take the action necessary to correct a problem that has festered for too long. For all these reasons, we urge your support of H.R. 1972.

Chairman JOHNSON. Thank you, Mr. Bryan.  
Mr. Budzinski.

**STATEMENT OF JOHN BUDZINSKI, BUSINESS MANAGER,  
STEAMFITTERS UNION LOCAL 601, MILWAUKEE, WISCONSIN**

Mr. BUDZINSKI. Thank you, Chairwoman Johnson and Members of the Subcommittee. My name is John Budzinski. I am the business manager of Steamfitters Local 601 in Milwaukee, and I am a member of the United Association of Plumbers and Steamfitters of the United States and Canada.

I am not experienced at doing this, and those people that had more experience told me that I should not read my notes to you, but I should talk to you, so I am going to try to do that and do it as briefly as I can.

I have been the business manager in Milwaukee for the last 15 years. My primary mission as business manager is to supply a work force to our contractors that will help them to build the homes, the schools, the pipelines, industry, powerhouses in the city of Milwaukee, the State of Wisconsin, and throughout the Nation.

With that, you might expect I come here to talk to you primarily about the impact of H.R. 1972 on my members, but I am not here to do that. You have written testimony from Bob Georgine, who is more of an expert at those concerns than I am. What I wanted to talk to you about primarily is the impact on my small contractors that this legislation may have.

Along with me, I have senior counsel for the Mechanical Contractors Association of America. They have management, in cooperation with senior counsel John McNerry, who sits on the board of the largest mechanical contractors association in the country, whose primary objective has been to amend or exempt our industry from this legislation.

When I first saw H.R. 1972, I was very pleased to hear that we had some legislation that was going to simplify taxes for all of our contractors and make their life easier, because it is our lifeblood; that is, the contractor. He needs to be a profitable, successful entrepreneur so he can afford to have a skilled work force that works for him. But as we looked further into this legislation, we had some grave concerns.

As you may or may not know, as a skilled tradesman, we must serve apprenticeship of 5 years or in excess of that with continuing education thereafter. It is not unusual for one of our craftsmen to work for more than one employer in any given year. By and large, it is unusual that we work for one employer for more than a year at a time.

Third, it is not unusual for our skilled craftsmen to have a large investment in tools, anywhere from \$2,000 up to \$40,000, or \$50,000, depending on the part of the industry they participate in. All of these would make our skilled craftsmen qualify as independent contractors.

As you may or may not know, the contractors that belong to the MCAA participate in what is called a multiemployer environment. It is because of employment in that environment, that the for education, health care and pension are restricted.

As a regent of the University of Wisconsin, appointed by Governor Thompson, and a member of the board of directors of Vocational Systems in Wisconsin, the cost of obtaining an education is very crucial to me.

Throughout our industry, apprenticeship has been a key in continuing education. Those dollars that are used for funding that education come under what is known as Taft-Hartley or ERISA funds, which allow only contributions for employees who could not be accepted on behalf of contractors. This legislation as designed would disallow those contributions, and would stop that educational flow.

Second and third, and as important, the health care system that has been developed by our industry through contractors and labor cooperation has done what the government is talking about doing today. It has provided health care, regardless of employer, regardless of length of employment, and regardless of location of that employee.

Today, the United Association, across the country through these funds, has established over 400 campuses throughout the country to educate our members, training over 250,000 skilled craftsmen. Again, with the contractors' involvement, we are able to provide health care and pension benefits for hundreds of thousands of members throughout this industry.

For this legislation to pass, and for these funds to be eliminated would cause the government to have to educate the skilled craftspeople that are being skilled by private industry, today and which costs the government and the taxpayers absolutely not one penny. Also we would have to look at how we revamp our health care for these people.

With these concerns in mind, I would ask you to respectfully look at this amendment, with the intent which we believe is great and good. But it is very important, we believe, for members of the construction industry to be exempt from this H.R. 1972.

I want to thank you for your attention and time on this serious manner.

Thank you.

[The prepared statement follows:]



United Association of Journeymen and Apprentices of the  
Plumbing and Pipe Fitting Industry of the United States and Canada

LOCAL NO. 601 STREET ADDRESS 3300 S. 103RD STREET  
MILWAUKEE, WI 53227 PHONE: (414) 543-0601  
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DATE 6/3/96

STATEMENT OF  
JOHN BUDZINSKI  
BUSINESS MANAGER  
STEAMFITTERS LOCAL 601  
Milwaukee, Wisconsin

on behalf of the United Association of Journeymen and Apprentices  
of the Plumbing and Pipefitting Industry of the  
United States and Canada

Before the Ways and Means Oversight Subcommittee  
The Honorable Nancy Johnson, Chair  
United States House of Representatives

June 4, 1996

To the Honorable Nancy Johnson and Members of the Subcommittee:

Thank you for the opportunity to share serious concerns about the impact of HR 1972.

For almost fifteen years as a business representative of Steamfitters Local 601 in Milwaukee, Wisconsin, it has been my responsibility to work in partnership with business. Our mission is to train and develop the skilled work force necessary to build homes, churches, schools, manufacturing plants, and breweries in and for Milwaukee, Wisconsin and the nation.

Through my work on various international labor/management committees and my service as a member of the University of Wisconsin Board of Regents and member of the State Vocational, Technical and Adult Education Board appointed by Governor Thompson, I can tell you that the experiences I relate to you are important to my colleagues and businesses throughout Wisconsin.

You might expect, as the Business Manager of Steamfitters Local 601, that I would talk with you about the tragic impact of this legislation on the members of the building and construction trades industry, particularly the Steamfitters in Milwaukee. I understand and fully realize how serious this impact will be on the working men and women of the organized trade labor movement. However, there are others who will most appropriately give this testimony.

Instead, it is most important that I share some special insights with you that are based on my experiences in working with the small businesses this legislation seeks to help. It is critical you understand how these small businesses will be affected. It is also critical that you understand how it is possible this legislation will put them out of business. I want to tell you this because this nation as well as members of Steamfitters Local 601 need small businesses to be strong - particularly small construction contractors.

If there is a fact of life that my members and I understand, it is that contractors need to be successful, and if they are to be successful, they must have an efficient, productive work force so they will be profitable. That is why when I first heard that the passage of HR 1972 would result in tax simplification and the reduction of red tape, I was very pleased.

Unfortunately, while this bill as written may have been developed with the strong desire to strengthen the nation by helping business thrive, it will cause havoc with the construction contractors. It is the small contractor who employs a majority of our work force about which we are most concerned. We need these contractors to be strong.

As our members know, the contractor must be profitable to be successful. The contractors and our members in partnership, know that a well trained skilled work force is the lifeblood of our industry. The skilled crafts person is an essential part of the product, service, and profit of the successful contractor.

This legislation destroys the basic structure of apprenticeship training and continued education that has established our skilled work force. This will greatly harm our nation's productivity as well as waste the substantial educational investment contractors have made.

The destruction is brought about because this legislation requires that any employee who receives substantial training from an employer evolves into an independent contractor. Once an employee has been reclassified by this legislation as an independent contractor, there is no reason for business to make

investments in education in its work force. Also, whatever investment has been made in employees is lost.

As you may know, these contributions are made in a multi-employer environment. The mechanism for receiving the employer contributions to these trust funds on behalf of the employees was created by congress through the Taft-Hartley and ERISA. These laws specifically prohibit any contribution of funds unless made only on behalf of an employee. Clearly, the funding for apprenticeship and continued education by contractors will be stopped by force of law and common sense.

**Another tragic result is that at a time when there is an increasing shortage of skilled workers, this nation will see its skilled trades resource decimated.**

Currently, businesses and skilled trade union organizations work together to initially train and continually educate tens of thousands of skilled workers. The United Association alone has the largest vocational system in the country. The approximately 400 campuses throughout the United States educates and trains over a quarter of a million skilled crafts people. This education does not cost the taxpayers one penny. The mechanical contractors in Milwaukee alone invest over one million dollars a year for apprenticeships and employee training in this effort. Should this legislation pass as is, there would be no incentive or inducement to continue this outstanding program. People would simply lose out. This country would lose out.

If this nation does not want to lose its leadership in productivity with the rest of the world, millions of additional tax dollars will be needed to replace the training programs now paid for by these labor/management partnerships. Simply stated, should this bill pass, hundreds of millions of dollars of education and apprenticeship training opportunities now privately paid for will be lost. As a nation competing in a world-wide market there is no justification for destroying one of the great vocational training mechanisms without a suitable alternative.

**To pass this bill unamended is to destroy the health insurance and pension trust funds established by business contributions for millions of Americans. These trust funds have proven one of the most cost effective mechanisms for the delivery of health care and pension programs to the worker and his/her family regardless of employer, length of employment, or job location.**

As you know, under the Management Relations Act, also known as the Taft-Hartley Act, employers make contributions to employee trust funds. Under the law, these contributions have to be made for the sole and exclusive benefit of "employees", their families and dependents. Because contributions to such multi-employer trust funds can be made only on behalf of "employees", it would be unlawful for the trustees of these funds to accept contributions on behalf of individuals who are considered to be "independent contractors".

Also, under the Employee Retirement Income Security Act of 1974 (ERISA), plan fiduciaries must discharge their duties with respect to a plan solely in the interest of participants and beneficiaries for the exclusive purpose of providing benefits to participants and beneficiaries.

A "participant" under ERISA is any "employee" or former "employee" of an employer who is or may become eligible to receive a benefit of any type from an employee benefit plan. Because the health and pension programs under Taft-Hartley and ERISA would be destroyed, not only would the contractors suffer from the loss, but millions of Americans would lose their health care and pension programs. This nation has spent significant resources attempting to develop health care plans that protect the workers and their families regardless of place of employment. I do not understand the wisdom of this destruction. My only guess is that it is an unintended, unanticipated result of an attempt to help small business.

This issue is so important that the Mechanical Contractors Association of America, the largest mechanical contractor's association in the United States representing approximately 1,800 contractors, has deemed the defeat of this legislation as its #1 legislative priority.

On behalf of small business contractors and hundreds of thousands of skilled crafts people and their families, I urgently and respectfully request that an amendment be adopted exempting the construction industry from this legislation.

I thank you for your dedicated attention to this most serious matter.

Chairman JOHNSON. Thank you very much, Mr. Budzinski. You pointed out some impacts that we would share your concern about. We will look at that very carefully.

Mr. Kane.

**STATEMENT OF RAYMOND PETER KANE, PRESIDENT, PISA BROTHERS TRAVEL SERVICE, NEW YORK, NEW YORK**

Mr. KANE. Madam Chairman, it is an honor and a privilege for me to appear before the House Ways and Means Subcommittee on Oversight today. I applaud the Subcommittee's efforts for holding this hearing, and I ask that my full statement be made part of the Subcommittee hearing record.

I am pleased to have the opportunity to comment on the independent contractor issue and the two bills before the Subcommittee. This legislation would have a positive impact on the thousands of travel agency owners across this country.

My name is Raymond Peter Kane. The name of my travel agency is Pisa Brothers Travel Service, which is located in New York City and was founded in 1924. I have owned and managed the agency since 1962. I also come before the Subcommittee today as a long-standing member of ASTA, American Society of Travel Agents. ASTA is the world's largest and most influential travel trade association with over 28,000 members—

Chairman JOHNSON. Excuse me. It would be helpful if you could pull your microphone slightly closer.

Mr. KANE. ASTA is the world's largest and most influential trade association, with over 28,000 members in 168 countries.

Our members in the United States represent some 13,000 travel agency locations. Sixty percent of the agencies are owned by women, many of whom started as independent contractors, which enabled them to have their own businesses and accumulate the capital necessary to own an appointed travel agency. Eighty percent of travel agency employees are women. Ninety percent of our members employ less than 10 people.

A majority of the travel agencies in the United States utilize the services of independent contractors. Over the years, agents have received mixed decisions from Federal and State tax auditors as to the status of their independent contractors. Since we are clearly small business men and women, we have had little or no recourse to challenge those audits.

In the seventies, in accordance with a widespread industry practice, Pisa Brothers began renting space to independent contractors in exchange for a percentage of the commissions that they earned from the travel bookings of their clients. This enabled these entrepreneurs to set themselves up in business without a large capital investment and enhance the earnings of my travel agency. During all of this time, we have scrupulously issued 1099s, reporting all income of the independent contractors to the Internal Revenue Service, and have abided by every one of the 20 guidelines that the IRS issued.

Pisa Brothers offers three different contracts to independent contractors. They are as follows: One, if a contractor wants Pisa Brothers to book and process reservations for the contractor's clients,

Pisa Brothers charges 70 percent of the commissions earned by those transactions.

Two, if a contractor wants to make reservations for his or her own clients and have Pisa Brothers process the reservations, then Pisa Brothers charges 50 percent of the commissions earned by those transactions.

Three, if a contractor wants to rent a desk on Pisa Brothers premises, book and process his or her own client reservations, then Pisa Brothers charges either 40, 35, or 30 percent of the commissions earned by those transactions, depending on volume.

In August 1991, I received a notice from the IRS that they wanted to conduct an income tax audit for the fiscal year 1989. This audit took place over a period of several months and resulted in a finding on February 18, 1992, of no change, which, as you know, means that the auditor found nothing wrong.

During this 6 months that the IRS auditor was in my office, the contracts between my agency and independent contractors were carefully scrutinized and found to be in compliance with the IRS regulations regarding independent contractors as indicated by the no change finding.

Two years later, with no change in the IRS rules and no change in my contracts with the independent contractors, the IRS has decided that these same independent contractors were not independent contractors all along and were always employees. For the years 1992, 1993, and 1994, the IRS is demanding \$274,000 in taxes and penalties.

IRS denied the section 530 coverage because they said I did not meet the consistency requirement. The IRS chose to ignore the fact that the house agents handled only house accounts, and independent contractors handled only their own accounts.

In other industries they have recognized that people with the same titles can perform completely different duties and can be independent contractors, but in the travel industry, in my case, they are choosing to completely ignore this by stating that all travel agents must be employees. How can you defend yourself against actions like this when the findings of the IRS on such an important matter can vary from one individual IRS agent to another?

In my industry, independent contractors are the most productive people. They are typical of small business people who will go to any lengths to satisfy their customers to build their following because this is their livelihood. Actually, the IRS probably collects more tax revenue due to the existence of these private contractors than if the same people were regular employees doing a routine job without the incentives that come from private ownership of their own business.

There is also a moral question here. These people have the right to be independent contractors. The IRS wants to deny them this right, not because they are not paying their taxes, but because it is easier for the IRS to monitor their payments as employees. If the IRS has a compliance problem collecting taxes from independent contractors, it should deal with this problem on its own merits and not try to change it to a classification problem in order to deny these people their right to be entrepreneurs simply for the convenience of the Internal Revenue Service.

In light of the recent actions taken by the major air carriers to cap travel agent commissions, this effort to simplify the definition of an independent contractor will be vital to us as more and more travel agencies look toward independent contractors to develop additional sources of revenue.

In conclusion, I hope you will support Congressman Christensen's bill, H.R. 1972. In my opinion, it is drafted in such a way as to provide the best protection for independent contractors. It clearly states the criteria that must be met to be classified as an independent contractor. This is so important if we are to remove the current confusion in the marketplace.

Thank you. I would be delighted to answer any questions you or the Subcommittee Members may have at this time.

[The prepared statement follows:]

**STATEMENT OF  
RAYMOND PETER KANE  
OF PISA BROTHERS TRAVEL SERVICE**

Madam Chairman, it is an honor and a privilege for me to appear before the House Ways and Means Subcommittee on Oversight today. I applaud the subcommittee's efforts for holding this hearing and ask that my full statement be made part of the committee hearing record. I am pleased to have the opportunity to comment on the independent contractor issue and the two bills before the Subcommittee. This legislation would have a positive impact on the thousands of travel agency owners across this country.

My name is Raymond Peter Kane. The name of my travel agency is Pisa Brothers Travel Service which is located in New York City and was founded in 1924. I have owned and managed the agency since 1962. I also come before the Subcommittee today as a long-standing member of the American Society of Travel Agents (ASTA).

ASTA is the world's largest and most influential travel trade association with over 28,000 members in 168 countries. Our members in the U.S. represent some 13,000 travel agency locations. Sixty percent of the agencies are owned by women, many of whom started as independent contractors which enabled them to have their own businesses and accumulate the capital necessary to own an appointed travel agency. Eighty percent of travel agency employees are women. Ninety percent of our members employ ten or less people. A majority of the travel agencies in the United States utilize the services of independent contractors. Over the years, agents have received mixed decisions from federal and state tax auditors as to the status of their independent contractors. Since we are clearly small businessmen and women, we have had little or no recourse to challenge those audits.

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The IRS denied the Section 530 coverage because I did not meet the consistency requirement. The IRS chose to ignore the fact that the house agents handle only house accounts and independent contractors handle only their own accounts. In other industries they have recognized that people with the same titles can perform completely different duties and can be independent contractors, but in the travel industry, in my case, they are choosing to completely ignore this by stating that all travel agents must be employees.

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Thank you. I would be delighted to answer any questions you or the Subcommittee members may have at this time.

Chairman JOHNSON. Thank you, Mr. Kane, for your testimony.  
Ms. Kelley.

**STATEMENT OF LAURADAY KELLEY, PRESIDENT,  
ASSOCIATION OF RETAIL TRAVEL AGENTS, AND VICE  
CHAIRMAN, COALITION FOR TRAVEL INDUSTRY PROFIT-  
ABILITY, HARRISBURG, PENNSYLVANIA**

Ms. KELLEY. Thank you, Madam Chairman. Thank you Members of the Subcommittee.

On behalf of the Nation's travel agents, travel agencies, and all other service providers and recipients in the travel industry, I appreciate the opportunity to appear before you today to testify on the issue of IRS treatment of independent contractors. I ask that my full statement be made part of the Subcommittee hearing record.

My name is Lauraday Kelley and I am vice chairman of the Coalition of Travel Industry Profitability and president of ARTA, the Association of Retail Travel Agents. The Coalition for Travel Industry Profitability is a proactive travel industry group that was formed in January 1995 by 23 major travel cooperatives representing over 23,000 travel agencies and their agents, a significant percentage of whom are independent contractors.

ARTA, which is part of CTIP, represents 3,500 travel agents around the United States. I am delighted to appear today with some of my industry colleagues to share our views with Congress on why we must work together to protect the rights of the independent contractors, as well as the rights of the service recipients.

Madam Chairman, I can tell you and the other Members of the Subcommittee that without a doubt, the issue of the IRS treatment of independent contractors is one of the most important issues affecting our industry today.

As you know, travel agents have never received consistent opinions from either Federal or State revenue collectors as to their independent contractor status. Typically, the arcane, 20-factor test combined with a broad and arbitrary interpretation of the safe harbor provision of section 530 of the Code have placed an incredible hardship on businessmen and women.

Travel agencies are typically small business and predominantly women-owned. When a call comes from the IRS, they cannot turn to their team of in-house attorneys for advice and counsel. Regardless of whether they are right or wrong, very few travel agents have the financial wherewithal to challenge the IRS.

This morning, I would like to focus my remarks specifically on a situation that travel agents and travel agencies face today. Time limitations do not allow me to tell you about the hundreds of horror stories I have heard from my members. However, I would like to tell the Subcommittee of one particular erroneous episode which represents the experience of many.

Compass Point Travel in Mountain View, California, is a small agency who since the 1980s, has employed both full-time agents and a number of independent contractors. These independent contractors have a signed contract with the agency.

The owner of the agency is extremely knowledgeable in the rules and requirements of the IRS independent contractors. In fact, she

participated in a debate on the feasibility of independent contractors in the travel industry for which she did extensive research on the subject.

In the fall of 1986, Compass Point Travel was audited by the State of California, after months of discovery, legal fees and lost revenue, Compass Point Travel won their case. The State appealed, but Compass Point Travel again beat them on appeal.

Then, one year ago, to the owners' amazement, Compass Point Travel received notification that they were now being audited by the United States Internal Revenue Service. The grueling exercise began all over again.

Again, after months of enduring the IRS audits, the IRS attempts at intimidation, more legal fees and more lost revenues, Compass Point Travel was advised they did not owe the IRS. All the while, Compass Point Travel was never actually advised that they were either in violation or not in violation of the current IRS code. As of today, they still have not been advised.

Madam Chairman, although Compass Point Travel had a positive decision, the expense, time and aggravation experienced clearly demonstrates the untenable situation for travel agencies and travel agency owners. On both the State and Federal level, there is no clear interpretation of the law as it relates to independent contractors.

Indeed, the current independent contractor law is so vague, it literally leaves the interpretation up to the whims of the individual auditor, which can only invite the type of horror stories I relayed to the Committee today, and I hear on a daily basis.

Travel agents are typically the smallest of the small service recipients. Our independent contractors are extremely vulnerable. The IRS clearly has an emphasis on "they are small, scare them, and they will pay" attitude.

America was built by small entrepreneurs, and in the travel agency community, there are more than 425,000 sellers of travel. These people cannot and should not be forced to classify themselves as employees, particularly when the trend today is toward home-based businesses. Nor can these small business employers who work on a very small profit margin afford to reclassify their independent contractors as employees. For many, such a decision will push them into bankruptcy.

For countless numbers of travel agencies that have experienced independent contractor issues with the IRS, the Coalition for Travel Industry Profitability strongly endorses Congressman Christensen's bill, H.R. 1972. I might also add, we were delighted that Congressman Christensen agreed to support report language that removes any possible interpretive ambiguity on the part of the IRS and will help ensure the IRS will follow the letter and spirit of H.R. 1972.

Specifically, the report language makes it unmistakably clear that although all three tests in the bill must be met to be considered an independent contractor, only one or more of the conditions within each test is needed to comply. For example, if a travel agency meets the requirement that its independent contractors rent space at a fair market value as provided in subsection (c)(1)(C), the agent need not have to comply with subsection (c)(2)(A), which pro-

hibits the service provider from performing the services exclusively for the service recipient. Due to the nature of the travel agency business, travel agencies have exclusivity contracts with their agents. Although H.R. 1972's language may seem legally straightforward, past experience with the IRS leaves us to believe that additional assurances are certainly necessary.

I have included a copy of the recommended report language in my testimony. I urge all Members of the Subcommittee to support this important language.

Madam Chairman, this concludes my remarks, and I thank you for the opportunity to be able to share my thoughts with you today.

I am happy to answer any of your questions.

[The prepared statement and attachment follow:]

**STATEMENT OF LAURADAY KELLEY  
OF  
COALITION FOR TRAVEL INDUSTRY PROFITABILITY  
AND  
ASSOCIATION OF RETAIL TRAVEL AGENTS**

Thank you Chairman Johnson and Members of the Subcommittee. On behalf of the nation's travel agents, travel agencies and all the other service providers and recipients in the travel industry, I appreciate the opportunity to appear before you today to testify on the issue of IRS treatment of independent contractors. I ask that my full statement be made part of the Committee hearing record. My name is Lauraday Kelley and I am the Vice Chairman of the Coalition for Travel Industry Profitability (CTIP) and President of the Association of Retail Travel Agents (ARTA).

The Coalition for Travel Industry Profitability is a proactive travel industry group that was formed in January of 1995 by 23 major travel cooperatives representing over 23,000 travel agencies and their agents, a significant percentage of whom are independent contractors. ARTA, which is part of CTIP, represents 3,500 travel agents around the U.S. I am delighted to appear today with some of my industry colleagues to share our views with Congress on why we must work together to protect the rights of the independent contractors as well as the rights of the service recipients. Madam Chairman, I can tell you and the other Members of the Subcommittee that, without a doubt, the issue of the IRS treatment of independent contractors is one of the most important issues affecting our industry today.

As you know, travel agents have never received consistent opinions from either federal or state revenue collectors as to their independent contractor status. Typically, the arcane 20-factor test, combined with a broad and arbitrary interpretation of the Safe Harbor provisions in Section 530 of the code have placed an incredible hardship on businessmen and women. Travel agencies are typically small businesses and predominantly women-owned. When a call comes from the IRS, they can't turn to their team of in-house lawyers for advice and counsel. Regardless of whether they are right or wrong, very few travel agents have the financial wherewithal to challenge the IRS.

This morning, I would like to focus my remarks specifically on the situation that travel agents and travel agencies face today. Time limitations today do not allow me to tell you about the hundreds of horror stories I have heard from my members. However, I would like to tell the Committee of one particularly onerous episode which represents the experiences of many.

Compass Point Travel in Mountain View, California, is a small agency who, since the early 1980's, employed both full time travel agents and a number of independent contractors. These independent contractors have a signed contract with the agency. The owner of the agency is extremely knowledgeable in the rules and requirements of the IRS for independent contractors. In fact, she participated in a debate on the feasibility of independent contractors in the travel industry for which she did extensive research on the subject. In the fall of 1986, Compass Point Travel was audited by the State of California. After months of discovery, legal fees and loss of revenue, Compass Point Travel won their case. The state appealed, but Compass Point again beat them on appeal.

Then, one year ago, to the owners' amazement, Compass Point Travel received notification that they were now being audited by the U.S. Internal Revenue Service. The grueling exercise began all over again. Again, after months of enduring the IRS audit, the IRS's attempts at intimidation, more legal fees and lost revenue, Compass Travel was advised that they did not owe the IRS. All the while, Compass Travel was never actually advised that they were either in violation or not in violation of the current IRS code.

Madam Chairman, although Compass Travel had a positive decision, the expense, time, and aggravation experienced clearly demonstrates the untenable situation for travel agents and travel agencies. On both the state and federal level, there is no clear interpretation of the law as it relates to independent contractors. Indeed, the current independent contractor law is so vague, it literally leaves the interpretation up to the whims of the individual auditor, which can only invite the type of horror stories I relayed to the Committee today, and I hear on a daily basis.

Travel agents are typically the smallest of the small service recipients. Our independent contractors are extremely vulnerable. The IRS clearly has an emphasis on a "they're small, scare them and they'll pay" attitude. America was built by small entrepreneurs, and in the travel agency community there are more than 425,000 sellers of travel. These people cannot and should not be forced to classify themselves as employees, particularly when the trend today is toward home-based businesses. Nor can these small business employers, who work on a very slim profit margin, afford to reclassify their independent contractors as employees. For many, such a decision will push them into bankruptcy.

For the countless number of travel agencies that have experienced independent contractor issue with the IRS, the Coalition for Travel Industry Profitability strongly endorses Congressman Christensen's bill, HR 1972. I might also add that we were delighted that Congressman Christensen agreed to support report language that removes any possible interpretive ambiguity on the part of the IRS and will help ensure that the IRS will follow the letter and spirit of HR 1972.

Specifically, the report language makes it unmistakably clear that although all three tests in the bill must be met to be considered an independent contractor, only one or more of the conditions within each test is needed to comply. For example, if a travel agency meets the requirement that its independent contractors rent space at a fair market value, as provided in subsection (c) (1) (C), the agency need not have to comply with subsection (c) (2) (A), which prohibits the service provider from performing the services exclusively for the service recipient. As you may know, most travel agencies have exclusivity contracts with their agents. Although HR 1972 language may seem legally straight forward, past experience with the IRS leads us to believe that additional assurances are necessary.

I have included a copy of the recommended report language in my testimony. I urge all members of the Committee to support this important language.

Madam Chairman, this concludes my remarks. Thank you for the opportunity to be able to share my thoughts and experiences. I will be happy to answer any questions from the Committee.

**Report Language Clarifying the Treatment of Travel Agents under  
The Independent Contractor Tax Simplification Act of 1996,  
HR 1972**

The Committee wishes to emphasize that the requirements of subsection (c) will be met if any one of the three factors are present. Therefore, a service provider will be classified as an independent contractor under the bill even though the service provider is required to perform service exclusively for the service recipient, if, for example, the service provider pays a fair market rent for use of the service recipient's place of business and otherwise meets the requirements of subsections (b) and (d). As a result, the bill will cause workers who may work full-time for a particular service recipient to be classified as an independent contractor. For example, although travel agents typically work out of the travel agency's office and are required to sign exclusivity agreements with these travel agencies, they often pay fair market rents. However, travel agents perform a personal service from which they develop a client base and are compensated by commission income derived from third parties. Therefore, travel agents, who may have an exclusive agreement with a particular service recipient, are not controlled by the service recipient because of the highly personal nature of the services performed.

Chairman JOHNSON. I thank the panel for your testimony this morning. It is very helpful to have your experience as we approach the responsibility to clarify the independent contractor law.

Thank you, Mr. Budzinski, for your comments to raise concerns about possible impacts that we may otherwise not be aware of.

Dr. Meek, your experience has a unique significance because your experience is applied to school districts throughout the Nation. It will divert a very significant number of educational dollars from our children.

It is also true that the need for specialized transportation services in communities is increasing and independent bus contractors are one of the few sources that many communities have to meet the intermittent transportation needs of special populations. So, it would be a loss to society for all those buses to be owned by the school department, as well as create costs and problems for school systems.

Are there any liability problems in the current relationship you have with your bus drivers?

As you point out, there are approximately 13,000 bus districts across the country. I believe the vast majority of them have the contractual arrangements I described with Talbot County, Maryland. Although, there are a few States that do have all of their drivers as employees on a statewide basis.

I agree with your assessment. I think the contractor arrangement provides for greater flexibility. Many of these contractors in fact operate these buses as family operations and have other jobs that they also do, including farming and other kinds of businesses.

The 40-year experience in Talbot County suggests that there are no liability issues that would significantly deter my recommendation to you to continue to see bus contractors operate in the manner in which they have successfully operated for 40 years or more.

Mr. Matsui.

Mr. MATSUI. Thank you.

Mr. Bryan, again, you raised some very important issues, then you outline the bill that Mr. Christensen introduced, H.R. 1972. Actually, you have the right interpretation of it; you raise the three points, and you have the conditions in the disjunctive.

I guess my concern is if, in fact, the Christensen bill as it is written, passes, we would not even have to talk about independent contractors, because you can almost have any employment relationship be an independent contractor relationship. So, I am assuming you are flexible in the sense that the legislation will be modified and you expect it to be modified if in fact we do do something legislatively in this area; is that correct? Or is this the position that you feel that there only should be three criteria, and there should be only one condition out of those three criteria, and, therefore, you basically change a lot of employment relationships.

Will you explain to me? You raise a specific issue that I think is legitimate.

Mr. BRYAN. I was invited here, Mr. Matsui, to basically tell my personal experience. I am an expert only in my industry. I do not profess to know everything about every other industry this might affect. I said in my testimony I think this bill is a good start, we all are familiar with the expression "if it ain't broke, don't fix it."

I think in this case, the existing policies as written "are broke." So, they need to be fixed.

I am not sure that H.R. 1972 is the perfect answer, but I am in favor of a movement toward a little more free economy or free market system in this aspect.

I think the key point in Mr. Christensen's bill is the contract says an awful lot. That is the third requirement and most important qualification in my mind. I think that the independent contractor status is a stepping stone from being an employee to being a full-fledged larger businessowner. You need that stepping stone.

In our industry the first step from an installer, who is employed by someone directly and gets all his tools furnished to him, is, he goes out and buys his own truck and tools and prints some business cards, and in our case, he gets a State contract license and sets himself up as a contractor. Then he becomes a businessman. I see nothing wrong with allowing him to do that.

Mr. MATSUI. Let me say this. For all of the people here today, if in fact the intent is to try to deal with problems you have described and the last panel described, I am with you. I think we need to deal with these issues. There is a lot of ambiguity in the law, and certainly the Internal Revenue Service can interpret it any way they want, and there is so much leeway that it creates tremendous dangers for all of you.

I think the gentleman who dealt with the cable industry on the last panel, all of you have raised some legitimate issues.

But if your intent is to support 1972, which basically would make major changes in the relationship between employer-employee, to the point where my interpretation about this airline employee would in fact be possible, then you lose me. Then I am not interested in working with any of you, because basically it is an attempt to try to make sure that you bring these people on and you disturb the employment relationship so benefits do not have to be paid, like pension benefits, health care benefits, minimum wages and things of that nature. That is not what you are talking about.

I would just urge all of you to be careful about what you are supporting, because this latter bill, 1972, would have that latter impact. So, we want to help with your problems, because I think you raise legitimate issues.

Mr. Meek, for example, that is a very tough issue. I think you started with these people as independent contractors over the years, 40 years, whatever it may happen to be, very legitimate, and then now you have a situation where some of these folks have their own buses and some do not. The Service is trying to interpret your entire operation. I think you have a very legitimate concern there.

I wouldn't want to get into the factual details as to whether it should be an employment relationship or an independent contractor relationship, because obviously there are a lot of facts. But you cannot be left in a situation where all of a sudden they are trying to get a couple hundred thousand dollars from a school district that probably is basically making it now. The same applies to all of you.

But those issues should be addressed. We have an obligation to address them. But I can guarantee you that some of us will not be particularly interested in attempting to find legislation that would allow employment relationships, employers particularly, with the

downsizing going on in this country and the insecurity of the average employee, to all of a sudden find themselves in a position where they are losing valuable benefits like health care and pension benefits.

Under Mr. Christensen's bill, you can make a lot of cases where currently traditional employment relationships, that you would all agree to, all of a sudden could become independent contractor relationships. So, I just urge you to read the legislation before you endorse this bill, because it does have some significant concerns.

Ms. KELLEY. Mr. Matsui, I have two things: One, I agree with what you are saying, but in view of all the downsizing that has taken place in this country today, there are thousands and thousands of people out of work, looking for employment. These people have become small entrepreneurs and many have become independent contractors and have hired themselves or contracted with other independent contractors. So, it is another end of the industry that is developing, and particularly with the emphasis on home-based businesses and two family members working, it has become a given that it is easier for two members of a family, at least one of them work out of their home. That becomes an independent contractor situation.

Mr. MATSUI. I agree with you. I think we need to try to address those issues, but we need to make sure there is a balance as well. All of us agree on that goal.

Ms. KELLEY. One other point. When we are talking about the problem that lies with the IRS not understanding, and not executing their duties properly, well, is it far easier to teach the current IRS personnel behavior modification, or to understand very thoroughly three rules with subtitles, as opposed to the 20-point test we have now? That is my only other comment.

Mr. MATSUI. Let me just address that. I know we want to end this panel, but the problem with these three rules, these tests here, is the fact that all you need to do is pick one out of the five conditions under the first criteria, one out of the four, and then obviously a written contract.

The danger you face there is you can almost make anybody an independent contractor in this kind of interpretation. That is where you have to be careful. Because you have some businesses exploit the work force, because obviously the big issue, we all know this, the big issue in terms of labor negotiations now are health care benefits, pension benefits, non-wage benefit issues. And we do not want to put a camel's nose under the tent where all of a sudden you are going to have a lot of people, more people than there are today, without these kinds of benefits.

I am just trying to assure everyone that I wanted to work with the specific issues and try to gain greater certainty in the relationship. But I will not participate if this is an attempt to try to destroy the employment relationship under current traditional employer-employee relationships now, to try to take away the benefits that many people are receiving.

Mr. BRYAN. Mr. Matsui, I think I can help you out a little with the analogy you used with the airline pilot. I do not propose to answer how Congressman Christensen would answer. But that airplane is an extension of that business's place of work. I clearly

think that he would have a tough time holding that job as an independent contractor, even under the restrictions of Congressman Christensen's bill.

But I am in agreement with you, in that I think we all see this as a start. I am looking for some consistency and some clear-cut definition. I think that is the message that is coming across here. Because what holds me back in my business is I have to make a decision; do I have an entire work force of just independent contractors, or do I have an entire work force of employees? It makes it very difficult in our industry. If you dare mix the two on the same premises or in the same business, you are inviting disaster.

The only reason we prevailed in the end is because we stayed strict to a specific program for 12 years. I still had a battle. But if you would allow a business through this bill or one very similar to at least have clear-cut guidelines as to who is an employee and who isn't, and then have it well-defined by a contract between the businessowner and the independent contractor, I do not think you would have a problem.

The real problem is with collection of revenue, I see the argument against this bill, but I think the real problem with collection of revenue is that you would actually receive more revenue, because in my industry the decision faced by the less scrupulous businessmen is do I completely ignore the law and run the risk of an audit and run and hide if it ever happens, or do I become a legitimate businessman and grow my business the right way and follow the law?

Too many people stay below that radar screen, and it causes headaches for us, it creates a lot of problems in the industry, and if a businessman could be faced with a clear-cut set of rules that he could grow his business under, I think you would have our industry flourishing and probably many others, and good legitimate use of legitimate subcontractors that are paying their taxes.

I would like to see the Congress concentrate more on compliance and maybe tracking the revenue movement. If the IRS was serious about solving the underground economy problem, they wouldn't allow these check-cashing stands on every corner, that if you cash a check for under \$10,000, there is no microfilm trail. This is what allows bandit dealers in my industry to cause us havoc. The IRS will not go after them because they know there is no paper trail to collect revenue.

Mr. MATSUI. I thank you.

Mr. BRYAN. I didn't see the red light go on.

Chairman JOHNSON. I thank the panel for your testimony here this morning. I think you will remember that Congressman Christensen in his testimony made the point that the IRS ought to be neutral in regard to these relationships; that people ought to have the right to be an independent contractor, but we shouldn't prejudice the benefits so that employers are encouraged to move employees into an independent status against their interests and against their will.

So, we do want a balanced law. You have brought forward some very serious problems and given us vivid examples of how the current law is not working and have raised very significant questions that need to be addressed in this session, and we will be working to achieve that goal.

Thank you very much.

[Whereupon, at 12:12 p.m., the hearing was adjourned, to reconvene on Thursday, June 20, 1996, at 10:38 a.m.]

# EMPLOYMENT CLASSIFICATION ISSUES

THURSDAY, JUNE 20, 1996

HOUSE OF REPRESENTATIVES,  
COMMITTEE ON WAYS AND MEANS,  
SUBCOMMITTEE ON OVERSIGHT,  
*Washington, DC.*

The Subcommittee met, pursuant to call, at 10:38 a.m., in room 1100, Longworth House Office Building, Hon. Nancy L. Johnson (Chairman of the Subcommittee) presiding.

Chairman JOHNSON. The hearing will come to order.

Today the Subcommittee will continue its examination of issues relating to the classification of workers as employees or independent contractors for Federal tax purposes.

For over two decades, Congress, the administration, and the Nation's employers and workers have struggled to make sense of the ambiguities and complexities in the common law 20-factor test governing the status of workers. I would hazard that probably no other area of the law has remained so unclear for so long.

The Congress believes that it is appropriate to provide interim relief for taxpayers who are involved in employment tax status controversies with the IRS and who potentially face large assessments as a result of the Service's proposed reclassification of workers until the Congress has adequate time to resolve the many complex issues involved in this area.

This is a sentence from the explanation of provisions in the Revenue Act of 1978 establishing the section 530 safe harbor. Who would have dreamed we would still be trying to resolve those many complex issues today?

The primary impetus for our hearing is to address the concerns being expressed by small businesses across the Nation that the IRS' efforts to reclassify workers is causing hardship.

In 1988, the IRS established its ETEP, Employment Tax Examination Program which target small businesses with assets of \$3 million or less for audits on the classification of their workers. Since 1988, IRS has conducted over 13,000 ETEP audits, recommending over \$830 million in taxes and reclassifying 527,000 workers. It is little wonder that the call for a bright-line objective test to distinguish between employees and independent contractors was ranked as the number one legislative priority in last year's White House Conference on Small Business.

In our continuing quest to find that line, the Subcommittee will hear today from the Treasury Department, the IRS, the GAO, tax practitioners, and witnesses from the private sector.

We want to welcome Don Lubick back to the Ways and Means Committee here today, representing the Treasury Department, once again after a 16-year absence.

IRS Commissioner Peggy Richardson is also here to discuss the Service's worker classification initiatives. I want to take this opportunity to commend Commissioner Richardson and the IRS for the steps the Service has taken under her direction to bring greater clarity to this difficult area.

After participating in the White House Conference on Small Business last year, Commissioner Richardson pledged that IRS employees would be retrained to better understand and apply the factors used to classify workers for tax purposes. Following up on the pledge, for the first time ever, IRS published its revised training materials for comment. This is a significant and positive first step on the IRS' part and reflects fine leadership by the Commissioner.

Unfortunately, even the IRS cannot make a silk purse out of a sow's ear, and that is exactly what the common law 20-factor test is. I sincerely hope that the Subcommittee's probe of this issue will lead to a renewed commitment to work together on a bipartisan basis to forge a lasting solution to this difficult problem.

Congressman Gilchrest is with us as our first witness, and it is, indeed, a pleasure, Congressman, to welcome you to the Ways and Means Committee because you are a Member reputed in this body for thoughtful and knowledgeable comments, and I look forward to your comments on this difficult subject this morning. Welcome.

Mr. GILCHREST. Thank you very much, Madam Chairman.

Chairman JOHNSON. Oh, excuse me. Before we start, I had forgotten that I want to yield.

Mr. KLECZKA. Slight procedure, Madam Chairman.

Chairman JOHNSON. Yes. I want to yield to Mr. Kleczka who is filling in as Ranking Member this morning for Mr. Matsui.

Mr. Kleczka.

Mr. KLECZKA. Thank you, Madam Chairman.

Congressman Gilchrest, you do not mind waiting a couple of minutes, do you?

Today is the Oversight Subcommittee's second hearing on the controversies surrounding classification of workers as employees or independent contractors. The witnesses scheduled to appear before the Subcommittee today will include experts on the issue, as the Chairwoman indicated, from the Department of Treasury, Internal Revenue Service, the U.S. General Accounting Office, the American Bar Association, and the New York State Bar Association.

All of us look forward to hearing their views on what should and should not be done in the area of worker classifications. Particularly, it is important the record reflect the adverse impact that shifting to independent contractor status will have on millions of workers who work long and hard each day as an employee.

As a result of our first hearing on June 4, 1996, I think it would be fair to say that something needs to be done in the area of worker classifications. We should continue our discussions on a bipartisan basis.

The proposals currently pending before Congress are much too broad and would allow for wholesale reclassifications of workers as independent contractors. A legislative solution will not be simple.

The business community does not speak with one voice on whether or what changes should be made to current law. Something narrowly targeted should be considered by the Subcommittee in a way that balances both the interests of small business and employees.

And last, before Congress adopts any new worker classification rules, the nontax society benefits of employee status should be thoroughly explored to ensure that workers do not unintentionally lose pensions, health insurance and other fringe benefits, unemployment compensation, and other worker workplace protections.

I know we all look forward to receiving the testimony of the IRS by Commissioner Richardson. She has done a great job of taking the bull by the horns and implementing several very positive initiatives to deal with the controversy of worker classifications.

She, like all of us, recognizes that the IRS' handling of employment tax audits has serious problems and as a result has initiated important administrative reforms such as the new audit training manual, more auditor training, the Multi-Tiered Settlement Offer Program, and an expedited examination appeals process. While maybe not perfect, her actions are obviously a step in the right direction.

I want to also welcome the new Assistant Secretary for Tax Policy, Mr. Don Lubick, to the Oversight Subcommittee. I should note that last week as a part of its markup on the Small Business Job Protection Act of 1996, the Senate Finance Committee adopted Senator Nickle's narrow package of amendments to provide several clarifications to the application of section 530 relief.

Ranking Subcommittee Democrat Bob Matsui is not able to be here today. However, I know he has talked with many of the witnesses in advance of the hearing and will provide an opening statement for the record. Both he and I are very interested in this issue and will continue to be active participants in the workings on its Subcommittee and on the Full Committee.

Finally, I am pleased that the Subcommittee's witness list and hearing record will provide a balanced discussion on the issue before us.

Thank you, Madam Chairman.

Chairman JOHNSON. Thank you very much.

And now, Mr. Gilchrest.

**STATEMENT OF HON. WAYNE T. GILCHREST, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MARYLAND**

Mr. GILCHREST. Madam Chairman, I do think currently there is pending legislation to determine the best uses for sows' ears in the Agriculture Committee. I am not sure how that will turn out, but we hope for the best.

I also would like to recommend for the Interior Committee to have these kinds of water pitchers. I think they are very nice. I wouldn't recommend them for Federal courthouses, however.

Madam Chairman and Members of the Subcommittee, I would like to thank you for the Subcommittee's indulgence. I know that the testimony on this for Members was actually on June 4, but I was unable to be in Washington at that time. So, I appreciate the opportunity to do this.

I am aware that the Subcommittee has already received testimony from Dr. Sam Meek, Superintendent of Talbot County Schools, and my testimony is meant primarily to add emphasis to what he said.

In Maryland, as in many other States, it is a common practice for school boards to contract out their schoolbusing services to self-employed individuals. I myself during the course of my college years spent 4 years driving a schoolbus, and I can tell you, as I will say later in my testimony, there is a very distinct difference between driving children with special needs and driving children that go to regular schools and do not have those special needs. So, I wanted to make that point clear early on because the IRS, I think, in determining their Tax Code needs to understand that there is a very big distinction between the type of training and the type of responsibility and the type of things people need to do under those circumstances.

Nearly every school district on the Eastern Shore has operated under such an arrangement as independent contractors for many, many decades, and everybody over there is very happy with it. Recently, however, this contractual arrangement has come under scrutiny from the IRS, and that agency has made the determination that under the common law test currently used to determine contractor status, these schoolbus drivers had to be considered employees. This determination has been particularly disruptive for the affected counties.

The IRS is currently assessing several counties for back payroll and other taxes, and the school districts are considering several options, none particularly desirable, for addressing this problem. The most likely response on the part of the school districts is to end their contractual relationship with the small business men who drive the buses and look for a much larger contractor to provide the service. Thereby, you have housewives, retired people, farmers, mechanics, and other contractors. This will bear a heavy burden on their particular businesses the quality of their life.

Probably the most puzzling aspect of the IRS action in my opinion is the complete absence of any public policy goal being served here. I realize that there must be some degree of protection against the sort of unscrupulous employees who would pressure powerless employees to accept contractor status against their will, but the Maryland case is the exact opposite. The most vocal critics of the IRS action are the bus drivers themselves.

I realize that independent contractor status can, in some cases, have adverse consequences for Federal revenue collection. It is easy to recognize that there is a greater potential for tax evasion for an independent contractor than for an employee. However, in the appeals process, it became clear that tax compliance among the schoolbus contractors approaches 100 percent. A change in the status of these contractors will yield insignificant revenues to the Federal Government, but such a change will create hardships for the districts. If they are forced to treat the bus drivers as employees, they will have to create benefit packages and a full range of other issues that the boards of education will have to deal with. It will also eliminate dozens of small businesses.

Section 530 provides that procurers of contractor services who are subsequently determined to be employers can be afforded relief if certain standards are met; that they had a reasonable basis for believing the contract relationship was appropriate; that they consistently issued 1099 Forms instead of W-2 Forms; and that they had no similar positions filled by employees.

The IRS denied section 530 relief to these school districts noting that the bus drivers for special schools were employees, and as I stated a little bit earlier, I find it somewhat astounding that the IRS fails to recognize that bus drivers for special schools are actually very different than bus drivers for regular schools. They require additional training. There are different hours of the day that you drive. There is a full range of special necessary responsibilities for special schools that you simply do not have for the regular public schools.

H.R. 1972 would solve this problem summarily, creating a new and clear parallel standard for defining contractor relationships with reasonable protections against abuse. The bill requires substantial investment in training or assets, a separate place of business, and an express contractual agreement. One can argue that this legislation would be unnecessary had the IRS been more reasonable in its pursuit of cases like the one I just described. However, the zeal with which the IRS seems to pursue these contract cases seem to have necessitated legislative action to provide protection for contractors and businesses who procure contract services.

I would, therefore, encourage two actions on the part of the Subcommittee. First of all, I would encourage the Subcommittee to use all available expediency in reporting H.R. 1972 or similar legislation to clarify the definition of a contractor, but recognizing the difficulty of passing any sort of tax legislation, I would also urge the Subcommittee to vigorously exercise its oversight of the IRS in the area of the independent contractor issue.

Once again, Madam Chairman, I appreciate the opportunity to testify before your Subcommittee.

[The prepared statement follows:]

STATEMENT OF CONGRESSMAN WAYNE T. GILCREST  
HOUSE WAYS AND MEANS COMMITTEE  
OVERSIGHT SUBCOMMITTEE  
JUNE 20, 1996

Madame Chairman and members of the committee, I would like to thank you for the committee's indulgence. I know that member testimony on the independent contractor issue was supposed to be presented at your June 6 hearing on the subject, a date when I was unable to be in Washington. I appreciate the opportunity to testify today on H.R. 1972, as well as a matter which has significant ramifications for the taxpayers, school districts, and children in my district.

I am aware that the committee has already received testimony from Dr. Sam Meek, Superintendent of Talbot County Schools, and my testimony is meant primarily to add emphasis to what he said.

In Maryland, as with other states, it is a common practice for school boards to contract out their school-busing services to self-employed individuals. Nearly every school district on the Eastern Shore has operated under such an arrangement for decades, and everyone has been happy with it. Recently, however, this contractual arrangement has come under scrutiny from the Internal Revenue Service, and that agency has made the determination that under the common law test currently used to determine contractor status, these school bus drivers had to be considered employees.

This determination has been particularly disruptive for the affected counties. The IRS is currently assessing several counties for back payroll and other taxes, and the school districts are considering several options, none particularly desirable, for addressing this problem. The most likely response on the part of the school districts is to end their contractual relationship with the small businessmen who drive the buses, and look for a larger contractor to provide the service.

Probably the most puzzling aspect of the IRS' action is the complete absence of any public policy goal being served. I realize that there must be some degree of protection against the sort of unscrupulous employers who would pressure powerless employees to accept contractor status against their will. But the Maryland case is the exact opposite -- the most vocal critics of the IRS's action are the school bus drivers themselves.

I realize that independent contractor status can, in some cases, have adverse consequences for federal revenue collection -- it is easy to recognize that there is a greater potential for tax evasion for an independent contractor than with an employee. However, in the appeals process it came clear that tax compliance among the school bus contractors approaches 100%. A change in the status of these contractors will not yield significant revenues to the federal government.

But such a change will create hardships for the districts. If they are forced to treat the bus drivers as employees, they will have to create benefits packages and deal with labor laws. It will also eliminate dozens of small businesses.

Section 530 provides that procurers of contract services who are subsequently determined to be employers can be afforded relief if certain standards are met -- that they had a reasonable basis for believing the contract relationship was appropriate; that they consistently issued 1099 forms instead of W-2 forms, and that they had no similar positions filled by employees. The IRS denied 530 relief to these school districts, noting that the bus drivers for the special schools were employees. I find it astounding that the IRS fails to recognize that driving a bus for

special schools is vastly different from driving buses for the regular schools -- it requires additional training, different work rules, etc. Yet the IRS has been unyielding on this point.

H.R. 1972 would solve this problem summarily, creating a new and clear parallel standard for defining contractor relationships with reasonable protections against abuse. The bill requires substantial investment in training or assets, a separate place of business, and an express contractual agreement. One can argue that this legislation would be unnecessary had the IRS been more reasonable in its pursuit of cases like the one I just described, however, the zeal with which the IRS seems to pursue these contract cases seems to have necessitated legislative action to provide protection for contractors and businesses who procure contract services.

I would therefore encourage two actions on the part of the committee. First of all, I would encourage the committee to use all available expediency in reporting H.R. 1972 or similar legislation to clarify the definition of a contractor. But recognizing the difficulty of passing any sort of tax legislation, I would also urge the committee to vigorously exercise its oversight of the IRS in the area of independent contractor issues.

Once again, I thank the committee for this opportunity to testify.

Chairman JOHNSON. Thank you very much, Congressman Gilchrest.

We did hear from Superintendent Meek last time. I think this is an extremely important issue because it is a perfect example of the problems created by the IRS going in and reclassifying people in the face of the section 530 language that recognizes longstanding practice. So, this is a very big problem that you point to.

Second, I think it is interesting, and I think this will be reflected in testimony that we hear later on, that among workers who filed their 1099 forms, those workers report 97 percent of the amounts as income. If the payments were not reported, the reporting average falls to 87 percent. So, the problem in this sector is not amongst those who report their 1099s from the point of view of tax compliance, and yet, for obvious reasons, the IRS' enforcement efforts have been focused at those who report their 1099s because they are visible, and that is one of the real problems that has plagued this compliance effort and one that I think the Commissioner is keenly aware of and that we are keenly aware of.

I am very interested in our work having an impact on your school district because school districts all over the country will be affected if we make a change in this area, and yet, it would have essentially no impact on the amount of tax revenue that the public gets. As you say, there is no public interest.

So, we appreciate your supporting your superintendent and drawing out very clearly for us the nature of the problem, and we are interested in assuring that our actions will solve it.

Mr. Kleczka.

Mr. KLECZKA. Thank you, Madam Chairman.

I am not very familiar with the Maryland School Board situation. Mr. Gilchrest, are you saying that the school district has two types of bus drivers, the contract type and also an employee type, which is responsible for the special education kids?

Mr. GILCHREST. This will vary, but for the most part, the employees of the school will carry children who are disabled, those who are in wheelchairs, those who have severe mental deficiencies.

Mr. KLECZKA. So, those bus drivers are employees?

Mr. GILCHREST. Of the school district.

Mr. KLECZKA. The bus drivers who transport the other population are contract?

Mr. GILCHREST. For the most part, those are individuals that contract with the school district for a particular area to pick up kids to take them to the different schools.

Mr. KLECZKA. Who owns the schoolbuses?

Mr. GILCHREST. The schoolbuses are owned by the contractors.

Mr. KLECZKA. So, I as an individual, if I want to drive for your school district, I would have to bring my own bus along. Is that how that works?

Mr. GILCHREST. For the most part, yes. There are some people, contractors, that might own three, four, or five buses, and he would hire people to drive those buses. There are others, though, who simply own their own schoolbus.

Mr. KLECZKA. For the individual who owns three or four buses, is he also an independent contractor and all of his drivers? At what point does he become a small business person himself or herself?

Mr. GILCHREST. He is an independent contractor, and then, basically, he would hire people to drive his buses, but he would contract with the school district for that particular area where they would pick up for that particular bus run.

For the most part, with very little variations, the board of education will contract with someone to pick up certain students along certain bus runs. There might be four bus runs with four buses and one contractor, and then that contractor would contract for those four bus runs and he would hire people to drive on his buses.

Mr. KLECZKA. In a situation where the person owns four or five buses, probably drives one him- or herself, are the other three or four drivers employees of that small business?

Mr. GILCHREST. I do not know every single situation.

Mr. KLECZKA. OK.

Mr. GILCHREST. Of the situations that I know, the person that might own four buses, the people that drive his buses will be employees.

I will give you an example. There is a man named Mr. Dorsey in Kent County who owns buses. He will hire people to drive those buses. Mr. Dorsey is the independent contractor that contracts with the school district, but the drivers of those buses, one of whom is his wife, will be employees of Dorsey buses.

Mr. KLECZKA. So, the argument here, or the problem here, is that the owner of the buses is not calling his drivers independent contractors, also?

Mr. GILCHREST. Say that again?

Mr. KLECZKA. So, the question or the problem in Maryland is not that the owner of multiple buses does not call his drivers or her drivers independent contractors. He does term them employees.

Mr. GILCHREST. That is correct.

Mr. KLECZKA. So, that is not the problem.

Let me ask IRS if they have any more information on this so I can get a better understanding.

Thank you very much.

Mr. GILCHREST. Thank you.

Chairman JOHNSON. Mr. Hancock.

Mr. HANCOCK. Just as a matter of curiosity, what would happen in your opinion, or are there any cases where the school contracts with a cab service to pick up kids where they do not have enough to justify a bus?

Mr. GILCHREST. Cab service?

Mr. HANCOCK. Yes.

Mr. GILCHREST. Do you mean in an automobile?

Mr. HANCOCK. Sure.

Mr. GILCHREST. I do not know of any situation.

Mr. HANCOCK. Well, I know, but it does happen in certain areas where they have got one person or two and they do not want to send a bus out there, and they arrange to pay for cab service to pick up that one child.

Mr. GILCHREST. What would happen if you had to arrange for a cab?

Mr. HANCOCK. Would that make the cab driver an employee?

Mr. GILCHREST. An employee of the school district.

Mr. HANCOCK. Yes.

Mr. GILCREST. That is a good question, Mel. I am not sure how that would work, but I am sure there might be some areas of the country where that happens.

Mr. HANCOCK. Oh, it does happen.  
Thank you.

Chairman JOHNSON. Mr. Laughlin.

Mr. LAUGHLIN. Mr. Gilcrest, as I understood your statement about Mr. Dorsey and his operation, all of the drivers to your knowledge are his employees.

Mr. GILCREST. Yes.

Mr. LAUGHLIN. It occurs to me that even the bus driver, or Mr. Dorsey could be an independent contractor.

Mr. GILCREST. I think that is probably likely, but the people in the incident where you have Dorsey Bus Service, where he contracts with the school district to drive students to the public schools, the people he hires are employees of Mr. Dorsey's.

Now, there are not too many contractors that own several buses. The vast majority of the contractors on the Eastern Shore are individuals that own their own buses, and they have an individual contract with the school district.

Mr. LAUGHLIN. You are primarily concerned with the relationship between the bus operator and the school district.

Mr. GILCREST. That is my primary concern. My judgment is if the IRS continues to pursue this policy, we will virtually have no independent contractors. They will contract out to basically the lowest bidder, and you will probably get some type of national bus service in there. Those people who are independent businessmen will become either unemployed or their independent status will be greater diminished by simply becoming employees of a very large bus contractor.

Mr. LAUGHLIN. Do you have the information of how many other States have a similar situation to Maryland or the Eastern Shore of Maryland where the school district contracts with private bus operators? In my State, to my knowledge, the school district owns all the buses. There may be a private contractor, but I am not familiar with it. I do know there are a couple of other States where they have a private contractor. Do you have that information?

Mr. GILCREST. No, I do not have that information. I know it will vary from around the country. I do know States like Delaware, many of the Mid-Atlantic States, and I am sure many other rural areas of the country have an independent contractor status, and my fear is that the ramifications of this to many States and school districts around the country that have the independent contractor status is that it is going to change.

I believe that Maryland is one of the first places they have targeted to change this independent contractor status.

Mr. LAUGHLIN. The last question I have, from your vantage point, living on the Eastern Shore around these school districts, is the school children transportation system broken to the point where it needs to be fixed by the IRS?

Mr. GILCREST. I would say the school transportation system in my judgment is working extremely well.

Of my three children, my two boys who are out of school now, rode on those buses. My daughter is now riding on these buses.

The bus drivers are people that live in the community. They know the children. They are fine. I do not mean to sound too corny on this, but some of those bus drivers have set some very positive role model examples for those kids because they are neighbors, and they are actually a part of our extended family.

Mr. LAUGHLIN. So, the system is not broken.

Mr. GILCREST. The system is not broken.

Mr. LAUGHLIN. Thank you, Mr. Gilcrest.

Mr. GILCREST. Thank you.

Chairman JOHNSON. Thank you, Congressman Gilcrest.

Mr. GILCREST. Thank you, Madam Chairman.

Chairman JOHNSON. Now I would like to call Don Lubick, the Acting Assistant Secretary for Tax Policy, Department of Treasury. Welcome.

**STATEMENT OF DONALD C. LUBICK, ACTING ASSISTANT SECRETARY FOR TAX POLICY, U.S. DEPARTMENT OF THE TREASURY**

Mr. LUBICK. Thank you, Madam Chairman and Members of the Subcommittee. It is a pleasure to be back here, and I am very pleased that my first visit here is talking about the same thing I was talking about when I went up to—

Chairman JOHNSON. Excuse me, Mr. Lubick. As you start, I didn't realize, but I meant to call you both at the same time.

Peggy Richardson, Commissioner of the Internal Revenue Service. Welcome, Commissioner Richardson.

Ms. RICHARDSON. Thank you.

Chairman JOHNSON. Mr. Lubick, if you will proceed.

Mr. LUBICK. I was saying I am talking about the same issue I was talking about when I left in 1980.

I would like, if you please, to have my written statement submitted for the record and then talk informally, if I may, about the subject.

Chairman JOHNSON. Certainly.

Mr. LUBICK. As you have stated, this has been a very contentious issue for a long number of years, the question of classification of workers for various purposes. I have been involved in it not only in my governmental role, but had extensive experience with it in private practice of law, representing people who were contending for independent contractor status and representing people that were contending that other people should be given employee status. So, I think I have been on every side of this question of representing employers, workers, and the government.

I would like to give by way of background some general principles that I think we ought to keep in mind as we search for a solution which I hope is not the quest for the impossible dream.

In almost all areas, the laws necessarily—if they are dealing with questions involving service providers—tend to separate workers into two baskets, and for convenience, historically, one kind of treatment is given to workers who are denominated as employees and to others who are denominated as independent contractors.

It has been pointed out that taxation is not the only area where this difficult distinction has to be drawn. It is significant under a variety of worker protection laws, such as, laws that provide work-

er's compensation to protect workers from injuries on the job, fair labor standards to deal with other protections for workers, and unemployment insurance to deal with those who are entitled to protection in the event they become unemployed.

The State laws as well as the Federal laws seem to use general terminology classifying employees on the one hand as the object of either protection or some requirement, such as, withholding in the tax law, and independent workers on the other hand.

I suppose it is possible to come up with other terms to get away from the term "employee" and "independent contractor," but I would suspect that if we used that other terminology, we are not going to produce any greater precision or any greater clarity than the familiar one that we have been using of "employee" versus "independent contractor."

The problem is that there are numerous kinds of arrangements for the provision of services that run a wide spectrum, and as we progress, we are finding there is more and more ingenuity and more and more variety in these arrangements, but the law must separate service providers into the basic two categories, those that are covered by the object of the law and those that are not.

Most workers, it would seem, fit clearly into one category or the other because of the characteristics of their work arrangements. There are a number of people whom we would clearly classify as employees, a number whom we would clearly classify as independent businessmen.

Inevitably, when you have two sets to deal with, there is a middle range of arrangements that share simultaneously some of the principal characteristics that are reflected in the independent contractor and in the employee status. So, it is not clear to which category they should be assigned.

One of the problems is that the tax law very often, too frequently I would say, drives businesses, workers, and government administrators to try to push the hybrid arrangements on one side or another. What we are concerned about is that the tax law determination may have consequences, often not the intended consequences, in many other areas, as Mr. Kleczka has pointed out, even though lip service is paid to the independence under each law of the definitional classification.

The fact is that historical practice, the use of common terminology, the similarity of the criteria to cast the worker on one side or another, all tend to point to similar outcomes. So, the tax decisions concerning classification will have an effect beyond either securing or undermining tax compliance.

The fact of the matter is that after looking at this question for over 25 years, we have found that we have inherently factual questions, an infinite variety of situations, and we have found that rules of classification are very difficult to verbalize in mechanical terms. Determining the nature of an employment relationship is similar to other legal concepts that you are familiar with, such as negligence. How do you tell what is or isn't negligence by setting forth a pattern of words that will apply in all cases?

Justice Stewart made a famous quotation about pornography—I know it when I see it, even though I cannot articulate how to define it. I think we have a situation here where there are general

principles that all of us would agree on. First of all, that the government should not be interfering with or dictating the legal form of a service relationship between the provider and the recipient except if it is truly necessary to protect an important government policy, whether that be tax compliance, unemployment protection, protection relating to job-related injuries, or the like.

I think there is another factor that everybody would agree on, that simply calling a worker an independent contractor by applying a label that the parties agree on, is not enough to justify a different treatment from a worker in an identical factual situation who receives unemployment protection, realizes tax compliance, and so on. Economic reality should override attempts by any individuals to opt out of a system simply by mislabeling.

So, that gets us down to how do we solve this particular situation, how do we prevent what I believe most persons want to prevent—inducing through the tax law a significant shift from employee status that would affect not only taxation, but other areas.

We have been searching for comprehensibility and certainty, and we have come to the conclusion that it is not likely attainable by verbal formulae. Our preference would be for consistency of classification in all areas if that is feasible and comparable treatment of workers in comparable economic relationships.

So, we have been searching in this area, and we have seen many bills introduced either for safe harbors or definitions that will solve the problem. In designing a safe harbor, if we have a safe harbor that covers too few workers, we haven't done anything, because all we are doing is giving safe harbor treatment in the obvious cases. If the safe harbor is too broad, it is going to undercut those legal protections that we want to afford workers, the government, or the employer in its area of application.

The same thing is true of definitions. You have alluded to the so-called 20 factors, and I will have something to say about that in a bit, but basically, as we have studied the offerings of factors that are supposedly conclusive, we have found that generally, the attempt to define them provides simply a road map to avoidance because individuals who want to classify in one direction or another are able to manipulate the definitions to throw the classification on one side or another. In effect, the use of definitive factors, for the most part, seems to shift the fight over uncertainty simply to a different terrain. If definitional factors are applied in a very mechanical way, they are easily manipulable.

We have come to the conclusion, therefore, that the time has come to see if there isn't another way to solve the problem. Instead of this quest for a verbal formula to put workers and independent contractors on one side, isn't there a way to defuse the conflict, to defuse the contentiousness of the issue? I have two suggestions to offer today. One is to shift the focus to simple and expeditious methods to resolve conflicts between businesses or workers and the government, and the second is to lower the stakes that are involved in this situation.

We would defuse the controversies by making them less than life-and-death issues. We have been presented with cases, and I have seen them myself, where the Service comes in to audit an employer, claims back taxes for several years, and the taxes are not

based on income which went into the balance sheet or the pockets of the employer. It is payroll. It is expenses paid. Of course, there may be a right to get the money out of the workers, but that is not very practical. They cannot be found, and who knows what they have done with the money.

So, the result is that in many situations, and this is what came up in the early days, we found that businesses were facing, in the event the audit position of the Service was accepted, bankruptcy and liquidation. So, we have to do something about that.

Second, I think we ought to be alert to the fact that a number of provisions of the tax law will induce shifting one way or another. For example, the 2 percent limitation on deduction of business expenses by employees is a real incentive to classify a person as an independent contractor, and there may not be a rational distinction for that rule.

I recognize that many of these rules cannot be changed because of revenue constraints, but I would urge that the Committee be alert in its actions in the tax law to see if it is possible to avoid making distinctions that sharpen the tax advantages where there perhaps is not so much justification.

In dealing with the ways to resolve the controversies, we would like to suggest two things. We would suggest the possibility of liberalizing by legislation the use of prospective reclassification in cases of reasonable error. Too often the situation has been if the Service's position is sustained, there is no way to avoid the onerous imposition of assessments that we have talked about on the business that will make its financial survival impossible.

In many cases that I have been involved in personally, if a way could be found to resolve the matter on a going-forward basis, the employer who had made a reasonable misclassification could survive and adjust practices. The Service has been moving in this direction, and the Commissioner has referred in her testimony to a settlement procedure that mitigates the impositions considerably.

I would suggest that the Committee consider legislation to go even further and to permit the Service, where the taxpayer had a reasonable argument and belief that it was entitled to section 530 protection, to allow complete prospectivity of classification.

One of the problems with the settlement procedure is that it may put the taxpayer under a shotgun situation. He may feel that he has a reasonable chance of winning a section 530 case, and yet, he is afraid to turn down a settlement offer even on a prospective basis because if he goes to court, he stands a chance of losing and then it is too late.

Therefore, we would suggest that legislation offer a new remedy to the taxpayer under audit. The taxpayer may think he is right, but cannot afford to settle. So, we would give this latitude to the Tax Court. We would enlarge jurisdiction of the Tax Court to allow an expeditious appeal from a determination by the Revenue Service. Much in the way that we allow determination of the qualified status of pension plans or the qualified status of exempt organizations, we would allow the Tax Court to decide under expeditious procedures the worker classification, and we would give the Court the same authority that we would give the Service in the event the Court finds against the taxpayer, but finds that the tax-

payer had a reasonable basis, had treated the workers consistently in all cases, had been filing information reports. In that case, we would allow the Court as a part of its decision to say yes, going forward, this rule is adverse to the taxpayer, but we will apply it only on a prospective basis.

The Tax Court has at the present time in small business cases procedures that make litigation expeditious and inexpensive. Rules of evidence are modified. We believe that if there is increased access to an independent body that taxpayers would feel much more comfortable. We believe that at the Internal Revenue Service as well, knowing that an independent body could ultimately make a decision, there would be a much greater disposition on both sides to reach a compromise and a reasonable settlement.

In addition to that, we——

Chairman JOHNSON. Mr. Lubick, if you could kind of summarize and move along.

Mr. LUBICK. All right.

Chairman JOHNSON. I think we need time to discuss some of these things.

Mr. LUBICK. I would like to just simply state one or two other items that I would suggest in this area that are administrative.

We think that flat safe harbors, that flat definitions give false illusions and will lead to unmanageable standards and litigation. The Commissioner's testimony will describe some proposed administrative guidance to mitigate actual or perceived problems with section 530.

Finally, we would suggest that if the Congress would permit us to give guidance that we could basically withdraw the 20-factors test and work to disabuse taxpayers of the notion that they have to parse literally the 20 factors that are in the Revenue ruling, and instead, we think working with the Service in this area we could clarify the factors to be used in deciding classification as well as the weight to be given them.

The 20 factors were never intended to do the job that they have been asked to perform, and if we are permitted to give guidance, I think we would follow a notice procedure on which the public and the Congress could comment and provide input, and I think we can do much better than the existing situation.

Basically, Madam Chairman, I think that there are always going to be some hard cases, but if we can reduce the stakes, if greater guidance and assistance allow only prospective review and provide a new jurisdiction that is independent of both the taxpayer and the Revenue Service that we can make very substantial progress in this area.

[The prepared statement follows:]

STATEMENT OF  
DONALD C. LUBICK  
ACTING ASSISTANT SECRETARY (TAX POLICY)  
DEPARTMENT OF THE TREASURY  
BEFORE THE  
SUBCOMMITTEE ON OVERSIGHT  
COMMITTEE ON WAYS AND MEANS  
UNITED STATES HOUSE OF REPRESENTATIVES

Madam Chairman and Members of the Subcommittee:

I am pleased to be here today to present the views of the Department of the Treasury on issues relating to the classification of workers as employees or independent contractors. This is a significant and complex issue that merits careful study. We commend the Members of this Subcommittee for holding hearings on this important subject.

Background

Whether workers are classified as employees or as independent contractors is significant for both Federal income tax purposes and Federal employment tax (i.e., Social Security, Medicare, Federal unemployment insurance and withholding) purposes. Income, Social Security and Medicare taxes on employees are collected mainly by employers through the withholding system, whereas the same taxes on independent contractors are collected mainly through self-assessment under the estimated tax system. Independent contractors can offset income by deductions for business expenses that generally are not as readily available to employees (except to the extent that the employee itemizes deductions and business expenses and other miscellaneous itemized deductions exceed 2 percent of adjusted gross income). In contrast, certain fringe benefits provided by a business to employees are eligible for greater tax preferences than are available to independent contractors, although independent contractors can adopt tax-qualified self-employed retirement plans that can be similar to employer-sponsored plans for employees. The classification of workers as employees or independent contractors is also significant under a variety of Federal and State labor and worker protection laws that cover only employees, such as unemployment insurance, workers' compensation, wage and hour requirements, and family and medical leave requirements.

Most workers are classified as employees or independent contractors based on the traditional common-law test for determining the employer-employee relationship.<sup>1</sup> This test

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<sup>1</sup>The Internal Revenue Code (Code) does contain special rules for classifying certain categories of workers. Briefly, these include mandatory independent contractor classification of certain licensed real estate agents, direct sellers, and sitting-service placement agents (sections 3506 and 3508 of the Code); and mandatory employee classification of corporate officers and

focuses on whether the employer has the right to control not only the result of the worker's services but also the means by which the worker accomplishes that result.

The common-law control test is, by its nature, a test that depends on the specific facts and circumstances of each situation. In an effort to administer this facts and circumstances standard better, the Internal Revenue Service (IRS) has derived from the case law a variety of factors that should be considered, with more or less weight being accorded to particular factors depending on the factual context. In the vast majority of cases, the classification of a worker under the common-law standard is clear. However, because the control test is inherently a factual determination, there are cases in which the correct status of a worker is less obvious.<sup>2</sup> The uncertainty in these cases has been perpetuated by the long-standing statutory prohibition on the issuance of regulations or revenue rulings regarding the proper classification of workers.

Current tax law does not consistently favor status as either an employee or an independent contractor.<sup>3</sup> However, in particular circumstances one of the classifications may be advantageous to a service provider, the service recipient, or both. A company's costs may, for example, be lower if its workers are classified as independent contractors rather than employees to the extent the company can pay independent contractors less than the sum of the cash compensation, the costs of the company's portion of Social Security and Medicare taxes, unemployment insurance, workers' compensation, other fringe benefits that the company incurs for employees, and the overhead costs of withholding and recordkeeping. In addition, the income and employment tax provisions of the Code may favor classification as an independent contractor where a worker has significant unreimbursed business expenses. This is primarily because independent contractors face significantly fewer restrictions on their ability to deduct trade or business expenses than employees, as noted earlier.<sup>4</sup> Conversely, employee status may be advantageous for workers with few business expenses

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certain agent-or commission-drivers, life insurance salesmen, home workers, and traveling salesmen (section 3121(d) of the Code).

<sup>2</sup>Cases in which there is intentional misclassification of an employee as an independent contractor should be distinguished from the classification issue generally. In these cases, there is no real question as to whether the workers are employees or independent contractors. Rather, the parties involved may use misclassification as a guise to avoid the costs of Federal and State mandates designed to protect employees or as a method to avoid full reporting of income and to evade taxes.

<sup>3</sup>Prior to 1984, compensation earned by independent contractors was subject to lower rates for Social Security and Medicare taxes than wage income. This disparity was believed to create an incentive for misclassification. The differences were actually less significant than they appeared, however. Although tax rates were lower for self-employment income than for wages, an independent contractor could not deduct self-employment taxes while an employer could deduct its portion of Social Security and Medicare taxes in computing its taxable income for income tax purposes.

<sup>4</sup>Also, the estimated tax system used to collect income, Social Security, and Medicare taxes from independent contractors largely avoids the overwithholding that can result when an employee incurs large business expenses, has net income that fluctuates during the year, or is employed for only part of a year.

who benefit from the tax advantages accorded to fringe benefits, especially those that are more cheaply obtainable or only obtainable through an employer, such as employer-provided group health insurance, workers' compensation insurance, or unemployment insurance.

Workers who are classified as independent contractors may also have greater opportunities than employees to avoid full compliance with the tax laws. As previously noted, employees are subject to withholding, and the amount of their wage income is reported with great precision to the IRS. Independent contractors may find it easier to omit some of their income on their tax returns without detection. Underreporting of income becomes more difficult when an independent contractor's gross income is reported to the IRS on information returns, although the worker can incorporate and avoid information reporting because of the current law rule which excludes payments to corporate independent contractors from reporting. Moreover, even independent contractors that report 100 percent of income have greater opportunities to overstate deductible business expenses. Clearly, some taxpayers have made use of these opportunities, and this has resulted in significant amounts of noncompliance.

#### Recent Legislative History

Since the late 1970s, Congress, Treasury, and the Internal Revenue Service have considered numerous proposals aimed at resolving issues associated with the classification of workers as employees or independent contractors. To date, legislation dealing with classification issues has focused primarily on relieving employers of what has been viewed as the excessive penalties associated with honest errors in the misclassification of employees as independent contractors.

Prior to statutory changes, when the IRS reclassified a worker as an employee, the employer was generally held liable for the full amount of unwithheld income taxes and the unwithheld employee share of Social Security and Medicare taxes for all years open under the statute of limitations. In addition, the employer remained liable for the employer share of Social Security, Medicare and Federal unemployment insurance taxes, plus interest on these amounts. Penalties also could be assessed. The employer's liability for underwithholding was abated to the extent that the employer could demonstrate that the misclassified worker had paid income, Social Security and Medicare taxes on the compensation received. Data to support the determinations were often difficult to obtain, however, especially if the worker was no longer providing services to the employer.

Section 530. In response to a number of large retroactive employment tax assessments in the 1970s, Congress provided certain employers with general statutory relief from IRS reclassification of workers from independent contractors to employees. Section 530 of the Revenue Act of 1978 prohibits the IRS from correcting erroneous classifications of workers as independent contractors for employment tax purposes, including prospective corrections, as long as the employer has a reasonable basis for its treatment of the workers as independent contractors. A reasonable basis includes reliance on (i) judicial precedent, published rulings, letter rulings or technical advice memoranda; (ii) a past IRS audit (although not necessarily an employment tax audit) in which there was no assessment attributable to the employment tax treatment of the worker or of workers holding substantially similar positions; (iii) a long-standing recognized practice of a significant segment of the industry in which the worker was engaged; or (iv) any other reasonable basis for the employer's treatment of the worker.

The relief provided by section 530 is not available unless the employer consistently treats the worker, and any other worker holding a substantially similar position, as an independent contractor (sometimes referred to as the "substantive consistency" test) and complies with the statutory requirements for payments to independent contractors. For example, section 530 relief is not available if the employer has failed to comply with the information reporting requirements associated with its treatment of the worker as an independent contractor.

Section 530 applies solely for purposes of the employment tax provisions of the Code. It has no legal effect on an employer's treatment of a worker as an employee for income tax purposes. Further, it does not affect the worker's own tax treatment for any purpose. Consequently, section 530 can result in the receipt of less than the appropriate amount of employment taxes for some workers. This is because these workers are simultaneously treated as employees for their own tax purposes, and thus are subject only to the employee share of Social Security and Medicare taxes, and are treated as independent contractors by their employers, which pay no employment taxes with respect to these workers. As a result, an amount equal to the employer portion of Social Security and Medicare taxes is not paid. Section 530 also has no impact on determinations of employment status for other purposes, such as eligibility for workers' compensation and unemployment insurance.

Section 530 was enacted as a one-year "stopgap" measure until Congress could devise a less contentious standard for classifying workers. It was extended several times and finally extended indefinitely in 1982.

Section 530 prohibits the IRS from issuing any regulations or revenue rulings regarding the proper classification of workers. As a result, the IRS has not been able to issue any generally applicable guidance in this area for close to 20 years.

Section 3502. In the Tax Equity and Fiscal Responsibility Act of 1982, Congress added section 3509 to the Code in order to mitigate employers' liabilities for retroactive employment tax assessments where section 530 relief was not available. Section 3509 generally limits an employer's liability for failure to withhold income, Social Security, and Medicare taxes on payments made to an employee whom it has misclassified as an independent contractor.

Under section 3509, an employer is liable for 1.5 percent of the wages paid to the employee, in lieu of the income taxes that were not withheld, plus 20 percent of the employee's portion of the Social Security and Medicare taxes on those wages. If the employer has not complied with the information reporting requirements associated with the treatment of the worker as an independent contractor, however, these percentages are doubled to 3.0 and 40 percent, respectively. In addition, the employer's liability under section 3509 cannot be reduced by any self-employment or income taxes paid by the misclassified worker. Section 3509 also does not relieve the employer of its liability for 100 percent of the employer portion of Social Security and Medicare taxes. The relief provided by section 3509 is not available if the employer has intentionally disregarded the withholding requirements with respect to the employee.

The rules of section 3509 were developed in an attempt to place employers and the Federal Government in approximately the same financial position, on average, in which they would have been if the amount of taxes actually paid by the misclassified employees had been determined and used to abate the employers' liabilities, without the need actually to determine those amounts. Thus, section 3509 has no effect on an employer's own liability for Federal or State unemployment insurance taxes or

the employer portion of Social Security or Medicare taxes. Also, in return for limiting the employer's liability for failure to withhold employee taxes, section 3509 prohibits the employer from reducing its own liability by recovering any tax determined under the section from the employee, and, as discussed above, gives it no credit for any taxes ultimately paid by the employee.<sup>5</sup>

Section 1706. In the mid-1980s, some employers in the technical services industry complained that the relief granted under section 530 created an unfair advantage for certain of their competitors. They noted that section 530 affects different taxpayers differently, depending on whether they satisfy the statutory conditions for relief. In particular, employers that have consistently misclassified their employees as independent contractors are entitled to relief under section 530, while other employers in the same industry (that, for example, have sometimes taken more conservative positions on classification issues) are not entitled to relief because they cannot satisfy the consistency requirements of section 530. The crux of the employers' complaints was that certain taxpayers in the industry achieved unfair cost savings by treating the service providers as independent contractors.<sup>6</sup>

As a result of these complaints, in section 1706 of the Tax Reform Act of 1986, Congress excluded from the ambit of section 530 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," effective for payments made after December 31, 1986. Section 1706 applies exclusively to multi-party situations, i.e., those involving (i) technical services workers, (ii) a business that uses the workers, and (iii) a firm that supplies the workers to the business. The effect of section 1706 is to deny section 530 relief solely to the firm that supplies the workers. Section 1706 did not affect the application of section 3509 to such firms.

#### Recent Administrative Initiatives

The IRS has recently announced several administrative initiatives to improve the current situation in the worker classification area.

In March of this year, the IRS released to the public for advance comment new training materials for IRS examiners. The training materials are intended to ensure that examiners make legally correct determinations about whether workers are properly classified as employees or independent contractors under the

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<sup>5</sup>Under section 3509, as under prior law, the full amount of the misclassified worker's gross compensation is subject to tax, even though, if the worker had always been treated as an employee, the employer would presumably have negotiated to reduce wages to reflect the employer's liability for its portion of Social Security and Medicare taxes, unemployment insurance, and any fringe benefits provided by the employer at its option.

<sup>6</sup>As explained above, however, misclassification of an employee as an independent contractor does not necessarily result in any cost savings. However, cost savings could be achieved if, for example, the client is able to pay the independent contractor less than the sum of the cash compensation, its portion of Social Security and Medicare taxes, unemployment insurance, workers compensation, the cost of other State and Federal protections, fringe benefits that it would have paid to an employee, and the overhead costs of withholding and recordkeeping. Cost savings also could be achieved if the worker accepts a lower payment as an independent contractor because he intends to evade taxes by underreporting income or overstating deductions.

common-law standard. The materials emphasize to examiners that they must approach the issue of worker classification in a fair and impartial manner, and remind examiners that either worker classification -- independent contractor or employee -- can be a valid and appropriate business choice. These new training materials also demonstrate how the application of the common-law standard has evolved to reflect the changing nature of business relationships. The materials (including the opportunity provided for taxpayers and all other interested parties to comment on a draft of the materials) and the IRS training program based on the new materials will help promote both consistency and additional clarity concerning IRS application of the common-law classification standard.

The IRS training document also addresses in detail the application of section 530 of the Revenue Act of 1978. It makes clear to examiners that section 530 should be actively considered during an examination. In fact, the materials state that examiners are required to explore the applicability of section 530 even if not raised by the taxpayer, in order to correctly determine the taxpayer's tax liability.

Another recent initiative taken by the IRS is a classification settlement program that allows businesses to resolve worker classification cases earlier in the examination process, reduce taxpayer costs, and ensure the proper application of the provisions of section 530.<sup>7</sup> Businesses that have misclassified their workers as independent contractors, have filed Form 1099 information returns, but have failed to meet all of the other requirements for relief under section 530, can settle the matter with IRS examiners by reclassifying their workers prospectively and paying only limited tax assessments.<sup>8</sup> This reduces the risk that tax assessments could be applied for multiple years.

Participation by businesses in the settlement program is entirely voluntary, and businesses declining to participate retain all rights that exist under the IRS's current procedures. The program is intended to simulate the results that would be obtained under current law if businesses accepting the offers had instead exercised their right to administrative or judicial appeal.

In addition, the IRS has recently announced procedures for allowing businesses, at their option, to resolve employment tax issues more quickly by appealing these issues to the IRS Appeals function even while an examination on other issues is still in progress. The appeals procedure runs for a one-year test period during which time it will be evaluated.

Further, we are working with IRS to develop administrative guidance on the often difficult issue of whether a taxpayer has satisfied section 530 by virtue of reliance on a long-standing

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<sup>7</sup>The program is scheduled for a two-year test period during which time it will be evaluated.

<sup>8</sup>If the business meets the section 530 reporting consistency requirement but the business either clearly does not meet the section 530 substantive consistency requirement or clearly cannot meet the section 530 reasonable basis test, the assessment would be limited to one year of employment tax liability (as limited by Code section 3509). If the reporting consistency requirement is met and the business has a colorable argument that it meets the substantive consistency requirement and the reasonable basis test, the assessment would be limited to 25 percent of one year's income tax withholding, Social Security and Medicare tax liability for the year (as limited by Code section 3509), plus the Federal unemployment insurance tax liability for the year.

recognized practice of a significant segment of the industry in which the worker was engaged. The guidance is expected to provide that, in defining a significant segment of an industry, no fixed percentage is appropriate for all cases because the determination is part of a facts and circumstances analysis involving a number of variables. However, depending on the facts, less than a half of the industry may constitute a significant segment of the industry. In addition, the guidance is expected to make clear that, while determination of whether a practice is "long-standing" is based on facts and circumstances, a practice will be presumed to be "long-standing" if it has been in effect for 10 years or more, and that an industry with a "long-standing" practice can include an industry that was established after 1978 (when section 530 was enacted).

We believe that these initiatives represent a significant response to concerns expressed by taxpayers, particularly small businesses, in the worker classification area. We would urge that these initiatives be given a chance to work, especially in conjunction with the legislative changes proposed on page 10 below to eliminate past employment tax liability in certain cases where taxpayers have a reasonable argument that they meet the requirements of section 530, and to provide easier access to an independent determination by the Tax Court.

#### Legislative Proposals

Concerns Regarding Proposed Changes to Classification Standards. The Subcommittee will be examining legislative proposals to change the Federal tax rules for determining whether a worker is an employee or an independent contractor. In particular, the Subcommittee has requested comments on H.R. 1972 and H.R. 582. These bills would provide new standards under which workers would be classified as independent contractors. Under these bills, where the standards were not met, the current common-law classification test would still apply.

At the outset, we note that worker classification is a difficult and long-standing issue that has far-reaching implications. Fundamental issues, including issues beyond the collection of income and employment taxes, may be affected by legislative changes altering the standard for determining whether a worker is an employee or an independent contractor.

Accordingly, in evaluating possible legislative proposals in this area, we believe it is helpful to bear in mind a number of important (albeit sometimes conflicting) principles and objectives. Among these is the principle that absent good cause, government generally should not interfere in the legal relationship between workers and service recipients. At the same time, legislative changes should not impair the ability of government to collect the proper amount of income and employment taxes in a reasonable and efficient manner. In addition, an effective system of government should attempt to promote certainty and fairness in the application of the law. Consistency of worker classification for various Federal and State law purposes, and for businesses entering into similar relationships with workers, are also important considerations, in part because consistency reduces compliance burdens for businesses. Further, much of the existing legal system that is in place to protect workers against certain types of risks applies only to workers who are classified as employees. For that reason, it is important that any legislation altering the status of workers be analyzed carefully to determine its potential impact on worker protections.

Under current law, worker classification in the Internal Revenue Code directly affects income, Social Security and Medicare taxes. However, it also affects other issues such as the availability of employer-provided pensions and group health

insurance. For example, under current law, tax-qualified retirement plans sponsored by a business are permitted to cover only the business's employees. Legislation that resulted in the conversion of employees into independent contractors for Federal tax purposes would reduce the number of people eligible to save for retirement in tax-qualified employer-provided pension, 401(k), and other retirement plans. These reclassified workers would be free to establish their own tax-favored retirement plans. However, with automatic employer contributions, employee savings through payroll deduction, employer matching contributions, employer education programs, and economies of scale, employer-sponsored plans have proven to be a particularly effective means of promoting retirement savings for workers, especially for middle- and lower-income workers who might be less likely to save outside the workplace. In addition, converting employees into independent contractors could result in fewer people receiving the benefits of lower-cost group health coverage through their employers.

In evaluating any proposed legislation, it is also important to consider whether a new statutory standard under Federal tax law would lead to similar changes in coverage under other Federal and State laws, such as the laws that provide unemployment insurance, workers' compensation, minimum wage and maximum hour protections, workplace health and safety standards, and family and medical leave protections to workers who are classified as employees. This might occur, for example, if businesses that reclassified workers as independent contractors under a new Federal employment tax standard also treated those workers as independent contractors for purposes of other laws that are based on employee status. Broader reclassification under these other statutory provisions could also result from subsequent efforts, in the interest of simplification, to eliminate inconsistencies between the classification standards under those State and Federal non-tax laws and a new Federal employment tax classification standard by conforming them to the new standard. These potentially sweeping implications should be explored carefully and thoroughly before enactment of any new statutory classification standard for Federal tax purposes.

As a general matter, experience suggests that it is difficult to devise one simple, specific statutory definition or safe harbor that applies appropriately to the many varied existing worker relationships and occupations. Moreover, specific statutory rules, by contrast to regulations and rulings, are not easily adapted to the changes that are constantly taking place in an area as complex and dynamic as the American work place.

Legislative proposals to replace current worker classification rules with new standards raise a number of serious concerns. First, in an effort to achieve simplicity and objectivity in this area, some proposals would prescribe "safe harbor" criteria for classification as an independent contractor that are easily satisfied and that could result in large-scale shifting of workers from employee to independent contractor status. For example, requirements that workers have significant training in order to constitute independent contractors could be automatically satisfied by large classes of workers with licenses, professional degrees, vocational training, or various types of technical training. Requirements that workers have made themselves available to work for others could be satisfied through low-cost advertisement or registration by employees who have no intention of working for anyone other than their employers.

Second, under some proposals, worker status is easily recharacterized without altering the underlying relationship between the worker and the employer. For example, it is not difficult for an employer to structure an artificial arrangement

that would appear to meet a requirement that an individual be able to realize a profit or loss to be considered an independent contractor. An employer could require the employee to purchase or rent certain tools and supplies used in generating the employer's product, but could protect the employee from loss by directly compensating the employee through a commensurate pay increase. This could permit an employee to appear to "realize a profit or loss" without changing the nature of the employer-employee relationship or the tasks that the employee would undertake, particularly if the worker purchases supplies and rents equipment from which the worker could "walk away" if employment terminates. By similar means, an employer can fairly easily restructure payments to make it appear that an employee will incur significant unreimbursed expenses. The employer can require the worker to furnish certain tools and supplies while the employer provides a corresponding increase in the payments made to the worker that is not characterized as a reimbursement. The requirement that the worker and service recipient enter into a written agreement concerning worker classification also would fail to prevent inappropriate recharacterization of employee status, particularly where workers do not have as much bargaining power as the business.

Third, in the interest of simplification, some legislative proposals sacrifice clarity, using terms that sound easy to apply in the abstract but would leave serious ambiguities regarding their interpretation. For example, proposals may require that a worker make "significant" investment in tools, equipment, or training to constitute an independent contractor. Yet what is "significant" is not objectively determinable, and may vary among occupations and industries. Such provisions would only replace the current standards with new standards that also have inherent ambiguities.

Fourth, by permitting workers to become independent contractors by meeting alternative criteria, many proposals would allow taxpayers to apply criteria that, while appropriate in certain contexts, are inappropriate for the occupation or industry being considered. Thus, the problems identified above are exacerbated when one or two criteria alone become determinative in classifying workers. In a well-meaning attempt to craft a "one-size fits all" solution, legislators may craft a standard that is too loose for many occupations and industries. For example, some might argue that it is appropriate to determine whether an architect, working full-time on a building project for an employer, is an independent contractor based on whether the architect has significant investment in training and has performed or offered to perform substantial services for others in the past year. However, these same broad statutory standards could then be applied to employees in fields with high turnover and significant training requirements, such as certain nurses working in hospital settings, to shift numerous employees to independent contractor status.

In summary, many legislative proposals establish standards that are easily satisfied or manipulable, lack clarity, and would impose alternative requirements that allow taxpayers to pick and choose elements in a manner inappropriate to the occupation or industry involved. While most workers are readily classified as employees or independent contractors, there will always be a class of cases that are less obvious. The formulation of objective, mechanical standards to resolve these cases has proven to be an elusive goal because classification under the common-law control standard looks to the realities of the situation and therefore is inherently fact-sensitive. Moreover, in light of the significant worker protections that hinge on status as an employee, it is important to consider carefully the risk that new statutory classification standards could result in significant shifts of workers from employee to independent contractor status.

Proposals for Statutory Modifications Relating to Section 530 and Tax Court Jurisdiction. Perhaps the greatest problem for business in this troubled area is not the possibility that an employer treating its employees as independent contractors will be required to reclassify them as employees for the future, but the risk of substantial employment tax liability and penalties for previous years, even where the employer had a reasonable argument and belief that it was entitled to section 530 protection.

To address this problem, we propose that Congress permit businesses that fail to meet the requirements of section 530 and misclassify workers as independent contractors to reclassify their workers prospectively with no employment tax liability for prior years, provided that they satisfy certain conditions.<sup>9</sup> To qualify for this relief, the business would have to meet the section 530 reporting consistency condition, and have a reasonable argument that it meets the section 530 substantive consistency and reasonable basis requirements. This "reasonable argument" standard is intended to provide relief to taxpayers who fall just short of meeting those section 530 requirements. Of course, as under current law, if workers are correctly classified as independent contractors, or if the taxpayer meets section 530, then the business would not be required to reclassify the workers as employees.

Under the proposal, a taxpayer that believes the IRS has erred in its case would be given an expanded opportunity to obtain an independent review of the IRS decision. United States Tax Court jurisdiction would be enlarged to cover worker classification determinations for employment tax purposes. Of course, the Tax Court would have the authority described above to determine whether misclassified workers should be reclassified on a prospective basis only.

Access to the Tax Court would permit disputes to be resolved more quickly and at lower cost than in Federal district court. The Tax Court provides simplified procedures that might be adapted for small business cases. Tax Court judges have considerable experience in resolving tax cases involving similar issues, and many small cases are currently resolved without requiring the business to retain counsel. We believe that the expanded Tax Court jurisdiction would provide a business with increased access to an independent judicial resolution if the business believed its determination, rather than the IRS position, was correct.

These legislative proposals -- to eliminate past employment tax liability in certain cases where taxpayers fall just short of meeting section 530, and to increase a small business's access to an independent, third-party determination -- should further help taxpayers to resolve worker classification problems in a fair and cost-effective manner. We believe that, in combination with the administrative steps described earlier, they would provide significant relief to small businesses from the most serious problems relating to worker classification.

In addition, we believe that it may be possible to improve understanding of the common-law classification standard through a revenue ruling or other guidance. The recently revised IRS training materials take an important step in this direction by emphasizing that the true common-law test is the right to "direct and control" and that the "20 factors" that are often referred to in connection with this test are relevant only insofar as they provide evidence bearing on whether the test is satisfied. We

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<sup>9</sup>This suggested legislative change builds on the relief provided under the IRS's Classification Settlement Program, described above.

think that it would be helpful to taxpayers for this message to be communicated through more formal guidance (such as a revenue ruling), and we also believe that such guidance could help taxpayers focus on factors -- likely five or fewer -- that are most relevant to their particular situations. At present, section 530 precludes the issuance of a revenue ruling or regulations to provide this clarification. We would be pleased to explore with Congress the possibility of amending section 530 at least to the extent necessary to permit publication of such guidance.

Proposals for Statutory Modifications Relating to Information Reporting. We believe that any proposal in this area should attempt to improve compliance with regard to independent contractors. Under current law, service-recipients engaged in a trade or business are required to report, on Form 1099, payments in the course of such trade or business to any individual independent contractor of \$600 or more during a calendar year. This information-reporting system is one of the most effective tools for enforcing proper reporting of income by independent contractors, because taxpayers are more likely to report a payment on their income tax return if they know the payment already has been reported to the IRS by the payor.

The penalty on a service-recipient for failure to file the information return, however, is only \$50 (unless the failure is due to intentional disregard of the reporting requirement). We believe this relatively minor penalty, last increased in 1982, contributes to substantial noncompliance with these reporting requirements. In recent years, many experts in this area have proposed substantially increasing this penalty. The Administration's fiscal year 1997 budget proposes to increase the general penalty for any failure to file an information return to the greater of \$50 per return (the current penalty) or 5 percent of the total amount required to be reported. Increasing the penalty in proportion to the amount of the unreported payment balances the need to have a stronger incentive to comply with the reporting rules with the concern that the penalty not be unduly harsh. The proposal includes limits on the penalty to ensure that the increase will not be imposed on those firms that have very substantially complied with the reporting requirements, i.e., where the failure is likely due to inadvertence or administrative error in a firm that has made a serious attempt to fully comply with the rules. Specifically, under the proposal the penalty will not apply if the failure is corrected by August 1 of the year the return is due. In addition, the penalty will be limited to \$50 per failure, as under current law, if the taxpayer properly reported at least 97 percent of all amounts required to be reported for that period. We note that the Tax Section of the New York State Bar Association has made a similar proposal. (See the 1995 Report on Proposed Reforms to Administration and Enforcement of Employment Tax and Income Taxes on Individual Workers.)

In addition, under current law, a service-recipient is not required to file an information return with respect to payments made to a corporation for services rendered. The Administration believes that corporations doing business with the Federal government should report as income their payments from the Federal government. Accordingly, the Administration's fiscal year 1997 budget would generally require Federal agencies to report payments of \$600 or more to corporations for services rendered, with appropriate exceptions as prescribed in regulations.

#### Conclusion

Worker classification is a difficult and complex issue that has far-reaching implications. Legislative changes that would result in the reclassification of workers from employee to

independent contractor status could affect a variety of protections for these workers. It is important to explore these potential consequences thoroughly before enacting any new statutory classification standard for Federal tax purposes. At the same time, we believe that Congress should consider proposals to eliminate retroactive employment tax liabilities in certain cases where an employer has a reasonable argument that it meets the requirements of section 530, and to permit taxpayers to resolve disputes with IRS in a simpler and more cost-effective manner.

The Treasury Department appreciates the ongoing efforts by the Members of this Subcommittee and others to address this subject. We would be pleased to explore these issues further with the Subcommittee.

Madam Chairman, this concludes my formal statement. I will be pleased to answer any questions that you or other Members may wish to ask.

Chairman JOHNSON. Thank you, Mr. Lubick, and I do look forward to getting to the dialog part of this panel. I appreciate the significance of your suggestions.

Commissioner Richardson.

**STATEMENT OF HON. MARGARET MILNER RICHARDSON,  
COMMISSIONER, INTERNAL REVENUE SERVICE;  
ACCOMPANIED BY STUART L. BROWN, CHIEF COUNSEL; AND  
MARTY WASHBURN, NATIONAL DIRECTOR, SPECIALTY  
TAXES**

Ms. RICHARDSON. Thank you, Madam Chairman and other distinguished Members of the Subcommittee.

Chairman JOHNSON. Commissioner, before you start—

Ms. RICHARDSON. Yes, ma'am.

Chairman JOHNSON [continuing].—I do want to put clearly on the record that you have responded to the concerns raised at the White House conference in a very aggressive fashion, and I appreciate that you have put out there a new proposal for a much easier settlement process, to limiting retroactive liability to a year, to making it easier to appeal in the process of a case.

I know you are going to go into some of these things, but it does show, and putting the draft out and the training materials, So, that practitioners can come. It does open up the dialog about this, and I commend you on your leadership.

Ms. RICHARDSON. Thank you very much, and we appreciate your support. I also want to make the point that it was not me alone who did that. I had the active and mostly enthusiastic support of many people at the IRS to help address this problem. So, I appreciate what they have done, too.

We do appreciate the opportunity to be here. I have with me Stuart Brown who is our Chief Counsel—he is on my immediate left—and Marty Washburn who is the National Director who oversees our Employment Tax Programs. They too have been very active in helping to come up with some constructive ideas to administratively address some of the issues that we face.

We do appreciate the opportunity to be here to talk about what we are trying to do to make the system fairer and simpler and more efficient; in particular, our improvements in employment tax administration. We have tried to respond to concerns we have heard from taxpayers, particularly small business owners, regarding the issue of worker classification, and we are trying to address them, as you pointed out, but the classification of workers as independent contractors or as employees is an issue that remains of great concern to the business community, but also, to us as well as to workers.

I want to emphasize that the Internal Revenue Service, as the tax administrator, is concerned about worker classification issues for one reason and for one reason only, and that is to perform our mission, which is to collect the proper amount of tax revenue in a fair and impartial manner. Unfortunately, though, misclassification of workers frequently does go hand in hand with noncompliance with the Federal tax laws, and so therein lies our basic interest.

Under the Internal Revenue Code, the Congress concluded that whether a worker was an employee or an independent contractor

should be determined by using the so-called common law standard, and that standard looks to whether a business has the right to direct and control the means and the details of how a worker performs his duties.

Applying that standard has always been a difficult task. Courts have looked to a variety of evidentiary factors to establish whether that right to direct and control exists. Ultimately, we and others culled from the factors some of the evidentiary factors, and there were about 20, and they came to be known as the 20 common law factors. Ultimately, we published those in our revenue ruling, but those factors were never intended to replace the legal standard of the right to direct and control how work is performed. They were merely intended as a guide to be used in identifying what evidence might be relevant in exploring the existence and extent of the right to direct and control a worker's activities.

From the perspective of tax administration, the factors are too numerous, too complex, and they do not often fit the circumstances of particular businesses today.

We also know that in applying the common law standard we have to take into account section 530. Many of you may recall, and as Mr. Lubick said, he was here before when this was enacted, section 530 was intended as an interim relief provision to be in effect for one year while Congress undertook full consideration of the issues that were leading to the controversies on worker classification. Unfortunately, here we are many years later still trying to discuss the issue and trying to decide how we can resolve it.

Now, I have stated publicly several times, and I want to emphasize again today, that the status of a worker as either an independent contractor or an employee is a valid and appropriate business choice. We at the IRS understand and recognize that businesses can properly classify workers as independent contractors. A worker's status must be determined accurately to ensure that workers and businesses can anticipate and meet their tax responsibilities timely and accurately, but we recognize that we at the IRS have a responsibility to make certain that the worker classification determinations under current law are accurate, even though current law has a lot of complexity.

In response to the numerous concerns both inside the Service and from taxpayers, we are changing our approach. We have recently undertaken four significant initiatives to improve administration and to respond to the concerns that we have heard.

I would like to summarize those, although I go into much greater detail in my written testimony. First, we said that we would revise the training materials for IRS examiners that handle worker classification issues to emphasize the principle that using independent contractors can be a legitimate business practice that should not and will not be challenged by the IRS. The revised materials are based on the position I have expressed at prior hearings and in speeches that, again, we as the tax administrator have the responsibility to collect the proper amount of tax.

On March 5, we released a draft of the training materials for public comment, and for the first time ever we requested comments on our training materials. We received over 45 comment letters, and I want to thank everybody who participated. Many of the com-

ments were strongly supportive of our effort to provide a clear, evenhanded approach to this area, and almost all of the commentators had thorough, thoughtful, and constructive comments with many useful suggestions.

We are currently reviewing the comments and revising our materials to respond to the concerns that were raised. In response to a number of comments that requested clarification of the section 530 industry practice of safe harbor, we are working with Treasury to develop a revenue procedure that will be proposed for comment and will address some of the more difficult issues that arise under that safe harbor, such as what is a significant segment, what is long-standing practice, and whether an industry is eligible for section 530 relief if the industry began after 1978.

My written testimony, again, goes into those issues in detail. We will be happy to talk about them later.

Later this summer in July and August, over 800 examiners, managers, and reviewers in our Employment Tax Program will be retrained, and we will also be providing training for all of our general program examiners by the end of this year.

The training materials are intended to ensure that IRS examiners properly classify workers as independent contractors or as employees in a manner that is impartial and reflective of current law. I believe that these training materials will provide our examiners with the tools to do this. The materials discuss types of evidence that may indicate whether an employee-employer relationship does or does not exist under the common law standard, and they should guide examiners in determining the types of evidence that would be relevant.

The materials also address facts necessary to determine whether workers are statutory employees, and they also emphasize—and I think this is important—that relevant evidence may change over time because business relationships and the work environment can also change over time.

In addition, they address the application of section 530 since, 530 can in certain circumstances relieve employers of employment tax liability that would result from reclassification, and we are reemphasizing our policy that IRS employees are to exercise strict impartiality in the conduct of their duties.

Thus, not only are examiners required to approach the issue of worker classification in a fair and impartial manner, they are also required to actively consider section 530 during the course of an examination.

We began our draft of the training materials with the philosophy of strict neutrality in the application of the law. We also began the draft with a strong practical concern that business practices are evolving rapidly and that our evaluation of the relevant facts and circumstances must also evolve in order for us to achieve fair and impartial results.

We are going to release to the public again for the first time ever the final version of those training materials, and we welcome any additional comments. Our intention is to ensure that our training materials remain current, and we want to hear from people who are interested in good tax administration and who can help us do that.

We also intend to tell businessowners what we are going to be looking for in future examinations so that they will have the opportunity to be more informed on decisions about worker classification and that they can anticipate and meet their responsibilities timely and accurately.

In addition to the new training materials, we have conducted a thorough review of our existing Employment Tax Compliance Programs. As a result, in March we also announced a new initiative we called the Classification Settlement Program which is intended to help reduce taxpayer burden by resolving worker classification issues as early in the administrative process as possible. It is based on the key principles of not reclassifying workers who have been correctly treated as independent contractors, resolving classification issues as early as possible in the administrative process, resolving those classifications uniformly throughout the country, and taking into account a taxpayer's past compliance with the common law standard and section 530 requirements in resolving these issues.

Finally, we have noted and take very seriously that our compliance programs should encourage correct classification and correct reporting of payments to workers whether they are employees or independent contractors.

We also announced in March a procedure for early referral of employment tax issues to the IRS Appeals function. The purpose of the early referral for employment tax issues is to allow them to be resolved more expeditiously through simultaneous action at the district office level and through Appeals.

Since the middle of March, taxpayers have been able to request early referral to Appeals of any developed unagreed employment tax issue that is arising out of an exam. Appropriate issues for early referral, if resolved, can reasonably expect to result in a quicker resolution of the entire case.

Finally, we require the approval of the national office for any and all large worker classification projects, including projects where the issue is the existence of an employer-employee relationship as well as those that involve, for example, employee leasing. We have taken this action because sometimes these big projects do involve large industries, and we want to ensure that we have uniform treatment throughout the country. They also often involve difficult technical issues, and we want to ensure that they are resolved at the national level.

We have reviewed and approved over a dozen worker classification projects in various market segments through this process, and we anticipate that it will make it easier for us to have uniformity across the Nation.

We also as I mentioned, have some concern about compliance. In preparing estimates of the employment tax gap, we did develop an estimate of the additional Social Security, Medicare, and Federal unemployment insurance taxes that would be due if we examined all instances of worker misclassification and if all payments to misclassified independent contractors had been treated as wages.

For 1992, we estimate that such retrospective reclassification would have produced recommendations of about \$3.3 billion in deficiencies, and after appeals and litigation those deficiencies would

have been set at \$2.6 billion. I want to underscore those employment taxes, Medicare, and FUTA taxes. The estimate does not take into account certain factors that offset the revenue loss such as the fact that independent contractors in the aggregate do tend to have fewer tax-preferred benefits than employees.

Because income underreporting contributes to the tax gap, I think it is also important to note the estimates we have on reporting compliance of misclassified compensation. On the average, misclassified workers report about 62 percent of their compensation. When 1099 Forms are filed, that greatly improves reporting, but that should be contrasted with employees whose wages are subject to withholding who report in excess of 99 percent of their wages.

We also want to thank this Subcommittee for your focus on the effect of reporting provisions on overall compliance, and we certainly welcome the opportunity to work with you and Treasury on any proposals that would be directed at improving reporting and compliance with the reporting obligations.

The Internal Revenue Service is taking steps to ensure that the classification projects are properly focused on serious deficiencies, that our examiners are thoroughly trained in the correct application of the common law standard and section 530 of the Revenue Act of 1978, and that worker classification controversies are resolved as early as possible.

These initiatives that I have reviewed for you are all relatively new, and I think it is too soon to say how effective they will be in actually addressing the problems that have been associated with worker classification. However, I do try to regularly meet with industry and practitioner groups, and I can report that the initial response to the initiatives has generally been very positive.

We feel that these programs should ensure impartiality and consistency by the IRS, and we also want to assure that the current law is accurately reflected in worker classification, and we want to reduce the burdens on taxpayers.

I would like to add that in areas like this where tax law interacts with business and workers in thousands of different situations, I firmly believe that the best way to ensure effective compliance in administration is to continue an open dialog between the IRS and the community. The positive effects of such a process are reflected in our new initiatives, and we continue to be encouraged as we move forward. We also want to continue to encourage comments.

This concludes my remarks, Madam Chairman. We would certainly be prepared to answer any questions that you or your Subcommittee Members have.

[The prepared statement follows:]

**STATEMENT OF MARGARET MILNER RICHARDSON  
COMMISSIONER OF INTERNAL REVENUE**

**BEFORE THE  
SUBCOMMITTEE ON OVERSIGHT  
HOUSE COMMITTEE ON WAYS AND MEANS**

**JUNE 20, 1996**

Madame Chairman and Distinguished Members of the Subcommittee:

I appreciate the opportunity to be here today to discuss the efforts of the Internal Revenue Service to make the federal tax system fairer, simpler, and more efficient for taxpayers. In particular, I welcome the opportunity to discuss the improvements in employment tax administration, the concerns that we have heard from taxpayers, particularly small businesses, regarding the issue of worker classification, and what the IRS is doing to address these concerns.

**INTRODUCTION**

The classification of workers as independent contractors or as employees is an issue of great concern to the business community, the IRS, as well as to workers. How a worker is classified for tax purposes under federal and state law has broad ramifications -- affecting tax liability, social security benefits, retirement, health insurance and other tax-favored fringe benefits, unemployment and worker's compensation benefits, and labor and occupational safety protections. The participants at the 1995 White House Conference on Small Business identified worker classification for tax purposes as one of their greatest concerns. In addition, last year I held a series of small business town meetings across the country during which small business owners underscored that this issue is of major importance to them.

I would like to emphasize that in analyzing a worker's status, the IRS is concerned for one reason and one reason only: to perform our mission, which is to collect the proper amount of tax revenue in a fair and impartial manner. Unfortunately, misclassification frequently results in noncompliance with federal tax laws; thus, it is an important area on which we need to continue to focus our compliance efforts.

**THE COMMON-LAW STANDARD**

Under the Internal Revenue Code, whether a worker is an employee or an independent contractor is determined using the common-law standard. This standard looks to whether a business has the right to "direct and control" the means and details of the worker's activities.

This standard was explicitly adopted by Congress in a 1948 resolution, enacted over President Truman's veto, which amended the Code to provide that the term "employee" would not include "(1) any individual who under the usual common-law rules applicable in determining the employer-employee relationship, has the status of an independent contractor or (2) any individual (except an officer of a corporation) who is not an employee under such common law rules." H.J. Res. 296 (62 Stat. 438). The resolution was enacted in response to proposed Treasury regulations which had defined the employer/employee relationship on the basis of the economic dependence standard suggested by the Supreme Court's decisions in United States v. Silk, 331 U.S. 704 (1947) and Bartels v. Birmingham, 332 U.S. 126 (1947). In response to the resolution, these proposed regulations were withdrawn, and the prior final regulations -- which had interpreted the statutory term "employee" on the basis of the common-law test -- remained in force.

Applying the common-law standard has always been a difficult task. Courts have looked to a variety of evidentiary factors to establish whether the right to direct and control exists. Because the common-law standard derives inherently from judicial decisions, the Internal Revenue Service and the Social Security Administration many

years ago reviewed the case law and listed all the types of evidence on which courts had based their decisions. Not surprisingly, different courts addressing different industries had considered different types of evidence to be relevant. All these types of evidence were placed on a single list. This list was used in training our examiners and in training by the Social Security Administration to determine whether workers are entitled to social security benefits. The list came to be known as the "twenty common-law factors" and was ultimately published, many years later, in Revenue Ruling 87-41, 1987-1 C.B. 296.

The list of "twenty common-law factors" was never intended to replace the legal standard of the right to direct and control how work is performed. It was merely intended as a guide for examiners to use in identifying what evidence might be relevant in exploring the existence and the extent of the right to direct and control.

I would like to emphasize that these factors do not answer the question of whether a worker in any specific business situation is an independent contractor or an employee. They assist in identifying the evidence that illustrates whether the requisite control exists. To apply the factors, our examiner with the assistance of the business must first determine what evidence is relevant to the business at issue. Then the examiner must determine what evidence is most important. Finally, the examiner must consider whether other evidence might be relevant. Clearly, this is not an easy process.

From the perspective of tax administration, the factors courts have used are too numerous, too complex, and often do not fit the circumstances of a particular business. However, we will continue to reexamine our approach to employment tax administration and look for new and innovative strategies to assure that workers are properly classified and that the existing statutory framework is complied with.

In addition to applying the common-law standard, section 530 must also be considered by our examiners. The enactment of section 530, as part of the Revenue Act of 1978, resulted in large part from increased IRS employment tax enforcement activities in the late 1960s. As a result of these activities, the number of reclassifications of independent contractors as employees increased substantially. In the view of many taxpayers, these reclassifications were based on a change in the IRS position of how the common-law rules applied. In response to these concerns, the Statement of Managers of the 1976 Tax Reform Act requested that the IRS "not apply any changed position or any newly stated position . . . to past, as opposed to future taxable years" pending completion of a study by the staff of the Joint Committee on Taxation. See S. Rep. No. 1263, 95th Cong., 2d Sess. 210 (1978).

Section 530 was intended as an *interim* relief provision, intended to be in effect for only one year, while the Ways and Means Committee "[undertook] full consideration of the issues underlying these controversies next year [1979] in order to formulate a proposal for a comprehensive solution." H.R. Rep. No. 1748, 95th Cong., 2d Sess. 4, (1978), 1978-3 C.B. 632. Section 530 was extended several times, then made permanent in 1982. However, it has never been codified as part of the Internal Revenue Code.

Section 530 relieves taxpayers from some of the effects of reclassification if they have provided required Forms 1099, have treated consistently a class of workers as independent contractors, and have relied on some reasonable basis for not treating the workers as employees. In addition, section 530 precludes the IRS from issuing any regulations and revenue rulings concerning the subject of worker classification.

I have publicly stated several times that the status of a worker as either an independent contractor or employee is a valid and appropriate business choice. It must be determined accurately to ensure that workers and businesses can anticipate and meet their tax responsibilities timely and accurately. Our examiners should be making accurate worker classification determinations under the common-law standard, despite its complexity.

On August 2, 1995, the National Director of our employment tax programs at the IRS testified on the subject of worker classification before the Subcommittee on Taxation and Finance of the House Committee on Small Business. On that occasion, he announced that in response to numerous concerns that had been raised, the IRS was developing changes to our approach to the worker classification issue in our

employment tax audits to address taxpayer concerns. In the past months, we have undertaken four significant initiatives to improve administration in this area and respond to concerns expressed by taxpayers. I would like to describe for the Subcommittee those initiatives and their status.

#### **WORKER CLASSIFICATION TRAINING INITIATIVE**

First, we said that we would develop new training materials for IRS examiners handling worker classification issues that emphasize the principle that using independent contractors can be a legitimate business practice that will not be challenged by the IRS. These materials are based on the position I expressed in prior hearings – that the IRS, as the tax administrator, has as its sole concern in this area to collect the proper amount of tax revenue in a fair and impartial manner. On March 5, 1996, we released a draft of the training materials for public comment, the first time we have ever requested comments on training materials. This action reflects our commitment to impartiality in this area. By the end of the comment period, the IRS received over 45 comment letters. I want to thank each person and group that submitted comments.

These comments reflected the reactions of a broad spectrum of the business and labor community and included a number of letters from members and representatives of the small business community. We were delighted to find that many of the comments were strongly supportive of the effort made to provide a clear, even-handed approach to this area. We were also pleased that almost all of the commentators went on to provide a thorough, thoughtful, and constructive analysis making a number of useful suggestions. We are currently reviewing these comments and revising our materials to respond to concerns raised. Later in my testimony I will discuss specific public comments in more detail.

We have trained a team of 20 instructors who will conduct training sessions during the months of July and August throughout the country for over 800 examiners, managers, and reviewers. We will also provide training for all of our general program examiners by the end of calendar year 1996.

The goal of the training materials is to ensure that IRS examiners properly classify workers as independent contractors or employees in a manner that is impartial and reflective of current law. The training materials provide IRS examiners with the tools to do this. They discuss types of evidence that may indicate whether an employer-employee relationship does or does not exist under the common-law standard, and guide examiners in determining the types of evidence that are relevant. They also address factors necessary to determine whether workers are statutory employees. The training materials emphasize that relevant evidence may change over time because business relationships and the work environment change over time.

In addition, the training materials address the application of section 530 of the Revenue Act of 1978. Section 530 can, in certain circumstances, relieve employers of employment tax liability resulting from worker reclassification. IRS policy requires IRS employees to exercise strict impartiality in the conduct of their duties. Thus, not only are IRS examiners required to approach the issue of worker classification in a fair and impartial manner, they are required to actively consider section 530 during an examination. Moreover, the training materials make it clear that the business need not concede or agree to the determination that the workers are employees in order for section 530 relief to be available.

As I previously stated, in order to ensure that the training materials adequately and effectively train our examiners on worker classification issues, we put them out for public comment soliciting input from the private sector including small business. I would like to take a few moments to mention some of the specific comments and what we are doing in response to them.

We began our draft of the training materials with the philosophy of strict neutrality in application of the law. We also began the draft with a strong practical concern that business practices are evolving rapidly and that our evaluation of the relevant facts and circumstances must also evolve to achieve a fair and impartial result.

\* We state clearly in the materials that independent contractors play a legitimate role in business operations. (Page 1-1)

- \* We emphasize the statutory common-law test of right to control and caution against a mechanical application of 20 factors. (Page 1-4)
- \* We emphasize that the nature of the business is important, and that the factors to be considered must be carefully weighed, not counted, with respect to that business. (Pages 1-5 and 1-6)
- \* We require that any agent conducting an employment tax examination make it his or her responsibility to raise the issue of whether the taxpayer may be entitled to relief under section 530. (Pages 1-1 and 3-33)

The commentators generally applauded this approach. However, they also offered thoughtful and constructive suggestions. We are just completing the process of revising the materials to reflect these comments and we have incorporated many of these comments into our final materials. A few examples will illustrate the range of the comments we have taken into account:

- \* We clarify that hourly payment and reimbursement of expenses can be consistent with independent contractor status.
- \* We make it clear that modern travel and communication systems have made use of a home office much less important in determining a worker's status.
- \* We state explicitly that a worker may wear both employee and independent contractor hats for a business – the worker can be an employee for certain services, an independent contractor for other services.
- \* We make it clear that a significant segment of the industry does not require a majority of the industry, and thus, less than a majority may satisfy the industry practice safe harbor.
- \* We provide specific instruction about the types of evidence that may support a business' reliance on the industry practice safe harbor under section 530, stressing that taxpayer surveys, while valuable, are not essential when other evidence is available.
- \* We have made it clear that this safe harbor is potentially available to employers in those industries that have come into being since 1978.
- \* We make clear that a practice may be long-standing even if it has not been in effect for ten years or more.
- \* We take the position that taxpayers who relied on the advice of a tax professional in classifying workers as independent contractors need not have investigated the employment tax expertise of the professionals in order to establish reliance on some "other reasonable basis."
- \* We provide that a reasonable effort by a business that falls just short of compliance with the common-law rules may be enough to establish a reasonable basis for purposes of section 530.
- \* In addition to requiring examiners to affirmatively raise the possibility of section 530 relief, we will develop a written plain language summary to section 530 that will be required to be provided to taxpayers at the beginning of an examination.

Also, in response to many comments regarding the difficult issue of whether a taxpayer has satisfied section 530 by virtue of reliance on a longstanding recognized practice of a significant segment of the industry in which the worker was engaged, we have worked with Treasury in developing guidance. This guidance will take the form of a proposed revenue procedure on which comments are invited. It will specifically address the points I have described above on the appropriate standard for a significant segment of the industry, the availability of the industry practice safe haven for companies within industries established after 1978, and the recognition that a practice extending beyond ten years will be presumed to meet the longstanding requirement.

Generally all of the comment letters have resulted in useful improvements to the training materials. One recurrent comment was not adopted. This comment suggested that section 530 relief should be tested without examining the worker's status under the common-law. After thorough analysis, we have not adopted this suggestion. We have included in our training materials a more detailed explanation of why determination of worker status is an important tax administration prerequisite for application of section 530 relief. We also will continue to stress that the taxpayer need not agree with or concede to our examiner's determination of status in order to obtain section 530 relief.

We intend to release to the public -- again, for the first time ever -- the final version of the training materials, and we welcome additional comments. It is our intention to ensure that our training remains current, and comments from those interested in good tax administration can help us do that. It is also our intention to tell business owners what we will be looking for in future examinations. This should give businesses an opportunity to make more informed decisions on worker classification to ensure that they can anticipate and meet their responsibilities timely and accurately. As the Business Journal in Memphis, Tennessee noted on May 6, 1996, "[t]elling [small] business owners what they're [IRS] looking for may be IRS' best weapon yet."

#### **CLASSIFICATION SETTLEMENT PROGRAM**

In addition to the development of new training materials, we conducted a thorough review of our existing employment tax compliance programs. As a result of this review, on March 5, we also announced a new initiative, the Classification Settlement Program or CSP, which is intended to help reduce taxpayer burden by resolving worker classification issues as early in the administrative process as possible. CSP will complement the worker classification training initiative I described earlier for the Subcommittee.

The CSP is based on the following key principles:

- Reclassification of workers who have correctly been treated as independent contractors must be avoided.
- Worker classification issues should be resolved quickly, and as early in the administrative process as possible.
- Worker classification issues should be resolved uniformly throughout the country.
- Resolution of worker classification issues should take into account a taxpayer's past compliance with section 530, as well as the common-law standard.
- The IRS' compliance programs should encourage correct classification and correct reporting of payments to workers.

The CSP helps examiners apply these principles by giving them procedures for settling worker classification cases in the early stages of the examination based on an appropriate application of the relief provisions contained in section 530 of the Revenue Act of 1978. Under the CSP, IRS examiners offer worker classification settlements to taxpayers under examination using a standard closing agreement developed in the IRS National Office. Generally, these closing agreements provide businesses that filed Forms 1099, but do not meet all the requirements of section 530, with an opportunity to reclassify workers prospectively, combined with a specified tax assessment not exceeding one year's tax liability.

The amount of the tax assessments made under the standard closing agreements depends on the extent to which the taxpayer has satisfied the requirements of section 530. For example, a business that has complied with information reporting requirements but does not meet any of the other section 530 requirements would generally not have a tax assessment under the CSP for more than one year's liability. A business that has come closer to meeting all section 530 requirements would have a smaller tax assessment. By contrast, under the IRS' usual examination procedures, a business would generally have a tax assessment for all open tax years. Of course, taxpayers that meet all the requirements of section 530 would have neither a tax assessment nor a request from the examiner to reclassify their workers.

The graduated settlement offers comprising CSP are intended to simulate the results that would be obtained under current law, if the businesses accepting those offers had instead exercised their right to an administrative and/or judicial appeal.

The CSP provides taxpayers with an additional avenue for resolving worker classification cases as early in the administrative process as possible. Taxpayer participation in the CSP is entirely voluntary, and a taxpayer may accept a CSP settlement offer at any time during the examination process. A taxpayer's rejection of a CSP offer in no way affects the outcome of the examination. Moreover, a taxpayer declining to accept a settlement offer under the CSP retains all rights to administrative appeal that exist under the IRS' current policies and procedures.

The CSP was made available on a two-year basis beginning March 5, 1996, to all taxpayers under examination that have filed the required information returns. The IRS will evaluate the success of the CSP in resolving worker classification issues during the two-year period and invites comments businesses and practitioners may have on the program.

#### **EARLY REFERRAL OF EMPLOYMENT TAX ISSUES TO APPEALS**

Also, on March 5, 1996, the IRS issued Announcement 96-13, 1996-12, I.R.B. 33, which contains the procedures for the early referral of employment tax issues to the IRS Appeals function. The purpose of early referral for employment tax issues is to resolve them more expeditiously through simultaneous action by the District Office and Appeals. As of March 18, 1996, taxpayers may request early referral to Appeals of any developed, unagreed employment tax issue arising from an examination that is under the jurisdiction of the District Director. Early referral of employment tax issues to Appeals is:

- Entirely optional,
- Initiated by the taxpayer, and
- Subject to the approval of both the District Director and the Assistant Regional Director of Appeals.

Appropriate issues for early referral include those that, if resolved, can reasonably be expected to result in a quicker resolution of the entire case and that both the taxpayer and District Director agree should be referred to Appeals early. Therefore, early referral may not be available for every employment tax issue.

The IRS has put the new early referral procedures into effect for a one-year period, during which time businesses and their representatives are invited and encouraged to provide feedback on the usefulness of the program.

#### **NATIONAL OFFICE INVOLVEMENT IN WORKER CLASSIFICATION PROJECTS**

Finally, we announced that we were requiring the approval of our National Office here in Washington of all large worker classification projects. This includes projects where the issue is the existence of an employer-employee relationship as well as those where the issue is the identity of the employer, for example, employee leasing. We have taken this action because these projects often involve an entire industry and we want to ensure uniform treatment of all affected taxpayers. These projects may also involve difficult technical issues, the resolution of which may require input from National Office staff. This review also ensures that any proposed project involving worker classification focuses on serious deficiencies, such as massive reclassification of workers, lack of information reporting or failure to deposit withheld trust fund taxes. In addition, National Office approval ensures that project members seek input from business people in the affected industry, and that all project members have been trained in the fair and impartial application of the existing statutory scheme of worker classification. Currently, the National Office has reviewed and approved over a dozen worker classification projects in various market segments.

#### **TAX NONCOMPLIANCE**

The Subcommittee has requested information on the amount of noncompliance attributable to misclassification of workers. Unfortunately, such estimates would be difficult to develop but we do have information that indicates the magnitude of the problem.

In preparing estimates of the employment tax gap, we developed an estimate of the additional social security, Medicare, and federal unemployment insurance taxes that would be due if the IRS examined all instances of worker misclassification, and if all payments to misclassified independent contractors had been treated as wages. For 1992, we estimate that such retrospective reclassification would have produced examiner recommendations of \$3.3 billion in deficiencies and that after appeals and litigation those deficiencies would have been set at \$2.6 billion.

We recognize, however, that the \$2.6 billion overstates, by an undetermined amount, the employment tax shortfall from worker misclassification. First, when workers are treated as employees, some of their compensation is received in the form

of fringe benefits which are not subject to tax. Thus, if workers are reclassified from independent contractor to employee status, only some of the gross payments they received as independent contractors would be taxable wages. To the extent that some compensation would be nontaxable fringe benefits, the \$2.6 billion loss is overstated.

Second, some worker misclassification results from legitimate uncertainty about the worker's status. That is what we are discussing today. Other misclassification appears to be intentional and may, in fact, merely be used as an excuse for outright tax evasion. We do not know what portion of the tax loss from worker misclassification is attributable to each cause. It seems reasonable, however, to assume that a disproportionate amount of the underreporting of income is attributable to those who are intentionally misclassified.

However much we reduce the \$2.6 billion for these two factors, we need to recognize that the \$2.6 billion is only the employment tax gap. The IRS estimates that for 1992 the income tax gap from misclassification is at least \$1.6 billion, but would be similarly reduced.

Thus, although there is uncertainty about the tax loss from misclassification and the consequent amount of increased noncompliance, we are certain that it is a significant amount, and is certainly worth expending the resources IRS has been devoting to it.

Other studies show that misclassified workers report only 62% of their compensation, but that the actual filing of Forms 1099 greatly improves reporting. Where Forms 1099 were filed, 77% of misclassified compensation was reported; where there were no Forms 1099, only 29% was reported. The IRS data also show that reporting is lower for misclassified workers than for independent contractors in general. Overall, independent contractors report 97% of income when Form 1099 are filed and 83% when Form 1099 are not filed. Workers whose income is subject to withholding report over 97% of income.

#### **Noncompliance Remedies**

As I stated, IRS studies show that when taxpayers are aware that the IRS has received information reports on payments made to them, taxpayers are more likely to file tax returns and accurately report their income. By improving the information-reporting requirements and compliance with those requirements, we could better address this noncompliance problem. In fact, the Administration's fiscal year 1997 budget includes two legislative proposals with that objective. First, federal executive agencies would be required to report payments of \$600 or more to corporations for services rendered, with appropriate exceptions as prescribed in regulations. Second, the penalty (currently \$50) for failure to file an information return, including a return reporting payments for services, generally would be increased to the greater of \$50 or 5 percent of the amount required to be reported.

I would like to thank the Subcommittee for its focus on the effect of the reporting provisions on overall compliance. We would welcome the opportunity to work with you on any proposals directed at improving reporting and compliance with reporting obligations.

#### **CONCLUSION**

The Internal Revenue Service is taking steps to ensure that worker classification projects are properly focused on serious deficiencies, that our examiners are thoroughly trained in the correct application of the common-law standard and section 530 of the Revenue Act of 1978, and that worker classification controversies are resolved as early as possible. The tax administration initiatives I have reviewed for the Subcommittee are all relatively new, and it is too soon to say how effective they will be in addressing the problems associated with worker classification. However, I regularly meet with industry and practitioner groups, and I can report that the initial response to these initiatives has, overall, been very positive. We feel that these programs should ensure impartiality and consistency by the IRS in reviewing classification of workers as employees or as independent contractors, assure that current law is accurately reflected in classification, and reduce taxpayer burden.

I would like to add that in areas like this, where tax law interacts with businesses and workers in thousands of different situations, I firmly believe that the best way to ensure effective compliance and administration is to maintain an open dialogue between the IRS and the community. The positive effects of this process are reflected in our new initiatives and we continue to be encouraged as we move forward.

This concludes my prepared statement, Madame Chairman. I would be happy to answer any questions you or other members of the Subcommittee might have.

Chairman JOHNSON. Thank you both for your testimony. I appreciate your thoughtfulness and your leadership, and I am impressed with the changed nature of our dialog on this subject, and it should remind people that when we do things like the White House conference or when there is a real problem developing, there is in democracy a way to address it, and both the response of the executive branch and the legislative branch do reflect the sensitivity of government to the concerns of the people.

There are several specific questions I would like to ask you. First of all, have you reviewed—this is to both of you—the provisions adopted by the Senate, and do you have any comment on them?

Ms. RICHARDSON. I understand there were some changes yesterday, and I haven't had a chance to thoroughly review them, but we are concerned, as I think Treasury is, about some of the provisions, and whether or not they will address the fundamental problems that we have today in the worker classification area.

One of the concerns is that, we do need to have objective criteria in as many situations as we possibly can to avoid some of the discussions and reviews that we have today.

I know there is a provision that would require us to provide written notice of the provisions of section 530. That is a part of our proposal in the revenue procedure, and we will be making that. Whether that passes Congress or not, that will be something that we will be doing, beginning very shortly.

Chairman JOHNSON. Thank you.

In other words, in light of your testimony today, the Senate proposals do not go far enough?

Ms. RICHARDSON. Correct.

Chairman JOHNSON. I guess that would be my understanding.

Ms. RICHARDSON. Correct. We would be happy to provide more specific comments when we have a chance to digest what happened yesterday.

Chairman JOHNSON. Also, Mr. Lubick, would you be prepared to provide us with legislative language for the suggestions that you made within the next few days?

Mr. LUBICK. We could perhaps provide detailed specifications, I think.

Chairman JOHNSON. But, I would prefer legislative language. In the end, that is what we have to do. We are rather late in this session. We are going to act on this issue, and if you could provide us with a legislative draft of just the suggestions you proposed.

It is my personal understanding that this Senate language does not go far enough. I think in view of the work that you have done, we can actually move beyond that, but I do want to get language that we all think will be intelligible and help to radically reduce the gray area, and I would like to get that out there as soon as possible so people have a chance to respond to it.

So, the more legislative language you can provide us, the better off we will all be.

Mr. LUBICK. We will try. Madam Chairman, you recognize, of course, that at least one of my suggestions was administrative.

Chairman JOHNSON. Yes, I do understand that, but I think the first two were legislative, were they not?

Mr. LUBICK. Yes, there were some legislative ones. We will try to be responsive.

Chairman JOHNSON. The other thing I would like your specific comment on, there were some very specific recommendations in Rep. Jay Kim's bill in regard to reform to section 530.

Now, you have touched on some of those same issues, the Senate has touched on some of those same issues, and we just want to see where the best language is now and where it is easiest to start working from.

I was very interested in your testimony that you think it would be possible to repeal the 20-factor test. That would be, I think, a great accomplishment, but of course, we have to put something clear in its place.

Mr. LUBICK. Correct. That would require us to work with the Service very closely to come up with something that they can live with as well.

Chairman JOHNSON. Yes.

Mr. LUBICK. We intend to do that.

Chairman JOHNSON. There are a couple of things that I want to get on the record. Since it is our experience that those who report their 1099s are reporting 97 percent of their income, why has there been a focus of the compliance programs of the past on 1099 reporters, and will you be able to target your compliance efforts in the future on the noncompliers, those who aren't reporting?

Ms. RICHARDSON. We certainly do plan to have a balanced program.

I think that our numbers show that where forms 1099 have been filed, about 77 percent of the misclassified compensation was reported. When there is no 1099, it is much lower, and then in certain segments, it can be even lower than that, but we are not just focusing on people who file 1099s.

Mr. WASHBURN. Yes. I might add to that.

Chairman JOHNSON. There does seem to be some difference of opinion as to the amount of income reported by those reporting their 1099s. The government Operations Report claims that those who do report their 1099 Forms, that in that category, workers report 97 percent of their income. So, I think we want to get clearer on that as we go forward and how much of our resources we need to focus on 1099 reporters and how much we need to focus on non-reporters.

Mr. WASHBURN. I wanted to just add, to respond to your question about why we focus on people who receive 1099s. That is just one of the tools that we use to identify possible misclassification, and GAO in a report, I believe it was 1991, recommended that we do that because it is a good way of looking at a worker who receives all of their income on a 1099 from one business. It raises a question that it is possible that he or she is an employee. It does not state that he or she is an employee.

It just raises a question, but we also initiate examinations based on SS-8s which are requests for a determination that employees normally submit concerning their status. We also raise the issue as part of our regular income tax examination. So there are a variety of ways in which we identify this potential problem.

Chairman JOHNSON. It does seem to me that the largest revenue loss would be among those not reporting their 1099s. How do you reach that group?

Mr. WASHBURN. You are correct. The largest revenue loss is statistically by misclassified workers who do not receive a 1099. In fact, a study that we did in the past shows that the compliance level for that group is only about 29 percent. The ones who receive the 1099s is about 77 percent. So, it averaged out at about 62 percent.

Chairman JOHNSON. But the average clearly isn't the issue.

Mr. WASHBURN. Correct.

Chairman JOHNSON. I mean, you need to look at the 29 percenters.

Mr. WASHBURN. Correct. When we begin an examination, we do not know initially whether 1099s have been issued. In some cases, they have, in some others cases, they have not. Of course, our new Compliance Classification Settlement Program reflects that if a business has issued 1099s, then the settlement program applies to them. It is where they haven't issued 1099s that we do not grant them the benefits of the settlement program. So, the examination looks at all aspects of the issue.

Chairman JOHNSON. The Commissioner mentioned that it was her goal to have the government neutral in regard to these things as long as you paid your fair share of taxes. Why do you care if somebody is an independent contractor or an employee just because they work primarily for one company? What is the tax loss?

Ms. RICHARDSON. We would not care as long as they were properly classified and properly reporting.

Chairman JOHNSON. We did have extensive testimony from those who install cable at our last hearing and in the instance of the cable industry, they had always been independent contractors. The people who lay the cable had always been independent, partly because cable companies lay cable periodically and depending on their ability to invest in that kind of capital expansion. There was no history of any other relationship.

So, why did you choose to go in? They were all doing their 1099s. The compliance was there. What would motivate the IRS, then, to go in, especially in view of the section 530 safe harbor language? What would have motivated the IRS to go in and try to reevaluate all of these? What does it matter to you? I think government should be neutral, and my understanding is—and we talked about this yesterday, Commissioner. We will get back to this, but you are doing this now in terms of doctors that practice within a hospital. They pay their own malpractice. They set their own hours. They do not receive employee benefits and so on and so forth.

I mean, why would we devote our compliance efforts to going into relationships that are already established, have been longstanding, people who are doing their 1099s, they are clearly paying their taxes, when we have a 29-percent down here, a compliance problem, with people who aren't doing their 1099s and almost certainly are not paying their fair shares? I do not get it.

Ms. RICHARDSON. Unfortunately, the cable issue is one that I believe is subject to section 6103 because there are some open cases on that. We would be happy to brief you and the Subcommittee

Members and your staff in private about that, but as a general proposition—

Chairman JOHNSON. Yes. I will take the general proposition.

Ms. RICHARDSON. Clearly, physicians, lawyers and other kinds of personal service providers, can have different kinds of employment relationships. They can be independent contractors. They can be employees. They can sometimes be both with different hospitals or different situations.

There is not just a general rule that necessarily applies to all doctors, but you are absolutely right that we are trying to find ways to devote our resources to the areas where we have the highest level of noncompliance, and clearly, as Mr. Washburn testified, where we have no information reporting and no withholding, those are the areas that we have the highest noncompliance, and we are trying to find ways to identify those industries or market segments, if you will, and then spend our energies there.

Chairman JOHNSON. I do appreciate how difficult it is to do that, but I do want a clear answer on why the IRS made the decision and is continuing to make the decision to go into areas where there have been longstanding relationships and it is unlikely you are going to get any more money. That just does not make sense to me.

Now, I agree with my colleague, Mr. Matsui, and with the sentiments expressed by Mr. Kleczka that we do not want to change this law in a way that identifies this business to spin people off because there are some very real disadvantages to being an independent contractor. There are some advantages, but I do need a better explanation, particularly in light of this information about examining hospitals and doctors because that may be another cable issue.

When section 530 was supposed to specifically say if this is the way you have always been doing it, we are not interested in coming in, we are interested in whether you file your 1099s and whether you are paying your fair share. Those are two different issues, but why are you initiating these, launching these efforts into areas where we have clear compliance? What does it matter to us if they are one thing or another?

Ms. RICHARDSON. In both of those areas, we would be happy to come up as soon as you like and brief you and the other Subcommittee Members.

Chairman JOHNSON. Can you give me a broader, general understanding of the rationale by which the IRS decides to go into an area where there are primarily people paying their taxes to deal specifically with reclassification?

I understand that we want people to pay their fair share. Why does reclassification matter if they are paying, they are reporting their income?

Mr. BROWN. Mrs. Johnson.

Chairman JOHNSON. Yes.

Mr. BROWN. May I respond to part of that?

Chairman JOHNSON. I would be happy to have you respond.

Mr. BROWN. I think you have to distinguish between the aggregate numbers for compliance in particular parts of the industry and the case-by-case situation. In any particular situation, a taxpayer or an employer may have different tax results from treating their workers as either employees or independent contractors.

One difference, of course, is that you have the SECA taxes versus the employee being liable for only half the FICA taxes. You have the impact of the 2 percent—

Chairman JOHNSON. Just to that point because I think this is the guts of this matter, I mean, from the point of view of what the IRS is choosing to do.

Under one category, you pay half of those taxes because that is the law. Now, if that is not a good law, we should change that law, but that should not be a reason why you seek to reclassify. Do you understand what I am saying?

Mr. BROWN. I think so. If an employer, if a business has a worker working for them and they improperly classify that worker as an independent contractor and the worker is, in fact, an employee, the business would have failed to pay the employer's share of the FICA taxes, and even though that might be made up, in part, in gross revenue terms by the worker's payment of the SECA taxes, the liability wouldn't be falling on the right person. While you might say that over time that difference would balance out as people adjust their behavior, looking at an individual case that has already occurred, you have that part of the liability falling in the wrong place.

There are two or three other points.

Chairman JOHNSON. There is no loss of Federal revenue.

Mr. WASHBURN. There is a loss of revenue. In other words, if you have an employer and an employee who generally both believe that there is an independent contractor relationship, the worker generally pays more, because they are paying SECA tax, which is more than they would have paid had they only paid one-half the FICA.

On the other hand, what they pay in addition to SECA tax does not offset the employer's share of the FICA, and the reason for that is that an independent contractor is entitled to deduct certain expenses without the 2-percent limitation that an employee cannot deduct. In addition, an independent contractor can deduct one-half of the SECA tax. So, there is a revenue in that.

Chairman JOHNSON. That is exactly my point. The revenue loss was legislated by the Congress because we thought it was fair. So, you should not try to reclassify someone to up the revenue when the Congress has legislated the policy that if you are in this category you pay less because you can take certain deductions.

Mr. WASHBURN. I am not talking about the section 530. I am just talking about where there has been misclassification and section 530 does not apply.

If section 530 applies, the revenue loss is larger, but you are absolutely correct that is the intention of the Congress.

Chairman JOHNSON. The policy that I am challenging, what I need to understand because I do not accept, is your decision to go into areas where relationships have been long established, and yes, people are independent contractors, and yes, consequently under the law they are able to deduct business expenses. So, yes, there is a small revenue loss because they are independent contractors. That does not justify your focusing on going in and trying to reclassify them because under section 530 they clearly were not intended to be the focus of classification change.

I understand that there are some people who are being classified and treated unlike other employees in order to get them out from under, but, you see, launching an initiative into a whole industry, or a whole group or type—"industry" is too broad a word—who have been consistently treated a certain way, to say they are not paying their fair share, this is not a rationale that holds up. They are paying exactly the share we legislated they should pay.

So, revenue cannot be a reason for launching that investigation. It cannot be a justification. Section 530 safe harbor isn't a justification. So, why do you do it, especially when you have a 29 percent compliance rate in the other categories?

Do I make myself clear? I am not a tax lawyer and I am not an expert, but I am concerned about what we are doing in terms of trying to get better compliance in an area where clearly there are problems.

Ms. RICHARDSON. I certainly cannot speak to all of the practices that have happened in the many years that have gone by, but I do know that in some of the areas that you have talked about, as well as some that we are looking at, there are practices in the industry that may vary from one part of the country to another. Sometimes, certainly even within an industry, practices vary.

What we need to do is take a closer look. There may be more than one side to this story, at least the one that you mentioned this morning, and I think that, at least based on information that we have had brought to our attention perhaps there isn't a nationwide practice.

Chairman JOHNSON. Thank you.

Ms. RICHARDSON. That is the justification for taking a closer look.

Chairman JOHNSON. I think you do get my concern.

Mr. Kleczka.

Mr. KLECZKA. Thank you, Madam Chairman.

I think it is an interesting question that is posed by the chairperson, and the question, if I might paraphrase, is when it comes to an independent contractor, who cares. Well, I think we all should care, and in fact, I am not here to defend the IRS. We will let my friend Mr. Traficant do that, but nevertheless, I would think that your charge and your mission is tax law compliance, and as part of that law, there is a section dealing with how we term independent contractors.

If, in fact, there might be a question, then we go to section 530 and see if it fits into that category. So, who cares? You should care, because you are being paid by the taxpayers to do this not only in this area, but naturally all tax areas.

When it comes to the employee, let us talk about what the difference between an employee and an independent contractor is. Let me just run through some things that are out there in the marketplace when it comes to employees and independent contractors, and let me ask the Commissioner to respond.

Let us try this one. Does an independent contractor benefit from wage and welfare benefits?

Ms. RICHARDSON. No.

Mr. KLECZKA. I meant pension.

Ms. RICHARDSON. The legislation.

Mr. KLECZKA. OK. Does the independent contractor from the employer or from the owner of the business get any pension or welfare benefits?

Ms. RICHARDSON. Typically not.

Mr. KLECZKA. Health care coverage?

Ms. RICHARDSON. Typically not.

Mr. KLECZKA. Unemployment compensation?

Ms. RICHARDSON. No.

Mr. KLECZKA. Worker's compensation?

Ms. RICHARDSON. No.

Mr. KLECZKA. Vacation, sick, family emergency leave?

Ms. RICHARDSON. Typically, they would not.

Mr. KLECZKA. Are they covered under the minimum wage protections?

Ms. RICHARDSON. I do not believe so.

Mr. BROWN. No.

Ms. RICHARDSON. No, I do not believe so.

Mr. KLECZKA. How about Fair Labor Standards Act, overtime protections, overtime benefits?

Ms. RICHARDSON. No. I think that applies only to employees as well.

Mr. KLECZKA. How about protections under OSHA?

Ms. RICHARDSON. No.

Mr. KLECZKA. Workplace protections, occupational protections?

Ms. RICHARDSON. No.

Mr. KLECZKA. Any anti-discrimination protection under EEOC?

Ms. RICHARDSON. I am not as familiar with that. I think it typically applies to employees, but there may be a broader definition. So, I am not an authority on that.

Mr. KLECZKA. OK. How about the right to collectively bargain?

Ms. RICHARDSON. Typically, that is an employee-employer relationship.

Mr. KLECZKA. Well, as I went through this list, who cares? I care, and I think a lot of people around this country care if, in fact, it is an independent contractor-type arrangement that has precedent, that is the norm in the industry. I do not care as long as that person pays his just debts and the independent contractor pays the taxes, but for the workers who are being reclassified in an attempt on the part of the employer to save all of these benefits, I think that is very serious and we should all be concerned about that.

Let me go back to something Mr. Lubick said. What was your statement when it came to common law and the 20 factors? Did you say we should abolish them or repeal them? I do not know if we can repeal common law.

Mr. LUBICK. My suggestion was that we can do it better. The 20 common law factors, as the Commissioner stated, was not intended to be more than a catalogue that might be instructive as to things that have happened in various court decisions. I do not think it was ever intended that one employer would sit down and read that summary like a statute.

We have been prohibited from issuing guidance and interpretation to try to help people, and we do try to help people. We could withdraw that revenue ruling because it was published in a context where we are not prohibited from giving guidance, but it seems to

me that it is the intent of Congress that we be restrained back in 1978 from rocking the boat, basically, by issuing new rules and regulations.

Well, 20 years have passed without anybody knowing what we think the differentiating factors should be between employees and independent contractors and what weight should be given to various things. We think we can do better.

Mr. KLECZKA. Let me ask this, then. Would you favor avoiding the common law analysis if, in fact, section 530 is available to employees, i.e., one or the other and not both?

Mr. LUBICK. Well, there are many situations where section 530 does not apply, at least it purports not to apply unless there is reasonable reliance on a number of factors. Therefore, section 530 provides and was intended to provide temporarily, only a different set of rules for one group of workers from those identically situated where the employers didn't fall within section 530. So, that has produced a strain, and if you are talking about those workers that are not working for employers entitled to section 530, they are very much in need of guidance and a restatement and an up-to-date explanation of the differentiation. It seems to me it is long overdue.

Mr. KLECZKA. Thank you.

Commissioner, is it possible for an IRS audit to grant independent contractor status to a competitor in an industry in which a majority of the other competitors have an employee-based work force?

Ms. RICHARDSON. Yes, I believe it would be as long as the people working for that business met the criteria, and the common law standard is about the right to direct and control the activities of the worker.

If you didn't do that, if you didn't, in effect, have that right to direct and control, but you told them what the results were that you wanted and said, here, go do the job and come back, and in that industry that is the way they handle their workers, whereas in every other industry people were told exactly how to do it and maybe provided with the tools and a whole host of other things that tend to be criteria looked at. Then, yes, we would be perfectly within our rights and it would be absolutely appropriate to classify those workers as independent contractors.

Mr. KLECZKA. But there would have to be some differentiation between the two competitors, i.e., how they handle their work force and how they handle their contractors, right?

Ms. RICHARDSON. Correct. I will say that I am frequently approached, as are other people at the IRS, by businesses who feel that they are being put at a competitive disadvantage not because their competitors are properly treating their workers as independent contractors, but because they have taken workers who were employees one day, continued exactly the same relationship, and reclassified them as independent contractors the next day, and they are then put at a competitive disadvantage because they continue to pay and treat their workers as employees.

Mr. LUBICK. Mr. Kleczka, may I add to that?

Mr. KLECZKA. Sure.

Mr. LUBICK. Your point is that we may have two employers with workers that are identically compensated, working under identical conditions. One employer before 1978 treated its workers as em-

ployees. That employer is never entitled to section 530. Another worker, prior to 1978, gave a looser interpretation to the common law definition and treated its employees as independent contractors. The situation was then frozen.

I have been in many situations where there are competitive disadvantages, and those employers that have to continue their classification as employees have felt seriously disadvantaged by the extension of the permission of the others to continue as independent contractors. I do not think anybody could disagree that in the long run we would all be better off if we could have a means of characterization that would allow us not to rely on section 530, but to be able to do the job right. That is what Congress had in mind when it adopted section 530. It wanted to take time out, we will freeze the situation for the moment, and then we will work out a rule that everyone can live with and everyone will be on the same level playingfield. That hasn't happened.

Mr. KLECZKA. But the situation I am thinking about is, let us say the employer with employees is pre-1978 and agrees that that is the way the situation should be, these are actual employees. Now a new company starts. A competitor starts who has taken a different track even though the independent contractors do everything that the older competitor's employees do. All right? There is where the abuse is coming in today.

So, now what you are doing is you are forcing the older competitor, the older business, the pre-1978 business, to start looking around at how he can or she can avoid the employment laws and move for competition purposes like his new competitor to independent contractors, and that is a situation we are seeing out there in the real world. I will tell you, it is very unhealthy. It is an impetus for the employer to do so but it is unhealthy for the work status and the benefits, as I enumerated before, for the poor employee.

Ms. RICHARDSON. If they are performing precisely the same tasks and have the same arrangements and they are directly in control—

Mr. KLECZKA. A company gives them a job just like the other company, yes, it is really close.

Mr. LUBICK. That is absolutely the situation. You can have two persons who are in exactly the same situation, but because of some classification decision that was made before 1978, before section 530, the situation is frozen, and one employer can go in an absolutely opposite direction from the other.

Mr. KLECZKA. Now, is there any possibility under current law for an input by one of those competitors? Let us say you are doing an employee classification and a dispute in an industry arises. Can I as the employer with employees say, hey, wait a minute, you are moving on this classification, I think it is wrong? Is there any public input of that nature available?

Mr. LUBICK. It can only go to you, sir.

Mr. KLECZKA. OK. Thank you.

Ms. RICHARDSON. We actually get a fair amount of information about practices in various segments of industries based on people who are concerned about the competitive pressures.

Mr. KLECZKA. Thank you, Madam Chairman. I have other questions, but I think we better let some of the other Members share.

Chairman JOHNSON. Mr. Hancock.

Mr. HANCOCK. Thank you very much.

There is a definite trend, and it has been going on for several years, moving more and more that the employers want to go with the independent contractors. What is the rationale for that? In your judgment, why are employers wanting to go on an independent contractor basis?

Mr. LUBICK. I would say in some cases employers do not wish to assume the paperwork burden of complying with various laws. They may not be tax laws. They may be other State regulatory laws. In some cases, they may feel that they do not want to include these workers in their pension plans and they want them to provide for their own pensions. It may be health care costs. In some cases, it may be that there is a tax avoidance motive. There are certainly situations where employers and workers have gotten together and say if you are independent I will not have to withhold on you or pay social insurance taxes, and you can do what you want. There are those cases.

I have just spent 2 years working in countries in Eastern Europe, and believe it or not, now that they are developing their own tax systems, they face this problem. It is very serious. Part of their problem is that they have social insurance contributions that may come up to 60 percent of payroll.

If you have got to pay a 60-percent tax on payroll and an income tax withholding as well, I can clearly understand why the degree of noncompliance reaches astonishing proportions.

Mr. HANCOCK. Mr. Lubick, I hope that you are studying that situation over there to avoid it in this country rather than to implement it.

Mr. LUBICK. I absolutely agree with you. That is one of the things that we have been recommending.

Mr. HANCOCK. In the real world of the small business man, one of the problems you have is the classification of employees even as far as wage and hour is concerned, a definition of who is a manager and who is an employee, and you never know for sure.

Wage and hour, when they come in, I can fully understand why someone would switch. I haven't had any problem with it, but I am familiar with a lot of situations where once they come in, the small business man who has complied, in considering the employees, says I am going to go on an independent contractor basis if I can otherwise wage and hour will be running my business rather than me running it.

So, it would appear that as long as we continue to have all of the regulatory compliances, the question marks, the audits, the people that are almost put out of business as a result of an unintentional error and the big penalties and that type of thing, that there is going to be more and more trend toward this effort of independent contractor.

Another question that I would like to ask Mr. Wagner—is that right?

Mr. WASHBURN. Washburn.

Mr. HANCOCK. Washburn. I beg your pardon.

You indicated that if an individual income tax return comes in and there is one Form 1099, you would look into that type of situa-

tion more from the standpoint of classification than you would otherwise.

Mr. WASHBURN. No. What we actually have a database of all of the Form 1099s that are filed, and we would make a computer-type run against a return to see if all of the income of a particular business was from one Form 1099. Again, that is just one of many ways that we identify potential cases. That is our job to try to identify potential problem cases. It does not mean there is a problem, but it just causes us to take a look at it.

Mr. HANCOCK. Once that particular problem is identified, that does not automatically cause a looking into the issue or the Form 1099, does it?

Mr. WASHBURN. No. Again, we have priorities. We have workload inventories. If a revenue agent was actually assigned the case, the revenue agent would make a judgment as to whether he or she wanted to pursue it, and if so they would usually send the business a letter, follow it up with a telephone call, and begin an audit. An audit is a gathering of the facts to see if there was a problem, and the audit, by the way, would usually be of the employer. I need to clarify that.

Mr. HANCOCK. I see the lights on. Can I ask one more question?

Chairman JOHNSON. Yes.

Mr. HANCOCK. Ms. Richardson, we recently held hearings on the Federal debt collection, the tax collection issues, and a significant portion of the tax debt has been classified by the Internal Revenue as currently not collectable. How much of that is attributable to payroll taxes on bankrupt taxpayers, and do you have any breakdown on what portion of these payroll taxes are from IRS reclassification determinations which resulted in the actual bankruptcy of these companies?

Ms. RICHARDSON. I actually do not have those figures in my head, but I will be happy to get them to you. I do not know that we have them broken out by that second category, but I can tell you how many are payroll taxes in the bankruptcy situations.

[The following was subsequently received:]

As of September 30, 1995, the currently not collectible (CNC) inventory equaled \$87.4 billion (not including \$6.3 billion of Trust Fund Recovery Penalty assessments that are potentially duplicative). Employment taxes comprised \$29.3 billion of the \$87.4 billion CNC.

For the same time period, \$8.7 billion of the \$87.4 billion was determined to be currently not collectible due to bankruptcy. Employment taxes comprised \$3.4 billion of the \$8.7 billion that was not collectible due to bankruptcy. Our data does not allow us to determine what portion of these payroll taxes are from IRS reclassification of workers that resulted in the actual bankruptcy of these companies.

Mr. HANCOCK. But there have been situations where a reclassification of employees have caused companies to go bankrupt.

Mr. WASHBURN. Yes. There have been cases where audits have created deficiencies that may cause a taxpayer to go bankrupt.

Ms. RICHARDSON. We will get whatever information we have.

Mr. HANCOCK. Thank you.

Chairman JOHNSON. Mr. Cardin.

Mr. CARDIN. Thank you, Madam Chairman.

Mr. Lubick, let me try to clarify your position, if I may. Chairman Johnson has asked for you to submit certain suggested legislation to this Subcommittee. You have indicated that currently

the section 530 relief is inadequate; that we cannot continue that indefinitely; that it has created inequities in the field. You also have pointed out in your testimony, your written testimony, that experience suggests that it is difficult to devise one simple specific statutory definition or safe harbor that applies appropriately to the varied existing worker relationships and occupations. Therefore, let me just ask, is Treasury suggesting that there is need for a statutory response in this matter or not?

Mr. LUBICK. We believe that a statutory approach that tries to set a bright-line safe harbor or a bright-line definition is going to fail because it will not cover all the situations. It will be manipulated by clever and even not-so-clever lawyers.

I can give you an illustration. For example—

Mr. CARDIN. I understand that you are concerned about the safe harbor or a specific set of circumstances that would clearly define an independent contractor relationship.

I guess my point is, what type of statutory approach would you propose, or would you prefer to address this issue by rule and regulation, and can you do it by rule and regulation?

Mr. LUBICK. I think we can give much better guidance than is out there now as to how a recipient of services or an employer, without trying to beg the question, can deal with the classification situation, how he can use the factors that courts have used in a much more intelligible way than the present 20 common law factors. We can do that without the benefit of any legislation.

It seems to me there are still going to be contentions. There are still going to be differences. If, however, the consequences of those differences are not devastating to the point of causing a business to collapse under the weight of a retrospective assessment and if the business feels that there is available in the event it cannot negotiate with the IRS a reasonable solution, if there is an impartial judge at the end of the line who is available to keep everybody in line, I think we can reduce the contentiousness because much less will be at stake. There will be a better feeling that there is a fair decision.

We will try to enlighten and make it as easy as possible, but if at the end the taxpayer does not think we have done it right, there will be somebody else who will call the shot, not us.

Mr. CARDIN. So, you are basically talking about a process change—

Mr. LUBICK. A process change.

Mr. CARDIN [continuing]. But not a substantive change in the underlying statutory law.

Mr. LUBICK. Yes, sir.

Mr. CARDIN. OK. I appreciate that, and I assume that is the type of information you will be making available to the Subcommittee.

Mr. LUBICK. Yes, sir.

Mr. CARDIN. Commissioner, let me at least ask you to perhaps supply to the Subcommittee, if you are not prepared to answer today, the point about the revenue impact on the Treasury.

All of us understand that the principal concern on an independent contractor versus employee, as far as government revenues are concerned, is whether the earnings are, in fact, reported as the earnings taxes, and you have indicated that if it is reported by

Form 1099 that there is a much better chance of compliance, if it is not reported at all then we have run into a serious compliance issue.

In response to the question by the chairman, you also indicated there is a secondary concern, and that is that an independent contractor has more flexibility in reporting certain business expenses which may have a revenue impact on the Treasury.

I am wondering whether you can supply us with information to pinpoint what we are talking about, what is the difference here. Are there documented significant revenue differences between an independent contractor and an employee in this area? Is this anywhere near the size of revenue impact of the reporting of the income for payroll taxes or income taxes?

Ms. RICHARDSON. We will be happy to provide that to you for the record, and actually in response to one of the Chairwoman's questions, we do have breakouts by types of Form 1099 as well and what the compliance is in those categories, but we will give you a more comprehensive breakout of all the information that we do have.

[The following was subsequently received:]

## Worker Misclassification and Federal Tax Revenue

One of the questions that is often raised during discussions of worker classification is the impact of worker misclassification on federal tax revenue. Interest in the answer to this question, we believe, is motivated by the desire to quantify the extent of the noncompliance, i.e., the misclassification of employees as independent contractors. The terms "revenue impact" or "revenue difference", however, are somewhat confusing in this context because these terms are generally used in the context of legislative changes and revenue estimation rather than in discussions of noncompliance.

In quantifying noncompliance the IRS uses concepts such as "tax gap" and "noncompliance rate". The tax gap is defined as the difference between the amount of tax owed (i.e., "true" tax liability) and the amount of tax paid, for a given tax year. The tax gap reflects any failure to conform with tax laws and regulations, including both intentional errors due to willful and deliberate action and unintentional errors due to ignorance, oversight, interpretation, misunderstanding, or carelessness.

The IRS has developed tax gap estimates associated with misclassified compensation for social security, Medicare, and FUTA taxes. The estimate for tax year 1992 is \$3.3 billion. This total includes a social security and Medicare component of \$2.9 billion and a FUTA component of \$0.4 billion. Although the IRS's income tax gap estimates include the gaps associated with misclassified compensation, the amounts cannot be explicitly identified because the data do not separately identify misclassified compensation.

In contrast with a tax gap estimate, a *revenue estimate* of the impact of worker misclassification would measure the difference between the tax revenue paid under current law when employees are misclassified and the tax revenue that would be paid under current law if employers were to properly treat their workers as employees. The IRS has not developed such a revenue estimate. To do so would be extremely difficult due to the lack of data, and the end result would be subject to controversy about the validity of the assumptions needed to develop the estimate.

In summary, a revenue estimate and a tax gap estimate are not the same thing. A tax gap estimate gives the difference between two "facts"—(1) the amount of tax owed and (2) the amount of tax paid—for one set of economic conditions—those that actually occurred. On the other hand, a revenue estimate of the impact of worker misclassification would give the difference between one "fact"—the amount of tax paid—for two sets of economic conditions—(1) the conditions that actually occurred and (2) the conditions (wages paid, benefits provided, business expenses reimbursed, etc.) that would have occurred had the workers been treated properly as employees. The IRS has developed tax gap estimates related to misclassification of employees, but has not developed revenue estimates associated with this issue.

**Where earnings and business expenses are reported by independent contractors.**

Our interpretation of the issue at question here is the revenue impact of worker misclassification that is attributable to differences in tax treatment of business-related expenses for employees and independent contractors. Or, stated differently, are the amount of business expenses allowable to misclassified workers who correctly file tax returns as employees different from the amount of business expenses "allowable" to the misclassified workers if they incorrectly file returns as "independent contractors?"

The TCMP study of 1984 employment tax returns, which is the source of compliance data related to worker misclassification, did not collect business expense data on the misclassified workers. Therefore, we cannot provide answers to these specific questions. We can, however, make the following generalization about the revenue impact based on current law:

*For a given amount of allowable business expenses, the amount deductible as an "independent contractor" will be greater than the amount deductible as an employee because of the two-percent-of-AGI limitation for itemized deductions for employees. The particular magnitude of any difference will depend on the amount of allowable expenses and AGI.*

**Breakout of Form 1099 compliance levels.**

The table below provides compliance information related to the reporting of payments and whether the payment was reported to the IRS on a Form 1099.

<b>Payee Income Reporting Compliance</b>					
<b>Name of Study</b>	<b>Tax Year</b>	<b>Type of Payment</b>	<b>Compliance Rate*</b>	<b>Was payment reported on Form 1099?</b>	<b>Comments</b>
SVC-1	1984	Misclassified Wages	62.0%	Yes/No (All payments)	SVC-1 was a TCMP study of tax year 1984 employment tax returns
SVC-1	1984	Misclassified Wages	77.2%	Yes	SVC-1 was a TCMP study of tax year 1984 employment tax returns
SVC-1	1984	Misclassified Wages	28.8%	No	SVC-1 was a TCMP study of tax year 1984 employment tax returns
Delinquent Form 1099-Misc Follow-up	1977	Commissions & Fees	83.2%	No	Study based on delinquent Forms 1099 identified in tax year 1977 small corporation TCMP
Form 1099 NEC Compliance	1979	Non-employee compensation	97.4%	Yes	Estimate pertains to filers of individual income tax returns
Form 1099 NEC Compliance	1979	Non-employee compensation	92.0%	Yes	Estimate pertains to filers and nonfilers of individual income tax returns

\* The compliance rate is defined as the amount of compensation reported divided by the amount of compensation that should have been reported.

Mr. CARDIN. That would be helpful because most of us are working under the impression that the dollars here are mainly unreported income and failure to pay payroll taxes. We are somewhat uncertain as to whether there is a significant impact on the Treasury as it relates to the taking of business expenses.

In your statement, you point out very clearly that your principal concern is to collect the proper amount of tax revenues in a fair and impartial manner, and with that in mind, let me just underscore the point that Mr. Gilchrest made in his testimony.

In the case of the schoolbus contractor who owns his or her own buses and pays all the payroll taxes, it is difficult for us to understand the attention that that type of a case would receive by the IRS.

Ms. RICHARDSON. That is something I am not specifically familiar with. I heard his testimony. We will certainly look into it, but I do think that is something that we need to look into, and we will.

Mr. CARDIN. Thank you very much.

Mr. LUBICK. I think, Mr. Cardin, your point is quite correct, however, that there is the secondary question as to what is the extent of noncompliance on a net income basis as opposed to the gross.

Mr. CARDIN. Correct.

Thank you.

Chairman JOHNSON. Just to clarify your testimony, Mr. Lubick, before we go on to the next panel, it is my understanding that you said, and from my notes I quote, "that we need to legislatively liberalize prospective reclassification, the right to prorespectively reclassifying where there was a reasonable error without penalty."

Mr. LUBICK. That is correct, Madam Chairman.

Chairman JOHNSON. You also said that we needed to legislatively offer new remedies, expedited appeals and so on.

Mr. LUBICK. The process items to which Mr. Cardin just referred—

Chairman JOHNSON. Right.

Mr. LUBICK [continuing]. Require legislation, as well as the possibility if you would like us to give better guidance in this area, then the restriction currently in section 530 has to at least be loosened.

Chairman JOHNSON. I was interested in your follow-up comment that administratively you thought better guidance could result in the deletion of the 20-factor test.

Mr. LUBICK. Yes.

Chairman JOHNSON. We do want to work on that.

Mr. LUBICK. We can give better guidance if you will let us do it. Right now section 530 prohibits us from giving that guidance.

Chairman JOHNSON. Well, those are the kinds of things that we will need to work on.

I have spoken with the Commissioner at other times, and there does seem to be an opportunity not for us to create a single bright line—I understand that that is certainly impossible—but for us to delineate the three or four most significant factors that would enable us to clarify a great deal of this. Would you agree with that?

Mr. LUBICK. I agree that we can clarify it not by a statutory bright-line test or a statutory combination of four or five bright-line tests, but I think we can make the evaluation of the factors under the existing general test clearer, and fairer.

Chairman JOHNSON. I would mention that it was brought up in the last hearing that we might be better off to clarify and codify section 530 than to start over again because at least we have a history there. Those are the kinds of issues that we need to discuss further.

Ms. RICHARDSON. Madam Chairman, I would also like to point out that in our training materials, we have attempted to refine the factors that would go with the common law test of the right to direct and control and no longer have, the 20 factors, but things that we think are relevant to the way people are doing business today.

Some of the changes that we have made are based on comments that we have received, but they are about trying to flesh out the kinds of criteria people should be looking at. So, we are through that process trying to make the 20 factors more appropriate and frankly getting rid of many of them that aren't that relevant.

Chairman JOHNSON. I appreciate that, and that may be the best way to go.

Also, just in light of the discussion that has taken place between you and other Members, I thought it was very interesting that your training materials indicate explicitly that a worker can be an employee for certain services and an independent contractor for others.

Ms. RICHARDSON. Correct.

Chairman JOHNSON. I think we have to be a little careful about talking too simplistically about if you are a like person then you get treated in a like way.

One of the problems is that you can be doing like services under like circumstances and still legitimately not be similarly classified.

Ms. RICHARDSON. I think that is the criteria that is significantly important in determining status. We need to spell it out so that people understand what is important and what is significant.

Chairman JOHNSON. All right. I thank the panel very much.

Mr. CARDIN. Madam Chairman, could I just very quickly?

Chairman JOHNSON. Yes.

Mr. CARDIN. There are taxpayers that are in different phases of the tax system today who must be somewhat perplexed because of the changing policy coming out of IRS in this area, and I am not being critical of IRS. It is just that this is an area in which we are trying to give clearer direction to the taxpayer, but the taxpayer may not know how to act because of the uncertainty of this area of law.

I know IRS is working on training manuals that are being revised as we speak and has announced today zero-tax settlement agreements and there are Tax Court appeals.

I guess I would ask that we give a little bit clearer direction to the taxpayer who is trying to plan and stay out of trouble as to what is the right way to proceed, and we need to take that into consideration.

Ms. RICHARDSON. Mr. Cardin, I do not know if you were here when I mentioned that we are going to put out the final training materials. We distributed for comment the draft materials. We will make the materials available to the public for the first time so that taxpayers will understand what our agents and examiners have been trained to look for, what is expected of them, and we will do

whatever we can to publicize our expectations. We also hope that people will continue to keep us apprised of when there are changes in certain situations that ought to be taken into account and how we should modify them.

Mr. CARDIN. We appreciate that, and we might be giving you some more specific examples. We appreciate just giving the best advice we can to our constituents in this area.

Thank you, Madam Chairman.

Chairman JOHNSON. Commissioner, when you get back to us with some of the estimates that you referred to—

Ms. RICHARDSON. Yes.

Chairman JOHNSON [continuing]. Would you make clear whether those estimates are based on 1-year liability under your new settlement program or whether they are based on multi-year liability, a policy that has caused a number of difficulties, and also, whether they take into account the rough 20-percent overturn rate on appeal or whether they do not? We want to try to get as clear an understanding as we can of the revenue issues involved.

[The following was subsequently received:]

The estimates provided are "tax owed (i.e., true tax liability) and the amount of tax voluntarily paid for a given tax year. The estimate does not take into account an overturn rate on appeal.

I thank the panel very much for their participation, and let me just say that it has been my policy personally not to put the timer on for government officials who are responsible not only to help shape the law, but also, to enforce the law, and so this panel has taken longer than usual.

With the following panels, we will follow our normal procedure, a 5-minute presentation for each of the panelists and then a 5-minute question period for each of the Members.

I thank you, Commissioner Richardson and Mr. Lubick.

Ms. RICHARDSON. Thank you very much.

Mr. LUBICK. Thank you.

Chairman JOHNSON. For those on the next panel, this is the first of three 5-minute votes. That means that we will recess for about a half-an-hour. We will reconvene at 1 o'clock.

[Recess.]

Chairman JOHNSON. I would like to welcome Mr. Gandhi, the Associate Director of Tax Policy and Administration Issues from the GAO. I am sorry you have had to wait, and my apologies to the following panels. We will try to move along promptly, but sometimes these votes take longer than you anticipate.

Mr. Gandhi.

**STATEMENT OF NATWAR M. GANDHI, ASSOCIATE DIRECTOR,  
TAX POLICY AND ADMINISTRATION ISSUES, U.S. GENERAL  
ACCOUNTING OFFICE; ACCOMPANIED BY TOM SHORT,  
ASSISTANT DIRECTOR, TAX POLICY**

Mr. GANDHI. Thank you, Madam Chairman.

Madam Chairman and Members of the Subcommittee, we are pleased to be here today to assist the Subcommittee in its inquiry into the classification of workers either as employees or independent contractors. Joining me here on my left is my colleague, Tom Short, who has been working in this subject area for a long time.

Proper classification of workers has been the subject of several of our reports and congressional testimonies. Today I would like to make four points.

First, in deciding how to classify workers, businesses may misclassify employees as independent contractors. In its most recent estimate on misclassification, IRS has estimated that in 1984, 15 percent of about 5 million businesses, that is, about 756,000 of them, misclassified workers as independent contractors. Many factors can cause misclassification, including cost considerations and confusion over the rules. For example, not incurring the costs of employment taxes and fringe benefits can give business cost advantages over competitors who use employees. Further, both we and the Treasury have found that the common law rules used for classifying workers are unclear and subject to conflicting interpretations.

Second, even with the confusing rules, IRS is responsible as the Nation's tax administrator to enforce compliance. Under its Employment Tax Examination Program, between 1988 and 1995 IRS has completed about 13,000 audits, resulting in some \$830 million in recommended assessments and about 527,000 workers reclassified as employees.

Third, deliberations over any changes to the classification rules may need to consider potential impact on the income tax compliance. IRS has found that independent contractors compared to employees have lower tax compliance and account for a higher proportion of the income tax gap. We identified two alternative approaches that could boost tax compliance. They include withholding income taxes on payment made to independent contractors and improved information reporting on such payments.

Fourth and final point is that aside from tax issues, an important consideration is the body of laws that create a safety net for American workers. Such laws generally apply only to employees. If changes to the rules lead to more workers being classified as independent and contractors, these laws would cover fewer people.

Let me briefly elaborate on the concerns we have over income tax compliance by the independent contractors and the implications for the safety net for American workers.

Since 1977, we have supported measures to simplify the classification rules. However, the development of clearer rules is neither simple nor easy. In any efforts to clarify the rules, the deliberations also may need to consider the potential impact on tax compliance.

IRS data for 1988 suggests that independent contractors accounted for most of the income tax gap created by those self-employed individuals who underreport their business income. The most recent estimates for this part of the income tax gap is about \$29 billion for 1992.

Among self-employed individuals, those who informally supply goods and services, such as street vendors and moonlighting craftsmen, reported less than 20 percent of their income, while the other self-employed individuals who operated more formally, such as gas station operators, reported less than 70 percent of their income.

Recognizing these concerns in 1992, we incentivized tax withholding and improved information reporting as alternative approaches to improved tax compliance by independent contractors,

while each approach will increase to some extent the burdens on the independent contractors and businesses that use them. We believe each approach merits congressional consideration.

Finally, aside from tax issues, another consideration is the potential impact on the body of laws that create a safety net for American workers because many of these laws apply only to employees. The laws do not protect independent contractors.

For example, unemployment insurance is nearly universal, covering over 90 percent of American workers. The 60-year-old program provides short-term financial support for covered employees who through no fault of their own become unemployed. It also helps the unemployed from having to turn to public assistance programs due to economic downturns. Payments to the unemployed may take on added significance, serving a macroeconomic role of helping to stabilize the economy.

However, the Federal law does not require coverage of independent contractors for unemployment insurance. While we have not made an extensive survey to determine all affected laws, they are quite numerous. They include basic protection involving issues such as minimum wage, mandatory overtime pay, discrimination, worker's compensation insurance, and employer-sponsored fringe benefits such as pensions. If clarifications of the rules pushes significantly more employees into independent contractor status, the worker protection laws would cover fewer people.

Madam Chairman, this includes my oral testimony. I request that my written testimony be made a part of the record. My colleague and I would be pleased to answer any questions you or other Members of the Subcommittee may have.

Thank you.

[The prepared statement follows:]

**STATEMENT OF  
NATWAR M. GANDHI, ASSOCIATE DIRECTOR  
U.S. GENERAL ACCOUNTING OFFICE**

Madam Chairman and Members of the Subcommittee:

We are pleased to be here to assist the Subcommittee in its inquiry into the classification of workers either as employees or independent contractors for federal tax purposes. Proper classification of workers has been the subject of several of our reports and congressional testimonies.<sup>1</sup> Today, I would like to make 4 points taken from these reports and testimonies.

- First, in deciding how to classify workers, employers may misclassify employees as independent contractors. In its most recent estimate on misclassification, IRS has estimated that 756,000 of 5.15 million employers (15 percent) misclassified workers as independent contractors in 1984. Many factors can cause misclassification, including cost considerations and confusion over the classification rules. For example, not incurring the costs of employment taxes (i.e., social security tax, unemployment tax, and income tax withholding) and employee benefits can give employers cost advantages over competitors who use employees. Further, both we and the Treasury Department have found that the common law rules used for classifying workers are unclear and subject to conflicting interpretations.
- Second, even with the confusing rules, IRS is responsible as the nation's tax administrator to enforce compliance with them. Under its Employment Tax Examination Program (ETEP), IRS has completed 12,983 audits, resulting in \$830 million in recommended tax assessments and 527,000 workers reclassified to "employee" status between fiscal years 1988 and 1995.
- Third, deliberations over any changes to the classification rules may need to consider potential impacts on income tax compliance. IRS has found that independent contractors compared to employees have lower compliance in paying income taxes and account for a higher proportion of the income tax gap. We identified two approaches that could boost independent contractor compliance within the existing common law rules. They include (1) improved information reporting on payments made to independent contractors and (2) withholding income taxes from such payments.
- Fourth, aside from tax issues, an important consideration in these deliberations is the body of laws that create a safety net for American workers. Such laws generally apply only to employees. If changes to the classification rules lead to more workers being classified as independent contractors instead of employees, these worker protection laws would cover fewer people.

I would like to discuss each of these points in more detail after providing an overview on factors that affect the classification decision.

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<sup>1</sup>These reports and testimonies include: Tax Treatment Of Employees and Self-employed Persons By the Internal Revenue Service: Problems and Solutions (GGD-77-88, Nov. 21, 1977); Tax Administration: Information Returns Can Be Used to Identify Employers Who Misclassify Workers (GAO/GGD-89-107, Sept. 25, 1989); Tax Administration: Approaches for Improving Independent Contractor Compliance (GAO/GGD-92-108, July 23, 1992); Tax Administration: Improving Independent Contractor Compliance With Tax Laws (GAO/T-GGD-94-194, Aug. 4, 1994); Tax Administration: Estimates of the Tax Gap for Service Providers (GAO/GGD-95-59, Dec. 28, 1994); and Tax Administration: Issues Involving Worker Classification (GAO/T-GGD-95-224, Aug. 2, 1995).

### FACTORS IN MAKING THE CLASSIFICATION DECISION

The rules for classifying a worker as either an employee or an independent contractor come from the common law. Under common law, the degree of control, or right to control, that a business has over a worker governs the classification. Thus, if a worker must follow instructions on when, where, and how to do the work, he or she is more likely to be an employee. IRS has adopted 20 common law rules to help employers classify workers (see appendix I).

If workers are determined to be employees, employers must withhold and deposit income and social security taxes from wages paid as well as pay unemployment taxes and the employers' share of social security taxes. In addition, the employers may be subjected to laws that govern the use of employees and any benefits provided to them. Employers do not have these responsibilities if the workers are independent contractors. Independent contractors must pay their own income and social security taxes on payments received. They have no unemployment tax responsibility but may purchase benefit packages to cover this contingency as well as others (e.g., health insurance).

Ultimately, the decision to classify a worker as an employee or independent contractor depends on each employer's circumstances. And, the extent to which a worker accepts the classification and understands its consequences plays a role.

### COSTS AND UNCLEAR RULES CAN CAUSE MISCLASSIFICATION

Employers sometimes misclassify employees as independent contractors. For 1984, the last time IRS made a comprehensive estimate, IRS estimated that about 756,000 of 5.15 million employers had misclassified about 3.4 million workers as independent contractors. IRS interpreted the classification rules in making this estimate. As shown in appendix II, this misclassification involved all industry groups and up to 20 percent of the employers in some industry groups.

This noncompliance produced an estimated tax loss for 1984, after accounting for taxes paid by the misclassified independent contractors, of \$1.6 billion in social security tax, unemployment tax, and income tax that should have been withheld from wages. In another set of estimates, IRS issued an employment tax gap report in 1995 that included the estimated tax gap associated with misclassification. This estimated tax gap was \$2.3 billion in 1987 and \$3.3 billion in 1992 for just social security and unemployment taxes.

In doing these estimates, IRS did not identify the reasons for the misclassification but factors such as costs and unclear classification rules can play a role. For example, employers can lower their costs, such as payments of employment taxes or benefits, by using independent contractors. This cost advantage could be offset if an independent contractor can negotiate higher payments to purchase their own health, retirement, or other benefits. Otherwise, the incentive to misclassify workers as independent contractors exists.

Second, many employers struggle in making the classification decision because of the unclear rules. Until the classification rules are clarified, we are not optimistic that the confusion over who is an independent contractor and who is an employee can be avoided. The Treasury Department characterized the situation in 1991 in the same terms as it used in 1982; namely, that "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."

In addition to confusion over the common law factors, Section 530

of the Revenue Act of 1978 has proven to be difficult to administer. Given complaints from some employers and independent contractors about IRS' attempts to reclassify independent contractors as employees, Congress passed this provision to limit IRS' reclassification authority. Section 530 provided qualifying businesses with safe harbors in determining who is an employee and an independent contractor.<sup>2</sup> In 1989, we reported that, for the cases reviewed, section 530 prohibited IRS from assessing \$7 million of \$17 million in recommended taxes and penalties against employers for misclassifying employees.<sup>3</sup> The employers usually avoided the assessments by claiming a prior audit protection, even when the prior audit did not address employee classification or occurred over 20 years earlier. Section 530 also has precluded IRS from issuing clarifying regulations since 1978.

#### IRS ENFORCEMENT

IRS is responsible as the nation's tax administrator to enforce the classification rules. Because of concerns about misclassification and income tax noncompliance by independent contractors, IRS centralized a portion of its employment tax compliance efforts into an Employment Tax Examination Program (ETEP) during 1987. IRS' strategy was to identify any misclassification and require employers to correct it. Employers whose employees are reclassified are liable for the portion of the employment taxes that they would have owed if the worker had been classified as an employee for the audited tax years.

From 1988 through 1995, IRS completed 12,983 ETEP audits. These audits recommended \$830 million in employment tax assessments and reclassified 527,000 workers as employees. In addition, the IRS Examination Division auditors, as part of their regular income tax audits, also may address classification issues. However, the Examination Division does not accumulate data to identify audit results on these issues.

Since late 1995, IRS has implemented initiatives to improve its enforcement of the classification rules and ease the burdens on those being audited. For example, IRS is revising its training to better ensure consistent application of the rules. IRS has circulated a draft of its training program so that employers know how IRS intends to interpret the rules. Further, IRS is testing ways to expedite and improve the settlement of disputes with employers over misclassification. These initiatives are too new for us to know whether they are working.

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<sup>2</sup>Under section 530, IRS may not assess employment taxes for misclassified workers against an employer that had a reasonable basis for its classification, such as a reliance on (1) a judicial or administrative precedent or technical advice and letter rulings to the taxpayer, (2) a prior IRS audit that did not challenge the classification scheme, (3) an industry practice, or (4) any other reasonable basis. To qualify for this protection, the business must have filed all required information returns and have treated similar workers uniformly.

<sup>3</sup>GAO/GGD-89-107, Sept. 25, 1989.

CONCERNS OVER INCOME TAX COMPLIANCE  
BY INDEPENDENT CONTRACTORS

Since 1977, we have supported measures to simplify the classification rules.<sup>4</sup> However, the development of clearer rules for all types of working relationships and businesses is neither simple nor easy.

In an effort to clarify the classification rules, we proposed a straightforward test in 1977 (see appendix III for details of this proposal). In sum, we proposed excluding workers from the common law definition of employee when they met each of four criteria.<sup>5</sup> If the worker met three of the criteria, we proposed that the common law criteria should be applied. Otherwise, we proposed that the worker should be considered an employee. Our proposal was not widely accepted for various reasons, which we had recognized. For example, Treasury and IRS were concerned about lower tax compliance and lost tax revenue from having more self-employed workers and fewer employees.

We have viewed our 1977 proposal as a good starting point for clarifying the classification rules. In doing so, the deliberations also may need to consider the potential impact on income tax compliance. IRS studies since the 1970s have documented a much lower level of income tax compliance by independent contractors compared to employees.<sup>6</sup> IRS data for 1988 suggest that independent contractors accounted for most of the income tax gap created by those self-employed individuals who underreported their business income.<sup>7</sup>

IRS' most recent estimates put this part of the income tax gap at \$29.2 billion for 1992. Among self-employed individuals contributing to this tax gap, IRS estimated that those who informally supply goods and services (e.g., street vendors, moonlighting craftsmen or mechanics, unlicensed child-care providers) reported less than 20 percent of their business income. The other self-employed individuals, who operated more formally (e.g., gas station owners), reported less than 70 percent; these estimates do not distinguish between independent contractors and other self-employed individuals such as those who make or sell goods.

Recognizing these concerns, our 1992 report identified other approaches to improve independent contractor compliance within

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<sup>4</sup>GGD-77-88, Nov. 21, 1977.

<sup>5</sup>The four criteria for independent contractor status included (1) separate set of books and records, (2) risk of a loss and opportunity for a profit, (3) principal place of business separate from those receiving the services, and (4) availability to provide self-employed services to the general public.

<sup>6</sup>Over the years, IRS has found that employees report almost 100 percent of their income while independent contractors report about three-quarters of theirs. A special IRS study in 1979 estimated that 47 percent of the independent contractors reported none of their business income.

<sup>7</sup>GAO/GGD-95-59, Dec. 28, 1994. Lacking a generally-accepted definition of "independent contractor", the report developed estimates on service providers as a surrogate measure since many are considered by IRS and the business community to be independent contractors. Depending on the definition of service provider used, their portion of the income tax gap created by self-employed individuals ranged from 56 percent to 81 percent.

the framework of the existing classification rules.<sup>8</sup> These approaches would (1) require businesses to withhold taxes from payments to independent contractors or (2) improve information reporting on payments made to independent contractors. While each approach would increase to some extent the burdens on independent contractors and businesses that use them, we believe each approach can help improve income tax compliance.

For example, withholding is the cornerstone of our tax compliance system for employees. It has worked well with over 99 percent of wages voluntarily reported. In addition, it provides a gradual and systematic method to pay taxes and better ensure credit for social security coverage. As early as 1979 we concluded that noncompliance among independent contractors was serious enough to warrant some form of tax withholding on payments to them.<sup>9</sup>

We continue to believe that withholding taxes from payments made to independent contractors has merit as a way to improve their income tax compliance. Several administrative problems would need to be resolved. For example, independent contractors with substantial business expenses, which lower taxable income, may have too much tax withheld from gross payments made to them. Appendix IV discusses such problems and possible solutions.

A second approach to enhance compliance--improving information reporting--parallels the withholding approach by shifting emphasis from unclear classification rules to the relatively clear laws on filing information returns.<sup>10</sup> Focusing on information returns could have a significant effect. IRS data has indicated that when information returns are filed, misclassified workers reported 77 percent of that income on their tax returns but only 29 percent of the income not covered by information returns.

While other options may exist, our 1992 report identified eight options that could strengthen information reporting and close potential loopholes:

- (1) Significantly increase the \$50 penalty for not filing an information return.
- (2) Do not penalize businesses for past noncompliance with information reporting laws if they begin to file information returns when the penalty is increased.
- (3) Require IRS to administer an education program to make the business community aware of the filing requirement and of IRS' intention to vigorously enforce it.
- (4) Lower the \$600 reporting threshold for payments to independent contractors.
- (5) Require information reporting for payments to incorporated independent contractors.

<sup>8</sup>GAO/GGD-92-108, July 23, 1992. This report also discusses the tradeoffs of clarifying the section 530 safe harbors (e.g., prior audit and longstanding industry practice) and codifying section 530 for employment as well as income tax purposes.

<sup>9</sup>Hearing on Compliance Problems of Independent Contractors, before the Subcommittee on Select Revenue Measures, House Committee on Ways and Means, July 17, 1979.

<sup>10</sup>In general, third parties (e.g., businesses but not individual homeowners) are required to annually file information returns at IRS to report \$600 or more in payments made to unincorporated individuals for services rendered in the course of trade or business. The information is also reported to these individuals.

- (6) Require businesses to separately report on their tax return the total amount of payments to independent contractors.
- (7) Require businesses to validate the tax identification numbers (TIN) of independent contractors before making any payments and withhold a portion of the payments until the TIN is validated.
- (8) Require businesses to provide independent contractors with a written explanation of their tax obligations and rights.

Each of these options involves tradeoffs between taxpayer burden and tax compliance. Appendix V summarizes the pros and cons of each option.

#### IMPLICATIONS FOR THE SOCIAL SAFETY NET FOR AMERICAN WORKERS

Aside from tax issues, another consideration in deliberating changes to the classification rules is the potential impact on the body of laws that create a safety net for American workers. Because many of these laws apply only to employees, the laws do not protect workers classified as independent contractors. Changes to the classification rules could increase the number of unprotected independent contractors.

For example, unemployment insurance is nearly universal, covering over 90 percent of American workers. This 60-year old program provides short-term financial support for covered workers who, through no fault of their own, become unemployed. It also helps the unemployed from having to turn to public assistance programs. During economic downturns, payments made to the unemployed may take on added significance, serving a macro-economic role of helping to stabilize the economy. However, federal law does not require coverage of independent contractors for unemployment insurance, although one state (California) has provisions that would allow independent contractors to apply for self-coverage.

While we have not made an extensive survey to determine all affected laws, they are quite numerous. They include basic protections involving issues such as minimum wage, mandatory overtime pay, discrimination, occupational safety and health requirements, workers compensation insurance, and employer-sponsored fringe benefits such as pensions. Thus, if clarification of the classification rules pushes significantly more employees into independent contractor status, the worker protection laws would cover fewer people.

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Madam Chairman, this concludes my testimony. I would be pleased to answer any questions you or other members of the Subcommittee may have.

## APPENDIX I

IRS' COMMON LAW RULES

IRS has summarized the common law into 20 rules. The facts of each case govern which rules apply, and the weight assigned to them in classifying a worker. Even so, workers are generally employees 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. Must 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 material.
15. Lack a major investment in facilities used to perform the service.
16. Cannot make a profit or suffer a loss from the 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 anytime without incurring liability.

## APPENDIX II

Table 1: Estimated percentage of employers with misclassified workers, 1984.

Industry	Percent of total
Construction	19.8
Finance, Insurance, Real Estate	19.3
Mining, Oil and Gas	18.6
Agriculture	16.7
Manufacturing	15.8
Services	15.4
Transportation	11.2
Wholesale and Retail Trade	9.6
Government	9.6
Not Otherwise Classified	12.6
<b>Total</b>	<b>13.4</b>

Source: Treasury Department

## APPENDIX III

GAO's 1977 PROPOSAL FOR CLARIFYING  
THE CLASSIFICATION RULES

To make the classification decisions more certain, we proposed a straightforward test in 1977. As in common law, our test recognized that a prime determinant of whether a worker is an employee or independent contractor is the degree of control, or right to control, the employer has over the worker. But our test also intended to recognize that some degree of control to protect the image of the manufacturer, supplier, or prime contractor should be allowed without creating an employer/employee relationship. Our test was also intended to provide a clear standard to assure better compliance. Therefore, we proposed that workers be excluded from the common law definition of employee when they:

- Have a separate set of books and records which reflect items of income and expenses of the trade or business;
- Have the risk of suffering a loss and opportunity of making a profit;
- Have a principal place of business other than that furnished by the persons receiving the services; and
- Hold themselves out in their own name as self-employed and/or make their services generally available to the public.

We also recognized that a worker may be able to meet some of our criteria and still have a valid basis for being self-employed. As a result, we proposed that the common law criteria should be applied when a worker met three of the four criteria. Otherwise, we proposed that the worker should be considered an employee.

At the time, our proposed solution was not widely accepted. Treasury and IRS were concerned that any change in the law which increases the number of self-employed would result in lost tax revenue. This was because IRS had found that self-employed taxpayers had a low compliance rate in reporting income earned. The Departments of Justice and Labor were concerned that the criteria would permit taxpayers to be considered self-employed when they have the form but not the substance of self-employment.

## APPENDIX IV

ADMINISTRATIVE ISSUES CONCERNING THE POSSIBLE  
WITHHOLDING OF TAXES FROM PAYMENTS MADE  
TO INDEPENDENT CONTRACTORS

Withholding taxes from payments made to independent contractors has the potential to significantly improve their compliance with income tax laws. For this potential to come to fruition, several administrative problems would need to be resolved. The most important consideration in any withholding system is that the tax withheld approximates the tax due for the year. Independent contractors can have substantial business expenses that reduce annual net income and taxes owed. In such cases, withholding could adversely affect their cash flow. Because such expenses may vary among independent contractors, a graduated withholding system to account for differences in expenses could be used. A simpler approach for businesses would be to withhold a flat amount (e.g., 5 percent) of all payments.

Another problem is that independent contractors may circumvent withholding by incorporating. To avoid this problem, withholding would need to apply to corporations. Large corporations may view withholding on payments to them as unjustified since IRS data suggest that their voluntary compliance exceeds that of self-employed workers.

Also, it is likely that any withholding system would exempt some independent contractors. For example, the flat 10 percent withholding proposal developed by the Treasury Department in 1979 would have exempted independent contractors who (1) normally work for 5 or more businesses in a calendar year or (2) expect to owe less tax than the withheld amount. Because some independent contractors may be exempt, it would be important to complement any withholding system with an effective information reporting system.

## APPENDIX V

OPTIONS FOR IMPROVING  
INFORMATION REPORTING ON  
PAYMENTS TO INDEPENDENT CONTRACTORS

In addition to discussing clearer classification rules and withheld taxes on payments to independent contractors, our 1992 report analyzed the pros and cons of eight options for improving the reporting on payments made to independent contractors, as follows.

Options	Pros	Cons
(1) Increase \$50 penalty for failure to file an information return (Form 1099-MISC).	<p>Should improve compliance in filing Form 1099-MISC.</p> <p>Should increase income reported and taxes paid by independent contractors.</p> <p>Would encourage IRS to check Form 1099-MISC filing during audits.</p> <p>Would discourage agreements to not file Form 1099-MISC in exchange for lower payments.</p>	<p>Would complicate IRS administration if other penalties for failure to file Form 1099-MISC are \$50.</p> <p>Would cause equity concerns if one penalty was higher than others.</p>
(2) Do not penalize businesses for past Form 1099-MISC noncompliance if they begin filing.	<p>Would encourage filing compliance.</p> <p>Would ease the transition to a higher penalty for not filing Form 1099-MISC.</p>	<p>Would not punish the noncompliance.</p> <p>Would result in lost penalty revenue.</p> <p>May foster expectation of future penalty forgiveness.</p>
(3) Have IRS educate businesses on Form 1099-MISC filing requirements and penalties.	<p>Should increase compliance in filing Form 1099-MISC.</p>	<p>Would add to IRS' costs or use funds that could be used for other educational purposes.</p>

<p>(4) Lower the \$600 Form 1099-MISC reporting threshold.</p>	<p>Would include more payments in IRS' match to detect unfiled Form 1099-MISC forms and unreported income.</p> <p>Should improve independent contractor compliance.</p> <p>Would mirror other lower thresholds (e.g., \$10 for royalties).</p>	<p>Would increase costs to businesses to file more Form 1099-MISC.</p> <p>Would increase costs to IRS to process and match more information returns.</p> <p>May exceed IRS computer capacity.</p>
<p>(5) Require information reporting on payments made to incorporated independent contractors.</p>	<p>Would deter attempts to avoid information reporting.</p> <p>Would not need to distinguish between incorporated and unincorporated workers.</p>	<p>Would increase costs to file more Form 1099-MISC.</p> <p>Would increase costs to process and match more Form 1099-MISC.</p> <p>May exceed IRS computer capacity.</p>
<p>(6) Require businesses to report the amount of payments to independent contractors on tax returns. IRS would match these amounts to amounts reported on information returns.</p>	<p>Should increase Form 1099-MISC compliance.</p> <p>Could enhance IRS' ability to detect noncompliance.</p> <p>Give tax return preparers more incentive to check compliance.</p>	<p>May not stop some businesses from hiding payments to independent contractors.</p> <p>May increase businesses' costs to report the information.</p>
<p>(7) Have businesses validate Taxpayer Identification Numbers (TIN) before making payments and withhold taxes until a TIN is validated.</p>	<p>Should improve IRS matching and increase taxes collected.</p> <p>Should make backup withholding more cost-effective by reducing it or starting it with the first payment.</p>	<p>Would add burden for businesses to validate TINs before paying contractors.</p> <p>Would increase IRS' equipment costs.</p>
<p>(8) Have businesses notify independent contractors of their rights and obligations to pay taxes as self-employed workers.</p>	<p>May improve tax compliance.</p> <p>Would encourage workers who believe they are misclassified to notify IRS.</p> <p>Would inform workers of their rights and obligations.</p>	<p>Would add burden on business to make the appropriate notifications.</p>

Chairman JOHNSON. Thank you very much, Mr. Gandhi.

Mr. Gandhi, in your testimony you mentioned that the IRS study based on 1984 returns concluded that 15 percent of employers misclassified 3.4 million employees as independent contractors. Was this statistic based on final determinations of a worker's status after the affected taxpayers had gone through administrative appeals or litigation?

Mr. GANDHI. No.

Chairman JOHNSON. No. Normally, at least based on the Commissioner's testimony, it appears that over 20 percent of examiner reclassification recommendations are overturned during litigation and appeals. So, actually, we need to reduce those figures by about 20 percent, would you agree, to get a more realistic idea of the real impact?

Mr. GANDHI. I think there is some concern about that, but I would have to check further on that to reply more carefully.

Chairman JOHNSON. I would like to get your thoughts on two things in regard to those statistics because they are driving policy-making and they are 12 years old.

Mr. GANDHI. Right.

Chairman JOHNSON. Especially in a society that has experienced the pace of change, in company structures, in the employee structure, in the whole economy out there, we cannot base policy decisions for the future on 1984 data. There must surely be something better, and I would like for you to get back to me both on how you would need to accommodate this data both for the impact of appeals, and for other changes that have gone on and where is there more recent data because this information is essentially useless to us.

Mr. GANDHI. That is correct, and I would like to make two points on that. One is that the employment audits are quite expensive audits, very costly audits. It takes a lot to do that, and the IRS is somewhat constrained with resources for that.

Chairman JOHNSON. I understand that.

Mr. GANDHI. The second point you make I think is an excellent one, which is that the working relationship has changed fundamentally.

Chairman JOHNSON. Right.

Mr. GANDHI. With the evolution of technology as a guiding force, the whole nature of work has changed, and I think that needs to be examined a little further.

Chairman JOHNSON. Also, too, because we ran into this when we were holding hearings on the big compliance audits that they do to get the kind of information that they need in a broader, more academic way, there are studies that go on in the private sector. What is there out there that might give us better information than this 1984 study?

Not only would you accommodate those figures for appeals, but also is there any way of looking at those estimates in terms of whether they involve one year of liability versus many years of retroactive liability?

Personally, I think it is simply incredible that in an area with as much uncertainty as we have in this law that we would have imposed a retroactive settlement, unless there was very clear evi-

dence of the goal being to circumvent the obligations of the employer, which I am sure there are cases of that sort out there, but in general, the principle of retroactively interpreting the law is a bad one, and I want to know whether those estimates of revenue loss include multiyear penalties.

Mr. GANDHI. OK.

Mr. SHORT. We do know they include multiyear. What we do not know is the portion that would be multiyear.

Chairman JOHNSON. Pardon?

Mr. SHORT. They do include multiyear retroactive assessments. What I do not know is the portion that do.

Chairman JOHNSON. Thank you. That would be very helpful because my impression is that more often than not the IRS did impose multiyear settlements, and when we are looking now at a policy of limiting retroactivity to one year, we are not going to get the kind of revenue impact that we might have gotten.

So, we need to understand these figures much better. We need to be able to adjust them for the new policy so that we would have a better understanding. Our data is terrible, and if you could give us some help from your more independent position, we would very much appreciate it.

Mr. GANDHI. Sure.

Chairman JOHNSON. Mr. Kleczka.

Mr. KLECZKA. Thank you very much.

I do note that you have a four-point test in your testimony, Mr. Gandhi—

Mr. GANDHI. Yes, sir.

Mr. KLECZKA [continuing]. Which, compared to the Christensen bill is much clearer and fairer, and I think the Subcommittee would do well to examine the GAO recommendations and see if possibly they could be included in any work product.

In your testimony, you did state some statistics as far as various employee groups underreporting.

Mr. GANDHI. Yes, sir.

Mr. KLECZKA. It seems to me that those facts and figures are above and beyond the issue we are talking about today, i.e., independent contractors, I note that the street vendors and gas station owners, those are individuals involved in a cash enterprise, and like a bar or anything else, we always have a compliance problem there because there is no way to audit how much actual cash came in versus receipt by check or credit card statements. So, I just wanted to note that and maybe ask you what the implication is of this stat to the entire question of independent contractors.

Mr. GANDHI. Well, to the extent that the independent contractor issue results from around the cash transactions, you would have all of the problems that you have in the other sectors, but what we do know for sure is that the general compliance level in the independent contractor arena is a very low one.

Mr. KLECZKA. Yes.

Mr. GANDHI. Only when you would have information reporting, that would substantially go up.

Mr. KLECZKA. But I think if I were an employer and I had a bona fide independent contractor working with me or for me, I would want to pay him with a check so that I can prove in an audit that

this was a legitimate business expense. So, I fail to see the correlation, although I would like to know, and never will actually ascertain, how much of the independent contractor payment is in cash, but again that is going to be almost impossible to determine.

Mr. SHORT. About the closest we can get to that is an estimate based on a 1985 study done by the University of Michigan. IRS combined that information to estimate the size of the informal economy with other information it had on reporting compliance.

About half—and I do not remember the exact percentages but we can get that for you—over half of those informal suppliers provided services, and the rest provided goods. So, the possibility exists that independent contractors would be part of that population.

As far as how much of it is actually in cash, I do not know that anyone knows that.

Mr. KLECZKA. What is the significance of reducing the threshold for filing Form 1099 from the current \$600? What will that accomplish?

Mr. GANDHI. I think if the threshold is lower, then you would have more of compliance, no question about that.

Mr. KLECZKA. You would have?

Mr. GANDHI. You would have more compliance there.

Mr. KLECZKA. OK.

Mr. SHORT. Well, another issue is. We do not know how much because it is not required to be reported, but certain independent contractor transactions do not get reported to IRS because they fall outside of that boundary or some other boundary. So, the goal would be to broaden the universe of Form 1099 reporting.

Mr. KLECZKA. OK. I think one of your recommendations which I favor on its face would be requiring businesses to separately report on their tax returns the total amount of payments to independent contractors. That has got to be the start, so you can track and see whether or not those contractors did report. Without this listing and I am an independent contractor, if I do not report a Form 1099 income, you are never going to know about it because there is nothing that you can cross-check or IRS can cross-check against. It does not seem like that would involve too much additional paperwork for an employer.

The other idea which I think we discussed in the previous panel, or was a question that I had that I didn't ask the other panel, was what would be your reaction to asking the filing employee or the filing independent contractor to attach to his Form 1099s that he received throughout the course of the year, like I have to attach my W-2s? What would be your reaction to that?

Mr. GANDHI. Well, I think that would increase a burden on the part of the independent contractors to do that, but I think to the extent that it improves the compliance, I would suggest that something like that ought to be considered.

Mr. SHORT. Yes. We haven't taken a position formally on that idea. The other issue here is the cost to the IRS to process more paper. Certainly, there would be a compliance—hopefully a positive compliance effect.

Mr. KLECZKA. Could you give me the pros and cons to requiring withholding of taxes to independent contractors?

Mr. GANDHI. Well, I think, generally, contention is made that the amount that you would withhold in the case of an independent contractor may be too much probably because of the expenses that are involved in it and that the determination of income may not be a correct one to provide the right amount of withholding, and that the independent contractor would face the cash flow problem.

On the other hand, one could suggest that as long as you have even a very small percentage, a very low percentage of the withholding, say 2 percent, 3 percent, you could get the independent contractors into the system.

The whole issue here is that as long as the people are in the system, their compliance level increases substantially, and to the extent that the withholding is involved, then the compliance is nearly 100 percent.

Mr. KLECZKA. So, you are saying it could be a much reduced amount, just so that the person is in the system or can be tracked.

Mr. GANDHI. That is correct.

Mr. KLECZKA. Good. Thank you very much.

Mr. GANDHI. Sure.

Chairman JOHNSON. Thank you.

I did want to come back to clarify a couple of facts that I need to see if you agree with.

Mr. GANDHI. Sure.

Chairman JOHNSON. My understanding is that where the independent contractor is a legitimate independent contractor and filing their 1099, compliance is 97 percent. In other words, they are reporting 97 percent of income. Is that correct?

Mr. GANDHI. That has been a survey of an earlier time which reported 97 percent, but then there is also a survey that IRS quoted today which is about 77 percent.

Chairman JOHNSON. That is what I want to get clear. My understanding is that IRS data shows that where 1099s are filed with regard to payments to independent contractors, it said 97 percent of the income is reported; that the 77 percent figure that the Commissioner used was in regard to people who are reclassified.

Mr. GANDHI. That are reclassified, yes, that is correct.

Chairman JOHNSON. Then the 29 percent is, in a sense, the underground, the people we are not seeing. They are not reporting anything at all, and when you do get them, they are reporting only on average 29 percent of income.

Mr. GANDHI. Correct.

Chairman JOHNSON. Do I understand that correctly?

In your testimony, you start a series of eight recommendations to increase reporting.

Mr. GANDHI. Right.

Chairman JOHNSON. We will take a very serious look at those. We do agree with you that better reporting is important, to increase penalties, trying to broaden the net of the reported participants, and we think that will enable us to ensure proper classification and also a fair share of revenue collection.

I wanted to ask you how do we better target the 29 percent and how do we target IRS' resources not at the reporters, but at the nonreporters. How do you find them?

Mr. GANDHI. Well, I think the IRS needs to be very vigilant about going after the particular groups of independent contractors. For example, some independent contractors, the compliance level is less than 29 percent. So, the question here is, how do you go about doing that.

Tom, do you have something to add?

Mr. SHORT. Yes. I was just going to add that this is a case that you rightly pointed out, where the information return was not filed. Obviously, if the IRS can figure out ways to induce compliance by the business in filing the information return when required, either through enforcement, through education, through whatever, that 29 percent will start to change.

Chairman JOHNSON. Do you have any comment on this case, the superintendent in Maryland and the effort of IRS to reclassify bus drivers?

Mr. GANDHI. Yes. We heard that today here, but we have not studied that to comment on it intelligently.

Chairman JOHNSON. I would be interested in any comment that you would have on that because that is going to have ramifications throughout the country at a time when, frankly, education dollars are at a minimum.

Mr. GANDHI. OK.

Chairman JOHNSON. Then, the last thing, you mentioned withholding as one of your recommendations, and withholding certainly makes sense, but when you look at who is an independent contractor and what their cash flow is. For example, if you lay cable, this is a professional job, and there is a regular cash flow. But a lot of these folks have very little, and I am not sure who does the withholding. I mean, administratively, this seems to be an absolute nightmare.

So, are you recommending withholding for everybody in this category or are there subcategories, and how would you just deal with the administrative problems of withholding?

Mr. GANDHI. We are painfully aware of the administrative problems involved in withholding, and that is simply one way of looking at it.

There are groups of people that you can think about withholding and those that are being paid regularly, but one can also think in terms of improved and enhanced information reporting. Withholding is not the only way of going about doing that. It is just one of the alternatives that we are talking about, and we do realize that that would put a lot of hardship on the part of independent contractors, no question about that.

Chairman JOHNSON. Thank you very much. I appreciate your comments, and I will look forward to your comments on a draft that we will circulate in the near future.

Thank you very much for being with us.

Mr. SHORT. Thank you.

Mr. GANDHI. Thank you.

Chairman JOHNSON. I would like to call now our first panel: Larry Campagna of Houston, Texas, on behalf of the American Bar Association Section of Taxation; Richard Reinhold, chairman of the Tax Section of the New York State Bar Association, accompanied by Sherry Kraus; Harvey Shulman, National Association of Com-

puter Consultant Businesses, general counsel; and Debbi-Jo Horton on behalf of the Tax Implementation Chairs of the White House Conference on Small Business. Welcome.

Mr. Campagna.

**STATEMENT OF LARRY A. CAMPAGNA, PARTNER, CHAMBERLAIN, HRDLICKA, WHITE, WILLIAMS & MARTIN, HOUSTON, TEXAS, ON BEHALF OF THE AMERICAN BAR ASSOCIATION SECTION OF TAXATION**

Mr. CAMPAGNA. Thank you, Chairman Johnson.

I appreciate the opportunity to present—

Chairman JOHNSON. Could you come a little closer to your microphone?

Mr. CAMPAGNA. Absolutely.

Thank you very much. I appreciate the opportunity to present the views of the ABA Tax Section today. I currently serve as chairman of the—

Chairman JOHNSON. You do have to get very close to the microphone to be heard.

Mr. CAMPAGNA. All right. I will try to swallow it.

Chairman JOHNSON. Sorry about that. Yes, just get right into it.

Mr. CAMPAGNA. I currently serve as chairman of the Employment Taxes Committee of the Tax Section of the ABA, and we submitted a written statement to this Subcommittee. This morning I will try to restrict my remarks to the topics that have been under discussion already today.

I must point out at the beginning, though, that my comments are my own to the extent that they vary from the prepared statement, and that the prepared statement itself is the view of the Tax Section and not the entire ABA. There are other sections of the ABA that may not share our approach.

I also need to state for the record that I have represented a number of taxpayers in disputes over classification, and that I am not here today on behalf of any of those clients.

Mr. KLECZKA. Which side were you on?

Mr. CAMPAGNA. I have been on both sides of these disputes.

Mr. KLECZKA. Thank you.

Mr. CAMPAGNA. I just want to cover three key points this morning that are covered in the written presentation. First, that only an objective administrable definition of independent contractor status can resolve disputes over the tax classification of workers. Unfortunately, any simple administrable definition also brings social and economic costs, such as the ones that have been addressed here this morning, and therefore, it will encourage some employers to reclassify workers in order to save on health and welfare benefits.

Those problems are beyond the scope of my expertise, and so I want to address the tax consequences here this morning in my testimony.

Chairman JOHNSON. Before you go on, though, in terms of that objective administrable definition, would you be in a position to define who would be incentivized to move employees into independent contract status and who would not if we changed the definition?

Mr. CAMPAGNA. I think my approach, Madam Chairman, would be to try to adopt a definition that would preclude as much reclassification as possible in that direction.

For example, if you adopted a definition that includes a certain percentage of the remuneration given to a particular person as one of the requirements for independent contractor status, for example, if it had to be less than 90 percent of the remuneration coming from one person or from one entity to be an independent contractor, then it would be difficult for companies to reclassify willy nilly.

Chairman JOHNSON. Thank you. I am sorry to interrupt you. Please continue.

Mr. CAMPAGNA. The second point to address this morning is that despite the significant and impressive efforts by the current IRS administration to develop new training materials and settlement programs, the current law is just too ambiguous to administer fairly and efficiently.

We appreciate the efforts the IRS has made, but section 530 is replete with undefined terms, and even more importantly, possibly, section 530 requires a result only for employment tax purposes. The safe harbors only apply for that purpose. So, the IRS still must go out and address the 20 common law factors for purposes like disqualification of employee benefit plans, whether a worker is entitled to certain deductions on Schedule C, and for other purposes.

As long as section 530 only provides relief in one area, all of the IRS' new programs will still leave disputes over worker classification.

Third, there are numerous ways that compliance can be improved even without an objective administrable definition of an independent contractor. We have tried to list in our prepared testimony many of the suggestions that have been presented in our Committees with regard to clarifying section 530, increasing penalties for noncompliance, for example, for the failure to give a Form 1099, and other items.

This morning I would like to focus on the section 530 problems because I think that is the way that this Subcommittee could help enforce the congressional mandate of a liberal construction of that statute.

The first suggestion, and I think the most important, is that section 530 of the Revenue Act of 1978 needs to be incorporated in the Internal Revenue Code. It just needs to be more accessible to people out there in the community.

The second suggestion is that if section 530 safe harbor relief is applicable, it should be applicable for all tax purposes, not just for employment taxes. The Service shouldn't disqualify somebody's pension plan if they had a reasonable basis for treating a worker as an independent contractor, and the worker shouldn't lose deductions on a Schedule C if there was a reasonable basis either.

Third, the prior audit safe harbor needs to be amended in at least two ways. It should be amended to clarify that if a taxpayer is relying on an audit that began after December 31, 1996, for example, the audit must have included an examination of worker status and worker classification.

It also should be amended in a different way to prevent retroactive reclassification of workers, but permit prospective reclassi-

fication by the Internal Revenue Service if the taxpayer does not have another reasonable basis other than that prior audit, and the prior audit did not consider the classification of the workers. So, we create a two-tier system where the old audits would be divided into audits that examined employment taxes and those that did not.

The fourth suggestion is that—or fifth suggestion, I guess this would be, is that section 530 industry practice needs to be clarified. That safe harbor needs to be clarified in a number of different ways that are listed in our prepared testimony.

Many of those suggestions, as you heard this morning, have now been incorporated by the Commissioner in the new training materials. So, I do not think there is much dispute about redefining industry practice now.

One important point is that industry practice should be allowed as a safe harbor even if that industry practice has changed. The IRS has been out there reclassifying workers right and left, and if the industry practice has changed because the IRS forced companies to reclassify, I think the industry practice safe harbor still should be available to that company if they can show that other competitors were changed over by the IRS.

Two final points on section 530. The first is that the burden of proof under section 530 should be clarified. A taxpayer's reasonable basis argument should prevail as long as the taxpayer can demonstrate a reasonable possibility of success if the reasonable basis issue were litigated. That is a test that is applied in many areas of the tax law currently and certainly would be administrable here.

The final suggestion I would address this morning, although there are others in our materials, is that section 530 should be clarified to indicate that reasonable reliance on, and reasonable interpretation of, the 20 common law factors can be a reasonable basis for safe harbor relief. There has been dispute about that in the past.

Thank you very much for the opportunity to address the Subcommittee. Our Tax Section stands ready to help in any way, and we are happy to answer questions when our time is available this morning.

[The prepared statement follows:]

STATEMENT OF THE SECTION OF TAXATION  
AMERICAN BAR ASSOCIATION

June 20, 1996

Subcommittee on Oversight  
of the  
Committee on Ways and Means  
U. S. House of Representatives  
on  
Employment Classification Issues

My name is Larry A. Campagna. I currently serve as Chair of the Committee on Employment Taxes of the Section of Taxation of the American Bar Association. These views are presented on behalf of the Section of Taxation. They have not been approved by the House of Delegates or the board of Governors of the American Bar Association and, accordingly, should not be construed as representing the position of the American Bar Association. We understand that the union caucus of the Labor and Employment Law Section does not concur in the views expressed in this testimony. These views are limited to the treatment of workers for income and employment tax purposes.

The classification of workers as employees or independent contractors for tax purposes has long been an area of controversy. The controversy stems from the lack of a clear and easily applied definition of either the term "employee" or "independent contractor," and the differing tax treatment accorded employees, independent contractors, and the taxpayers for whom they provide services.

In 1982, the American Bar Association adopted a formal legislative recommendation that included a five-factor test for independent contractor status. Since that time, numerous other definitions have been proposed by other professional associations and by members of Congress. We are not here today to present a proposal for a definition of an independent contractor employee, nor will we take the Subcommittee's time discussing what we believe to be the factors that should be taken into account in developing a workable definition of employee or independent contractor. We wish only to point out that the most successful resolution of the classification controversy will involve Congress developing a workable definition of an independent contractor or employee. Only an objective, administrable definition can resolve this controversy with finality.

We were specifically asked to comment today on the recent worker classification initiatives adopted by the Internal Revenue Service and to address whether those initiatives will adequately remedy the problems in worker classification. We applaud and appreciate the IRS effort to undertake these initiatives, which represent a significant improvement from both a technical and practical perspective in the administration of worker classification disputes. While we support and appreciate the efforts undertaken by the IRS in its new settlement program, the revised training materials, and the appeals policy changes, these initiatives will not solve the problems in worker classification. In fact, the IRS initiatives perpetuate many of the areas of disagreement between the IRS and taxpayers, especially on the applicability of the safe harbor relief available under Section 530 of the Revenue Act of 1978.

We recently submitted comments to the IRS regarding the draft training materials that were published by the IRS in a proposed form. While those materials would provide IRS employees with far more detailed guidance on the technical issues relating to the common law tests and Section 530 safe harbor relief, the materials still evidence a reluctance to liberally construe and administer the safe harbor rules in favor of taxpayers. Moreover, as long as the Section 530 safe harbor relief applies only for employment tax purposes, the IRS is not free to ignore the common law tests, because the common law standards still apply for income tax purposes, for disqualification of employee benefit plans, and for other matters.

Perhaps an example from the proposed training materials will illustrate the difficulties inherent in the IRS's duty to administer the current law. One of the Section 530 safe harbors prevents reclassification of workers if they were treated as independent contractors in accordance with a "longstanding recognized practice of a significant segment of the industry." The only decision from the United States Court of Appeals that has addressed the "significant segment" issue held that the taxpayer need not prove that a majority of the industry treated similar workers as contractors. Nevertheless, the IRS training materials seize on the words "recognized practice" to take the position that "there must be general consensus in the industry that treatment of workers as independent contractors is appropriate or correct." The requirement of a general consensus is not based on any judicial decision, and it essentially creates a presumption that the taxpayer must prove that a majority of the industry has accepted independent contractor treatment for similarly situated workers. This is but one example of how difficult it is for the IRS to administer this Section 530 as currently drafted. The statute is replete with ambiguous terms that need objective definition if the statute is to serve as the relief provision it was intended to be.

Similar ambiguities exist in the new settlement program undertaken by the IRS. For example, a business is eligible to settle for 25% of the employment tax liability computed pursuant to Section 3509 for one audit year if the business can show that it has met the reporting consistency requirement of Section 530 and that it has a "colorable argument" that it meets the substantive consistency requirement and the reasonable basis test. There is no definition of the term "colorable argument." In litigation, trial lawyers frequently refer to a "colorable argument" as one that is "non-frivolous." But recent informal comments suggest that the IRS expects something much more substantial than a non-frivolous argument.

On the whole, the new IRS initiatives are a welcome breath of fresh air. Nevertheless, we have objections to certain language in the proposed training materials and the settlement program. Also, the new initiatives leave unresolved a number of the pending controversies. Although the new training materials and other initiatives represent a significant step toward clarification of various IRS positions in the employment classification area, they are not the ultimate solution.

We have several suggestions that we believe will improve compliance until a definition of employee can be developed.

Prior studies have indicated that classification audits do not necessarily generate significant sums of additional tax revenues. This is particularly the case if the taxpayer has provided information returns, Forms 1099, to the Internal Revenue Service with respect to the amounts paid to its workers. The information returns permit the Internal Revenue Service to ensure that the workers have reported all of their income. Furthermore, the Internal Revenue Service's own statistics suggest that 97 percent of the amounts reported on information returns are included on taxpayers' returns. Classification audits will not uncover the entities and individuals who fail to file either tax returns or information returns, or collect any additional revenues from them.

We suggest the following changes to increase compliance until a workable definition of employee can be developed:

1. Incorporate the Section 530 safe harbors into the Internal Revenue Code and specifically extend them for all tax purposes, not just employment taxes. For example, if Section 530 safe harbor relief applies, then it should prevent disqualification of employee benefit plans and it also should prevent income tax adjustments to the worker's return that ordinarily would result from reclassification. This will make the rules more readily accessible to taxpayers and make the application of the Section 530 safe harbors uniform.
2. The application of the Section 530 prior audit safe harbor should prevent retroactive reclassification of workers, but permit prospective reclassification by the Internal Revenue Service if the taxpayer does not have another reasonable basis for its classification of its workers and the prior audit did not consider the proper classification of workers. We can see no reason to prevent the Internal Revenue Service from reclassifying workers

prospectively if the taxpayer has no basis, other than a prior audit which did not consider employment tax issues, for classifying its workers as independent contractors.

3. The Section 530 prior audit safe harbor should be amended to clarify whether the prior audit must have addressed employment taxes. We suggest that if the taxpayer is relying on an audit that began after December 31, 1996, the audit must have included an examination of employment taxes for the prior audit safe harbor to be applicable.

4. The Section 530 industry practice safe harbor should be clarified in several ways. The taxpayer should be permitted to define the industry either nationally or by the taxpayer's competitive region. A percentage test should be provided by Congress to define "significant segment of the industry" so that taxpayers and the Internal Revenue Service will have certainty in applying this rule. Congress should also clarify that an industry practice can be considered "longstanding" even if the practice began after 1978. (The proposed IRS Training Manual states that a longstanding practice is clearest if it began before 1978, but that the practice could begin after 1978.) The industry safe harbor should also permit a taxpayer to rely on industry practice even if the industry practice changes. This is particularly important if a significant segment of an industry has reclassified its workers as a result of IRS audits, so that the taxpayer will not be caught having relied on prior industry practice.

5. The Section 530 rule requiring consistent reporting for each worker should be modified. The IRS issued a revenue procedure (No. 85-18) years ago that clearly allows taxpayers to prospectively reclassify contractors as employees without loss of Section 530 relief. Nevertheless, the statutory language makes taxpayers reluctant to reclassify their workers as employees because doing so theoretically could eliminate the Section 530 safe harbors for periods prior to the reclassification. The consistency rule should be revised to prevent taxpayers that change their treatment of workers from employees to independent contractors from taking advantage of the Section 530 safe harbor.

6. The Section 530 safe harbor should be available to taxpayers even if there is no showing or admission that the workers in question are common law employees. While the IRS training materials indicate that Section 530 relief must be examined independent of the results on the common law tests, a true safe harbor relief provision should allow taxpayers to avoid completely an IRS examination of the common law test.

7. The burden of proof under Section 530 should be clarified. A taxpayer's reasonable basis argument should prevail as long as the taxpayer can demonstrate a realistic possibility of success if the "reasonable basis" issue were litigated. This standard is consistent with other standards required in tax practice, including those established by the IRS in Circular 230, and has been interpreted to mean approximately a 30% chance or a one-in-three chance of success in litigation.

8. The "other reasonable basis" safe harbor of Section 530 should be clarified to indicate that an application of the 20 common law tests can justify a taxpayer's reasonable basis.

9. The penalty applicable to failure to file information returns should be increased. An increase in the penalty will increase the impetus for taxpayers to file the appropriate information returns and for the Internal Revenue Service to audit in situations where reclassification of workers would not be appropriate. The penalty should not apply in *de minimis* circumstances where the taxpayer correctly issues information returns to most of its workers.

10. The amount assessable under Section 3509 for misclassification of workers should be reduced unless the misclassification is attributable to intentional disregard of rules and regulations. A reduction of the monetary consequences of reclassification will eliminate some of the controversy associated with retroactive reclassification of workers. Alternatively, taxpayers who have misclassified their worker (but without intentional disregard of rules and regulations) could be permitted to agree with the Internal Revenue Service to prospectively reclassify workers as employees rather than litigate the classification issue for prior periods.

11. Section 1706 of the Tax Reform Act of 1986 should be repealed, so that the safe harbor provisions will apply in the case of technical services personnel. There is little rationale for the singling out of technical services personnel for a special rule, and the definition of technical services personnel is too ambiguous to apply in today's service-oriented economy.

Chairman JOHNSON. Thank you. I appreciate your very specific testimony and look forward to working with you.

Mr. Reinhold.

**STATEMENT OF RICHARD L. REINHOLD, CHAIRMAN, TAX SECTION, NEW YORK STATE BAR ASSOCIATION**

Mr. REINHOLD. Thank you, Madam Chairman. I am the chairman of the New York State Bar Association Tax Section this year. I have been in private practice for 20 years. With me this afternoon is Sherry Kraus who is the author of the Tax Section's report on independent contractor issues.

I would like to make five points. Our first point is that we think it is very important that the tax law provide clarity in terms of the distinction between an employee and an independent contractor. These are very important issues involving a lot of money for individual taxpayers both on the worker and the employer/independent contractor side, and too important to be left to the vagaries of inconsistent determinations.

Second, it is our judgment as practitioners that in very general terms independent contractor status can often result in the avoidance of significant amounts of taxes for several reasons, the first being the simple failure to report income in many cases, the second being the opportunity to overstate Schedule C expenses, and the third the opportunity to avoid the 2 percent of AGI floor on non-reimbursed expenses.

I will say in that regard that I think it is garden-variety tax advice to someone considering setting up an enterprise that independent contractor status is preferable, and there are other factors, on the very important basis that one can then be aggressive, if you will, in claiming expenses on Schedule C. So, from our point of view as practitioners, we see a lot of opportunity for tax avoidance in independent contractor status.

The third point I would like to make is that we think that the common law control test does not work, and we similarly think that the 20 factor interpretation of that test, while a sensible interpretation of the present law, also does not work, and we think that that situation is exacerbated by changes in the modern workplace which I know you have referred to previously. People can work at remote locations. People can work with a PC and a fax, which they can supply themselves rather than having the employer supply. So, we think that the common law control test ought to be replaced with something that allows people to know clearly which side of this important issue they stand on.

Fourth, we think that the section 530 provision has outlived its usefulness. It is the antithesis of a solution rather than a solution itself. It freezes the law in one particular place and, therefore, does not permit clarification that ordinarily occurs through the litigation process and the IRS interpretive process, and it creates an uneven playingfield that seems to us very problematic from a policy viewpoint. The changes in the 1986 act for technical service workers to get free of section 530, I think, are a good example of that.

So, in short, we think that section 530, while perhaps an appropriate patch while Congress considered the independent contractor question, is not appropriate.

We recommend a safe harbor for independent contractor status that effectively has four elements that are described in our statement, and for persons meeting that, we would provide independent contractor status. For those who meet two or fewer of the elements, we would classify them as employees, and we think that these tests would provide very certain tax treatment for a very large number of taxpayers.

Finally, and this is not something our Subcommittee considered, I would say that we disagree with Secretary Lubick's assertion that changing the definition of employee for tax purposes would necessarily change the definition for any State law purpose. It would be a very simple matter in drafting to make clear that a change applies only for one purpose, and if the States and so on wanted to adhere to the Federal tax definition of employee, they could either do so, or not do so.

That concludes my portion of our statement today. I would be happy to answer any questions that you have.

[The prepared statement follows:]

Committee on Ways and Means  
Subcommittee on Oversight  
U.S. House of Representatives

Hearing on Employment Classification Issues

June 20, 1996

Statement by Richard L. Reinhold on Behalf of  
New York State Bar Association, Tax Section

My name is Richard Reinhold. I am currently the Chair of the Tax Section of the New York State Bar Association. The Tax Section is dedicated to achieving a fair and equitable tax system, and to the development of sound tax policy. I am a partner in the New York law firm of Cahill Gordon & Reindel. I am accompanied by Sherry Kraus, a tax lawyer from Rochester, New York; Sherry is a principal author of our 1995 report (the "report") on worker classification-related tax issues. (The report was reprinted in Highlights and Documents, October 26, 1995 at p. 1399.)

We are grateful for the opportunity to present our views today. We will make three principal points by way of background to our recommendations:

° In light of the significant variation in taxpayer liabilities that arise from independent contractor or employee classification, and the importance of these obligations to the proper functioning of the Social Security system, it is of crucial importance that the rules for determining employee and independent contractor status be clarified.

° The so-called "control" test used to distinguish employees from independent contractors is hopelessly uncertain in its application. This ambiguity in the law creates significant costs for taxpayers and government without any concomitant benefit.

° Section 530 worsens the problems of present law by preventing clarification of the law, and by creating disparities in the treatment of businesses based on historic differences in audits (including audits that did not involve employment tax issues) or the practices in a segment of the employer's industry.

In light of these points we recommend that:

(1) Congress adopt clear rules distinguishing employees and independent contractors. We think the safe-harbors for determining independent contractor status in certain pending bills (H.R. 582 and H.R. 1972) represent a good start, but we are concerned that the criteria used may be subject to manipulation.

(2) Section 530 be modified in a number of respects, most importantly to (i) apply only so long as the pertinent definitional criteria are unchanged, (ii) eliminate the moratorium on pronouncements on worker classification issues by the

Internal Revenue Service and (iii) apply only as a result of an employment tax audit (as opposed to any audit).

We make other recommendations in our report at pp. 1407-10.

I will briefly summarize our reasons for these conclusions.

First, substantial differences in the worker's and employer's\* tax obligations hinge on the worker's status as an employee or independent contractor. Given the probability that taxes that are not collected via withholding at source are less likely to be paid, significant revenue loss -- both employment tax and income tax -- likely attends mis-classification of employees as independent contractors. Non-compliance with employment tax requirements also impairs the functioning of the Social Security benefit system. One can only imagine the situation of an alien transported to the United States to confer with a tax advisor: he first learns that up to 39.6% may be withheld as income tax from wage-type income, that a 15.3% employment tax is also levied on such income, and that substantial life-long benefit entitlements are earned by paying the employment taxes. Presumably, the alien is then shocked to find out in many cases it is not clear whether the income taxes are withholdable, or whether it is the worker or the employer who is required to pay the employment taxes.

Second, the common-law control test now used to distinguish employees from independent contractors does not work. (This criticism applies equally to the 20-factor test used by the Service.) Aside from the most obvious cases, there are few situations where respectable arguments cannot be made on both sides. The modern work situation places even greater strain on the test, given employees' ability to work flexible hours, to work from their homes or other remote locations, and to purchase tools (e.g., fax and PC) instead of having the employer supply them (the employees' purchase of such tools need not change the essential economic relationship of the parties). While appropriate rules might be fashioned from the concepts underlying the control test (see our recommendation below in "Fifth") the test is simply not adequate to the task of distinguishing, with sufficient certainty, between employees and independent contractors.

Third, the uncertainties that bedevil present law are exacerbated by §530 of the Revenue Act of 1978. In fact, present §530 is the antithesis of a solution: by freezing the status quo, it prevents the law from progressing towards more rational conclusions. The result is variations in the treatment of similarly-situated workers, and preferences of one business over another. The object of § 530 -- protecting reasonable taxpayer reliance -- is certainly laudable, however, and we strongly urge that any change in the definitional standard of who is an employee be wholly prospective.

Fourth, it seems likely that, in general, independent contractor treatment probably results in avoidance of worker taxes for several reasons, including failure to include amounts paid in income, overstatement of Schedule C expenses and

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\* I will use the term "employer" as shorthand for both the employer as well as the service recipient in an independent contractor relationship.

avoidance of the 2% of AGI floor on deductibility of unreimbursed expenses. Employers may favor independent contractor status for non-tax reasons (a desire not to afford qualified plan or medical benefits) or tax-motivated reasons (reduced wages acceptable due to absence of tax withholding). From a compliance viewpoint, employee status and withholding of tax generally is preferable, except in cases such as those involving significant employee expenses where employee treatment is impractical.

Fifth, although some rough justice in defining who is an employee is probably necessary, many situations can be addressed adequately through safe-harbors. For example, an independent contractor might be required to satisfy each of four substantive tests: (1) the worker could suffer a loss from the services (due to the incurrence of expenses, including depreciation), (2) the worker has a separate principal place of business from the employer's, (3) the worker has a significant investment in facilities or tools not typically maintained by an employee and (4) the worker makes his or her services available to the public and has performed substantial services for at least two unrelated employers in the current year or the preceding year. We are concerned that a measure that allows reliance on a single factor may be subject to manipulation. For example, a worker might in all respects resemble a traditional employee except that he might hold himself out as available to third parties and briefly work for another employer, or might work from quarters adjacent to his home using a PC. These workers would nonetheless be classifiable as independent contractors under H.R. 582 and H.R. 1972.

Sixth, §530 ought to be revised in a number of respects. As noted, we would remove the bar on IRS interpretation of employee status issues. Additionally, we would limit §530 relief to cases where the audit that forms the basis for taxpayer reliance focused specifically on employment tax issues affecting the individual in question or similarly situated individuals.

Chairman JOHNSON. I would like for you to answer questions when we finish with the panel, but I would like for Ms. Kraus to go through the more specific recommendations that you have made, especially in light of your recommendation that we not, in a sense, clean up section 530.

**STATEMENT OF SHERRY S. KRAUS, INDIVIDUALS COMMITTEE, TAX SECTION, NEW YORK STATE BAR ASSOCIATION, AND CO-AUTHOR OF "TAX SECTION REPORT"**

Ms. KRAUS. All right, Madam Chairman. Thank you.

I would just like to start at the beginning with a very important point that is made in our report, which is that any changes and reforms in the worker classification area must go hand in hand with reforms in the compliance area.

Our report goes extensively into the problems, the huge exemptions in reporting under Form 1099 where even if an employer is in full compliance, there are many payments that go out to workers that do not require Form 1099 reporting. You have heard this morning, of course, a lot of statistics regarding the tax gap with the self-employed. So, much of that, it seems likely, is due to the fact that there is just nothing going into the IRS on these payments, including, for example, a building contractor who works for a homeowner and may put on a \$70,000 addition. There is nothing going into the IRS on that at all because of the domestic employer exemption from form tax reporting.

In our town in upstate New York, many businesses will ask their workers to incorporate. All the worker has to do is pay \$300 to incorporate, and suddenly that exempts the employer from 1099 reporting. So, there are massive gaps and exemptions here that do create a problem.

If we are going to reform the worker classification area, we have to reform the tax reporting and compliance area so that the decision of whether you are an independent contractor or an employee truly is a tax-neutral decision, and so we no longer have this tension of if you are an independent contractor you can get by with underreporting and if you are an employee you cannot.

We also in our report reviewed the bills that were before Congress at that time, including the Kim and Christensen bills. I would like to comment that while we agree with the approach of having certain objective criteria determine a safe harbor for independent contractors, we found those bills not to be the solution. While the bias right now at the IRS is toward employee characterization, we believe that under either one of these bills, the pendulum would swing greatly to the other end of the spectrum and make it too easy to be an independent contractor, thus, undermining employee status altogether.

What we did in our report, and Rick adverted to it, is we agree that there needs to be objective bright-line tests not only for independent contractors, but also, for employees. We cherry-picked through the bills, and looked at case law and tried to pick the factors that we believed truly are the elements for independent contractor status. They are in the report and summarized as follows:

One would be whether the worker could suffer a loss. It is very unusual for an employee to be able to actually suffer a loss in his/

her business. We look at whether the worker maintains a principal place of business, separate from the employer, has a significant investment in facilities and tools, makes his services generally available to the public, has worked for more than one employer in the last year, has a written agreement with his employer specifying that he will be treated as an independent contractor and will assume the liabilities and obligations to report consistently, and has to maintain his own books and records. If the worker meets all of those criteria, the worker would be classified as an independent contractor. Then we make an attempt to say what criteria should define employee status. If the worker works for an employer for 20 hours or more and meets two or fewer of the criteria for the independent contractor classification, the worker will meet bright-line test of being classified as an employee.

Now, we believe this will take care of the vast majority of disputed issues under current law. However, there will be some workers that do not fall into either of these tests, and for those in the middle, we would continue to apply the common law test, but we would recommend removing the moratorium on Treasury under section 530 to allow Treasury and the IRS to give us greater guidance in the area, so that for the workers who do have to be under this test, then you can have better criteria.

We also look at the section 530 safe harbor that Rick was talking about. We recommend the codification of that safe harbor. However, we also recommend some tightening of that safe harbor. We think the present audit safe harbor is over-board. For example, the IRS should not be bound if they go in and do any type of audit. The IRS does not always audit everything, and if they simply audit an income tax area, the employer should not be protected in perpetuity from ever having to reclassify his workers to the appropriate classification by reason of the private audit safe harbor rule. So, we agree with recommendations that the prior audit safe harbor be restricted to employment tax audits only. We also make a recommendation that has not been discussed today which is the statute of limitations. At the present time, there is nothing to prevent the IRS from going back indefinitely, well more than 3 years, in making these assessments, and they do. We recommend a procedure for allowing certain electing employers to start the statute of limitations running so that they will not be exposed for more than 3 years in the event they are erroneously classifying their workers. We then turn to recommended reforms in the compliance area, the most important of which is to increase the penalty on employers who do not do the Form 1099 reporting as required.

Right now the penalty is nominal. Employers have no great risk if they decide not to send the Form 1099, or if they enter into some agreement with their worker, collusively, not to report the payments. Then we need the penalty stiffened.

We also need to make it easier for the employer to verify the 10 numbers for those who do want to comply. Right now the system is very cumbersome. If a worker gives you a wrong number, a wrong Social Security number, it is more than a year later before the employer knows about it. So, a lot of money is lost to the system that way. Basically, the other primary recommendation is to

lower the threshold for reporting on Form 1099, and you talked to the gentleman from GAO about that.

Right now there are too many exemptions from Form 1099 reporting. If the employer pays the worker less than \$600, he does not have to send a Form 1099. If the worker incorporates—that only costs \$300 or so in New York to incorporate—the employer does not have to send a Form 1099. If the worker works for a domestic employer, you do not have a Form 1099 going into the IRS.

We also need the \$600 threshold lowered so that more reporting goes in. We need to get rid of the incorporation shelter at least as to workers who do it to avoid reporting at all. Basically that is our detailed summary of our report recommendations.

[The prepared statement follows. The full report is being held in the Committee's files.]

**HOUSE WAYS AND MEANS COMMITTEE  
SUBCOMMITTEE ON OVERSIGHT  
HEARING ON EMPLOYMENT CLASSIFICATION ISSUES**

**Summary of Recommendations in Report  
Submitted by  
New York State Bar Association, Tax Section**

**Sherry S. Kraus, Co-Principal Author of Report**

The Tax Section undertook a review of the employment classification area and issued a report on October 16, 1995 making recommendations for reform. As requested, a copy of the report is attached for inclusion in the Subcommittee's hearing record.

This is an area long overdue for reform. Employers need reform because, as to many workers, they must apply vague guidelines in the decision of whether to classify that worker as an independent contractor or an employee. Furthermore, employers have no easy, inexpensive means for review by the Internal Revenue Service as to whether that classification is correct. This is particularly troubling since, under current interpretations of the law, employers face an unlimited statute of limitations for deficiency assessments if they have incorrectly treated a worker as an independent contractor when the worker should have been treated as an employee. For this reason and the fact that mistakes often affect large categories of workers, employers face potentially devastating deficiency assessments in worker reclassifications.

The Treasury and the Internal Revenue Service agree that there are problems in applying the common-law criteria to determine the appropriate classification of a worker. Treasury has noted that the present method for classification "does not yield clear, consistent or satisfactory answers and reasonable persons may differ as to the correct classification." In a study involving tax year 1992, it was estimated that worker misclassifications resulted in lost tax revenue in the range of 2.1 billion dollars.

Nor is this an issue that affects only small business employers who, historically, have been more likely to hire independent contractors and other short term workers than large business. As evidenced by the recent tax audit of IBM, the problem is now extending into the highest reaches of corporate America as a consequence of corporate downsizing and the significant economic advantages of hiring the worker back as a consultant with independent contractor status.

The worker can be caught in the middle. There are significant economic savings to an employer who treats the worker as an independent contractor instead of an employee. As to that worker, the employer does not have (a) to pay employment taxes, (b) to withhold employment and income taxes, (c) to pay FUTA taxes, (d) to meet extensive filing and record-keeping requirements or (e) to include the worker in the employer's qualified health, disability or pension plans. Because of these potential economic savings to the employer, the worker may be pressured into agreeing to be treated as an independent contractor in order to have the job even if such might not be the appropriate classification for the worker.

On the other side of the coin is the worker who may press his employer to be treated as an independent contractor rather than as an employee. Notwithstanding the greater employment tax costs to the worker from independent contractor status, a cash strapped worker may seek this treatment to increase cash flow by avoiding income and employment tax withholding that would be required if the worker were treated as an employee. Unscrupulous workers might seek this classification with the intention of more easily avoiding tax compliance by underreporting or nonreporting of payments received. On this point, it should be noted that the lost tax revenues from misclassification of workers (2.1 billion dollars in 1992) pales in comparison to the lost tax revenue from under reporting of income by self-employed workers (estimated to be 20.3 billion dollars

in 1992). Currently, the ability of the Service to improve reporting compliance by self-employed workers is undercut by existing laws that are inadequate to the task.

Studies support the conclusion that self-employed workers have a significantly higher level of compliance in reporting payments made to them if the payments have been reported to the Internal Revenue Service by their employers on Form 1099-MISC. Unfortunately, there are many exceptions to an employer's obligation to file an information return on Form 1099 for payments made to independent contractors. If, for example, (a) the worker incorporates, (b) the worker receives payments of under \$600 a year, or (c) the worker provides services to a non-business employer such as a homeowner, no return is required. Accordingly, these payments will not be reported to the IRS for cross checking on the worker's income tax return to ensure that the payments are included. Furthermore, even if the payment falls within the Form 1099 information reporting requirement, only nominal penalties are imposed on the employer who fails to report such payments.

I understand that staff has given you a copy of our 1995 report for inclusion in the hearing record. This report recommends a number of specific legislative and administrative steps to enact meaningful reform in this area. We believe, however, that any changes to reform the worker classification rules must go hand-in-hand with reform to improve compliance and reporting of income by self-employed workers.

Our report also reviews recent legislative approaches for reform in this area, including the Kim and Christensen Bills. We believe that the objective criteria for classification of a worker as an independent contractor under the Christensen/Kim/Lantos bills could be so easily satisfied in the employer/worker relationship that there is a significant risk of undermining treatment of workers as employees, especially given the current cost incentives to employers to classify their workers as independent contractors.

Our report recommends the adoption of objective safe harbor tests to determine independent contractor status and employee status. In defining these safe harbors, we attempt to select the most important criteria for distinguishing independent contractors from employees. We recommend that a worker be classified as an independent contractor if (a) the worker could suffer a loss as well as make a profit in the performance of services; (b) the worker maintains a principal place of business separate from the employer's and has a significant investment in facilities and tools not typically maintained by employees; (c) the worker makes his services available to the general public and the worker has performed services for at least one other employer during the current year or the previous calendar year; and (d) the worker enters into a written qualified agreement with his employer that (i) specifies the services to be provided by the worker and the duration of the services, (ii) provides that the worker is aware of his employment tax obligations and will report and pay in accordance with independent contractor classification and (iii) requires the worker to maintain his or her own set of books and records with respect to the worker's business. If the worker satisfies all of the above criteria, he or she would be classified as an independent contractor.

As to the objective criteria that must be satisfied for classification of a worker as an employee, we recommend that such classification be required if the worker meets two or fewer of the objective criteria required for classification as an independent contractor and works for the employer for twenty hours or more per week. Workers not meeting either the independent contractor safe harbor or the objective tests for classification as an employee would be tested under the common-law rules. So that clearer guidelines can be developed for application of the common-law rule tests where necessary, we recommend that the current moratorium on Treasury Guidance imposed by Section 530 be removed.

The report also recommends modifications to the Section 530 safe harbor. Section 530 would be incorporated into the Internal Revenue Code so that the safe harbor would extend to income tax as well employment tax treatment. The codification of Section 530 will also permit Treasury and the Internal Revenue Service to issue needed guidance in the form of regulations and revenue rulings to implement this relief provision in the manner in which it was intended. We also recommend narrowing the application of the Section 530 safe harbor to limit the "prior audit" safe harbor to Internal Revenue Service audits which have examined the employment tax status of the employer's workers.

As additional relief to employers from retroactive assessments of employment taxes, we recommend the adoption of a new procedure that would allow an employer to file a supplemental Form 1099 which would have the effect of starting a three year statute of limitations period for the Internal Revenue Service to review the classification of that worker as an independent contractor. This procedure would be an alternative to the more cumbersome private letter ruling process and would be elective to the employer. The procedure would be used by employers who have a concern regarding whether they are correctly treating a worker as an independent contractor and do not wish to be open to assessments from IRS reclassification of the worker for the indefinite future.

The report recommends a number of reforms intended to improve compliance in reporting of income paid to independent contractors: (1) We recommend increasing the penalty for an employer's failure to file information returns to the greater of \$50 or 5% of the amount required to have been reported correctly but not so reported. We also recommend raising the cap on the penalty from its current \$250,000 level to a substantially higher amount. (2) We recommend lowering the \$600 reporting threshold for payments made to independent contractors in order to increase the payment information reported to the IRS on Forms 1099. Treasury would be directed to set appropriate reporting threshold levels for the type of services performed. (3) We recommend requiring information reporting on Form 1099 for payments made to workers who are incorporated. The present law exemption provides an easy avoidance mechanism to workers who do not wish to have Form 1099 reporting on their payments. (4) We recommend establishing a system whereby employers can make a quick TIN check through an IRS "800" number to verify the social security number given to them by a worker prior to making any payments to the worker. The current TIN verification system is so cumbersome that it often takes more than a year for the IRS to notify the employer that a TIN is invalid. This results in significant loss of revenue and inability of the Service to computer match the payment made by the employer to the worker's tax return. To discourage workers from deliberately falsifying TINs, we recommend that the TIN statements given to the employer be certified by the worker. (5) We recommend that businesses be required to segregate and separately report on their tax returns payments made to independent contractors just as now must be done for payments made to employees. A correlative change would require the worker to attach all Forms 1099 received to his or her income tax return just as Forms W-2 must be attached to an employee's return. We believe this will assist the IRS in computer matching of payments received by independent contractors.

We recommend requiring businesses to provide all workers who are treated as independent contractors with a written explanation of their tax obligations and rights as self-employed workers. The worker should be able to make an informed decision as to the overall benefits and costs of working for one employer versus another. A better understanding of the additional employment tax burdens and other costs (e.g. health insurance, life insurance) may improve the odds that the worker will set aside sufficient funds to pay income and employment taxes.

If the cost of requiring and allowing more magnetic-media filing of Forms 1099 is not too great in comparison to the benefit received, we recommend that the low-volume filer exception for magnetic-media filing of Forms 1099-MISC should be reduced or eliminated. This should give the IRS a greater ability to process and cross-check data.

We also recommend the creation of a new Form 1099-IC to be submitted by employers for payments made to independent contractors. The segregation of these payments from other miscellaneous payments will allow for better cross-checking by the IRS.

We recommend that a study be undertaken by Treasury analyzing the viability of imposing income and/or employment tax withholding on payments to independent contractors. Former studies have failed to come up with a flat rate withholding system that does not result in overwithholding to the worker.

Finally, we recommend that consideration be given to including an amnesty program as any part of legislation to increase the penalties on employers for failure to comply with Form 1099 information reporting on independent contractors.

The Tax Section urges the Committee to undertake drafting of legislation to enact the needed reforms of this area. We stand ready to assist in any way needed in this process.

Chairman JOHNSON. Thank you very much. I appreciate the specificity of your recommendations.

Mr. Shulman.

**STATEMENT OF HARVEY J. SHULMAN, PARTNER, GINSBURG, FELDMAN AND BRESS, WASHINGTON, DC, AND GENERAL COUNSEL, NATIONAL ASSOCIATION OF COMPUTER CONSULTANT BUSINESSES**

Mr. SHULMAN. Thank you, Madam Chairman.

My experience in dozens of IRS employment tax matters across the country leads me to give you the same simple message that many others have today. Namely, recent IRS actions cannot get us out of the current independent contractor mess. Instead, it has come time for Congress to bite the bullet and to do something on this issue.

Everyone here is throwing out the number "five." I have five sets of issues, also. I would suggest that you focus on the details in my written testimony.

First, I do agree that a new statutory definition of independent contractor is essential, but this is because in my view the common law test will always be unclear and tilted against small business, and—a point that many people have not made—it is going to be outdated in this information age.

For example, self-employed proprietors and professionals often do not have the ability or the need to rent an office space, to pay for costly advertising, to buy computers devoted solely to business operations, or to serve many clients concurrently. These factors should not make these workers any less of an entrepreneur. Yet, the IRS has said otherwise under the outdated common law test.

In addition, the IRS has too often viewed many self-employed professionals as employees because the IRS has actually ignored the common sense rule in the Restatement of Agency Rule, it says that special skills and a high level of independence on the job are actually evidence of independent contractor status, not reasons to more closely suspect that an employment relationship exists, which is the way the IRS tends to look at professionals.

These results can be even worse when the test is narrowly applied to new professional occupations, like computer programmers or software engineers. Therefore, I do have some disagreement with my colleagues on this "risk of loss" element. How many times can you say that a lawyer or an accountant or a computer professional has a "risk of loss?" We all know the rates that these people charge are outrageous to begin with. So, you do not have to work many hours to recover your expenses, but that shouldn't mean that these professionals are not considered self-employed entrepreneurs.

Second, I believe that Congress must improve section 530 of the Revenue Act by adding language that the IRS cannot dilute.

The testimony you heard earlier talks about improving the consistency standard and what is a substantially similar position. But, no one has talked about that in detail. That is discussed in my written testimony in detail, the unreasonable evidentiary burden that is imposed on taxpayers, and what is a reasonable basis for classification.

Although many IRS positions on these issues have actually been rejected by the courts, the IRS continues to non-acquiesce in these decisions, and unless you do something about it legislatively, the Training Guide can be overturned a year from now by some other IRS Commissioner.

Third, I think there are two especially unfair laws beyond IRS control that Congress must fix now. First and foremost, you must repeal section 1706 of the 1986 Tax Reform Act. The repeal is supported by a strong bipartisan consensus in Congress and among tax professionals. It is even mentioned in the ABA testimony today, and throughout the business community. It is hard to believe, Madam Chairman, that in a high-tech economy, this irrational law prohibits certain taxpayers in the computer and engineering industries, no matter how reasonable their actions are, from submitting a section 530 Safe Haven Relief claim.

It is ironic to hear witnesses today complain about the common law test and to ask Congress to fix section 530 when many taxpayers in America's high-tech industries—the driving force of today's economy—are denied any eligibility whatsoever for section 530 relief and instead are left to defend themselves in IRS audits solely under the ancient common law test. How can we let this continue?

Before any other changes, Congress must close this gaping hole in the section 530 safety net by repealing 1706.

Likewise, Congress must change the tax assessment and judicial review procedures which now result in an automatic employment tax lien on a business even before the business has had its day in court. Once these liens are imposed, suppliers and banks stop doing business with a small business. This strangle-hold on small business that the lien imposes means the lien is the death sentence, and you never get to court no matter how right you are in classification.

Fourth, Congress must stop many of the investigative techniques used by the IRS in these audits. These have not been mentioned today, but how can we continue to let the IRS auditors interrogate third parties like a small business' clients and contractors, in order to get information on worker classification?

I can tell you I have seen how IRS contacts with customers and contractors terrifies these people and leads them to stop doing business with a firm under audit. Yet, these contacts are still sanctioned by the IRS manual.

Finally, Congress must act to increase compliance relating to the reporting of payments made to contractors, and it must impose greater penalties for failures to report payments or declare income.

In closing, Madam Chair, as we get ready to enter the 21st century, we must bring an end to the IRS regulatory framework which threatens self-initiative, entrepreneurship, and small business growth. Why should a computer programmer or a stockbroker or a doctor who wants to be self-employed be forced by our government to work as an employee?

I hope my testimony shows we can have both high tax compliance and greater flexibility. The Finance Committee in the Senate last week marked up the House-passed small business tax package, and it included some minor worker reclassification reforms. They should be congratulated, but please go further and help finish that job, including by repealing section 1706.

Thank you.

[The prepared statement follows:]

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Before the  
 Oversight Subcommittee  
 of the  
 Committee on Ways and Means  
 U.S. House of Representatives  
 Washington, D.C.  
 March 20, 1996

TESTIMONY OF  
 HARVEY J. SHULMAN  
 PARTNER in GINSBURG, FELDMAN & BRESS, CHTD. (WASHINGTON, D.C.)  
 AND  
 GENERAL COUNSEL of NATIONAL ASSOCIATION OF COMPUTER CONSULTANT BUSINESSES

**INTRODUCTION.** My name is Harvey Shulman. I am a partner in the Washington, D.C. law firm of Ginsburg, Feldman & Bress, Chtd. and have been a lawyer for 24 years. I am also general counsel of the National Association of Computer Consultant Businesses ("NACCB"), which is the largest national association at exclusively represents high-tech firms that provide computer and engineering professional consultants to customers in need of temporary support for special projects. Along with my colleague Craig Eter, who helped prepare this testimony, I have been involved in approximately 50 employment tax examinations and compliance checks throughout the country in the past several years.

My message today is quite simple: Unfortunately, I have serious doubts that the new IRS Training Guide can really get us out of the independent contractor "mess" that now exists. It is said that a newly revised Training Guide makes major improvements from the draft that was released on February 28, 1996 -- and obviously, practitioners and taxpayers will have to review the revised Guide and make a judgment if that is the case. But even if such improvements exist, it appears that at least four major faults will remain.

## II. FUNDAMENTAL PROBLEMS IN EMPLOYMENT TAX EXAMS UNTOUCHED BY THE GUIDE

**First**, despite the Training Guide, the interpretation and application of the common law factors seems destined to remain too ambiguous and particularly tilted against small businesses like start-up sole proprietors and professionals in this information age. For example, rented office space, computers and office equipment solely dedicated to business operations, advertising, and multiple concurrent customers are all allegedly hallmarks of independent contractor status under the centuries-old common law test and are addressed in the Guide as "financial control" factors. Yet as the Guide occasionally suggests, 1990's economic realism demonstrates that many neophyte -- but legitimate -- sole proprietors often do not have the luxury to spend precious dollars on these items, nor does it make sense for them to do so especially when they are "knowledge" workers whose investments are in their heads to be taken to on-site locations of their customers. Moreover, why should sole proprietors be asked to pursue multiple concurrent customers when many are striving -- and delighted -- to keep a single large customer happy. In addition, the fundamental factor of "behavioral control" has become more difficult to apply in this information age, as the Guide properly recognizes in its effort to distinguish "suggestions" from "instructions" under the common law test. Even a perfect Training Guide is limited in its ability to apply a centuries-old common law test to occupations that did not exist 10 or 20 years ago.

**Second**, too often the IRS's interpretation of Section 530 of the 1978 Revenue Act has remained at odds with the Congressional directive that this law be construed liberally in favor of taxpayers. For example, the IRS's position on the consistency standard as applied to workers in "substantially similar positions" is too cramped. Likewise, Section 530 is undermined when the IRS refuses to recognize that decisions by other federal or state agencies or courts that a worker is an independent contractor under other statutes. So too, the IRS has been unreasonable in issuing a "nonacquiescence" to court decisions which found that a taxpayer can have a "reasonable basis" under the common law for classifying workers. These examples show how Congressional benevolence has been transformed into bureaucratic severity.

**Third**, the IRS task of implementing the Guide in the field is enormous, is likely to take years, and does not remove the serious collateral harms that result during worker classification audits. As to implementing the Guide, not only must the "substance" of the IRS positions be communicated to IRS field personnel, but there must be a wholesale shift in attitude among those personnel. But more significantly, even if that training effort succeeds, taxpayers will consider the process to be a failure unless major changes are made in the procedures that IRS auditors use to conduct an audit and the procedures for making assessments. It should not be acceptable for IRS auditors to continue, as they do now during employment tax audits, to interrogate a small business's customers, clients, and independent contractors in order to get information to use in making a worker classification decision. I have personally seen how such IRS contacts by themselves often terrify those who do business with a firm under audit and cause many of them to avoid that firm. The firm may ultimately win its audit, but be out of business because of the IRS investigative techniques that are untouched by the Guide and still sanctioned by the IRS Manual.

Fourth, the Guide cannot by administrative fiat resolve problems that were clearly created by statute. For example, there is a strong bi-partisan consensus in Congress, supported by tax professionals and by the business community, that Congress must repeal Section 1706 of the 1986 Tax Reform Act. Nothing in the Guide can remove this irrational statutory provision that prohibits taxpayers in the computer and engineering industries -- no matter how reasonable their actions may have been -- from claiming Section 530 relief. In fact, the Guide specifically notes that even if, for example, the IRS agreed with an engineering firm that it has been a common, consistent and longstanding industry practice to treat engineers as independent contractors, Section 1706 prohibits recognition of this and every other reasonable basis. Likewise, the Guide cannot eliminate the unfair employment tax "assessment" process which is mandated by statute and which requires the IRS to impose a lien on a business for employment taxes even before the business has had its day in court before an unbiased judge.

### III. ADDITIONAL STEPS REQUIRED BEYOND THE GUIDE

The conclusion with which I am left is that despite the Guide, we must replace the common law employment test with a simpler, shorter and more definitive classification test that takes the focus away from classification and places it on maintaining high levels of tax compliance: simply put, there should be greater initiatives to insure reporting and payment compliance, with increased penalties for failure to comply, and there should be far less focus on the complex classification issue. But we cannot stop there. We must improve and enhance Section 530 -- including repeal Section 1706 (which is Section 530(d)) -- provide taxpayers more procedural protections during employment tax audits, and stop the crazy tax assessment and lien process that undermines whatever other substantive standards and procedural rights we provide to taxpayers. We must take these steps so that self-initiative, entrepreneurship and small business growth -- all of which suffer under the current IRS classification scheme -- are no longer sacrificed as a price to pay for tax compliance. We can have both high tax compliance and fewer restrictions on the ability of firms and workers to establish an independent contractor relationship. Several approaches are possible. Four steps are appropriate.

First, H.R. 1972, introduced by Congressman Christensen, provides a simpler, shorter and more definitive classification test. In response to some criticism that H.R. 1972 may allow for too many workers to be treated as independent contractors, it must be remembered that to a large degree marketplace forces will eliminate any realistic probability that every worker will become an independent contractor. In addition, H.R. 1972 addresses only Internal Revenue Code issues: a worker who is an employee for purposes of wage and hour law, equal employment law, National Labor Relations Act purposes, OSHA and other laws will remain an employee under those laws. There are also reports that some Members of Congress are concerned that some low-paid classes of workers with little skills or education may be coerced by some firms into becoming independent contractors against their will, without reasonable opportunities to work as employees for other firms. These Members have suggested that Congress must create additional categories of "statutory employees" at the same time that it enacts H.R. 1972. However, it may be more prudent to wait a few years after the enactment of H.R. 1972 to determine if these predicted abuses have come to pass. Regardless, whether new "statutory employee" categories are enacted now or in the future, the bottom line is that H.R. 1972 provides a good foundation for simplifying the common law test.

Second, whether or not H.R. 1972 is enacted -- and certainly if it is not enacted -- Congress must clarify and enhance the rights afforded to taxpayers by Section 530. To begin with, Section 530 will remain like a cruise ship with a gaping hole in it until Section 1706 -- which is subsection (d) of Section 530 -- is repealed, and the computer and engineering industries are given the same rights as every other industry. In addition, my detailed testimony explains how Congress must direct the IRS to liberally apply several of the provisions in Section 530, including those relating to what is "inconsistent treatment" of workers holding "substantially similar positions", what constitutes a "longstanding recognized practice of a significant segment of an industry", what constitutes "any other reasonable basis", and which party has what burden under Section 530. In addition, Section 530 should be extended to cover income tax audits of the workers themselves.

Third, we must change the assessment process in employment tax audits, and the IRS investigative process used during the audits themselves. My detailed testimony includes suggestions on how Congress should make changes to the statutory assessment procedures (unless a taxpayer is found to have intentionally misclassified workers or to have withheld and not paid over taxes). Unlike income tax audits where no assessment can be made or lien can be filed until after a court trial before an unbiased judge, the Internal Revenue Code requires the IRS to make an assessment, which becomes a lien, right after the IRS Appeals Office upholds a worker classification decision. This IRS assessment and lien action leads many financial institutions to cut off a small business taxpayer's line of credit. A court might ultimately rule in favor of the taxpayer in a refund suit in court, but many taxpayers never get that far because they will be forced out of business due to the pre-judicial assessment and lien. As to the IRS investigative procedures during audits of contacting a taxpayer's customers, clients and independent contractors, either the IRS should quickly amend its Manual to stop these actions or Congress should step in.

Fourth, and finally, Congress must take steps to require greater compliance related to the reporting of payments made to independent contractors, and to impose greater penalties for failures to report that are more than de minimis. A \$50 penalty for not issuing a 1099, at least where such failures are widespread, is too low; attachment of Forms 1099 to an independent contractor's income tax return, just like Forms W-2 must be attached to an employee's income tax return, should also be considered. Other improvements are also possible. However, I would like to stress that none of these steps should be taken to impose greater burdens on small businesses and independent contractors unless they are accompanied by the type of relief set forth above.

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Thank you for the opportunity to testify. Below are details of some of the above topics.

## ATTACHMENT TO TESTIMONY OF HARVEY J. SHULMAN

**I. REVISION OF SECTION 530 SAFE HARBOR RELIEF PROVISIONS**

Until a new definition of employee or independent contractor is legislated, Section 530 represents the only back-up alternative to the unpredictable 20-question common law test. As such, a reasonable, understandable and non-discriminatory updated version of Section 530 is critical to protect small business.

A. **Congress Should Repeal Section 1706 of the 1986 Tax Reform Act.** A prerequisite to "improving" Section 530 is making it applicable to all taxpayers including those in so-called three-party arrangements in the technical services industry. To "leave these taxpayers in the dust", while making Section 530 a better law for everyone else, is illogical and unjust. As a result of Section 1706 of the 1986 Tax Reform Act, Congress removed the Section 530 safe harbor for only the technical services industry, and it did so in a most insidious manner. In particular, it focused only on so-called "three-party" situations in the technical services industry in which a worker (the first party) uses the services of a broker (the second, or intermediate, party) to locate consulting opportunities with a client or customer (the third party). Section 1706 took away all Section 530 relief from the intermediate party, the broker. In fact, customers who contract directly with consultants in so called "two-party" situations still have Section 530 relief; and, even in the "three-party" situations, the customers also retain Section 530 relief -- only the broker has been targeted.

As a result of Section 1706, the technical services industry is the only industry in this country where the employment tax liabilities of certain firms are determined under only one test, the 20-factor common law employment test. In every other industry, -- whether in "three-party" or "two-party" situations -- every firm has its employment tax obligations determined under two alternative tests: either the 20-factor common law employment test or a back-up, alternative employment tax safe haven such as Section 530. If a worker is determined to be self-employed under either alternative, then the worker -- and not the firm -- must pay the employment taxes. The denial of both alternatives to the technical services industry is clearly discriminatory and, for this reason, we urge repeal of Section 1706.

In order to understand the compelling reasons for repealing Section 1706, it is important to understand how that provision was enacted. Section 1706 originated as a non-controversial "revenue offset" measure that was estimated to raise \$12 million per year; it was never analyzed in detail and it was never discussed in any hearings. As a proposed "revenue offset" measure, it was also somewhat of an "experiment" in reaction to claims that the Section 530 safe haven was "too liberal" and had led to tax noncompliance which sometimes resulted in unfair competitive advantages to certain firms and workers -- claims which, it should be noted, would apply to every industry if they are true.

Unfortunately, the "experiment" that became Section 1706 created a nightmare for the technical services industry by placing it in the very same vulnerable situation that all firms faced in the 1970s and that led in the first place to enactment of the Section 530 back-up, alternative employment tax safe haven. As a result, Congress received thousands of complaints that the Section 1706 "experiment" had failed, and in 1987 over 125 members of the House -- including a bipartisan majority of the Ways and Means Committee -- called for a two year moratorium on Section 1706 while it could be studied. The proposed moratorium was not pursued, but in 1988 Congress passed Section 6072 of TAMRA to require the Treasury Department to study the impact of Section 1706.

The Treasury Department Study, released in March 1991, is the most comprehensive and unbiased analysis of Section 1706. The Treasury Department Study contains new information, not available in 1986, which confirms that the discrimination against the technical services industry cannot be justified -- and that legislative relief is necessary.

First, the Study concluded that although the technical services industry had been the only industry singled out for loss of the Section 530 back-up, alternative employment tax safe haven, that discrimination had been imposed against an industry in which there is actually better tax compliance in comparison to many other industries. When Congress enacted Section 1706, it did not know this fact!

Second, the Study found that especially because of its application to only so-called "three-party situations" in the technical services industry" -- and the exemption of "two-party" situations -- Section 1706 is "difficult to justify on equity or other policy grounds."

Third, the Study confirmed that application of the "20-factor common law [employment] test can be difficult, in particular in the multi-party situations affected by Section 1706" (emphasis added); indeed, the Study quoted an Assistant Treasury Secretary who admitted that this test "may also produce inappropriate results" and "does not yield clear, consistent, or satisfactory answers".

Fourth, the Study dispelled the notion that the government loses tax revenues when technical services workers perform services as independent contractors instead of as employees. The Study found that when workers in any industry perform services as independent contractors, some may underreport their incomes or overstate their business expenses. But the Study concluded that for the technical services industry, "Misclassification of employees as independent contractors increases tax revenues, however, and tends to offset the revenue loss from undercompliance by individuals, because direct [taxable cash] compensation to independent contractors is substituted for tax-favored employee fringe benefits."

In short, after the Treasury Study, there is no longer any justification for continuing the tax discrimination created by Section 1706. If the technical services industry is to be denied all Section 530 relief, then so must every other industry; if "three-party" relationships in our industry are to be denied Section 530 protection, then so must "two-party" situations -- and no one is proposing those drastic alternatives. Nor can it be said that classification of workers as independent contractors actually results in revenue losses. Finally, after the Lambert's Nursery decision, it is untrue that firms which have used both employees and independent contractors cannot compete on a "level playing field" with firms that use only independent contractors on the assumption that the IRS will deny Section 530 relief to the former firms while granting Section 530 relief to the latter firms; it is the relationship with each group of workers that counts, not whether the workers are performing similar services.

Enough has been said and studied on this issue. Now is the time to repeal Section 1706.

**B. Congress Should Define the Term "Substantially Similar Position".** To qualify for relief, Section 530 requires the taxpayer to have consistently treated the workers at issue – and all workers holding "substantially similar positions" – as independent contractors. Although Section 530 itself does not define the term "substantially similar position", the IRS interpretation of the term has not been in accordance with original Congressional intent and the IRS interpretation has, in fact, been rightfully rejected by the judiciary. Without clear guidance from Congress as to what is a "substantially similar position", the IRS interpretation of this term will continue to be confusing at best, and erroneous at worst, and yet it will be asserted against taxpayers who will then be forced to litigate with the IRS over that interpretation. The details of our proposal follow.

Prior to the draft Training Guide, the most recent "official" IRS position on this issue was set forth in Rev. Rul. 87-41. In that ruling the IRS stated that a determination of whether an individual who is treated as an employee "holds a position substantially similar to the position held by an individual whom the taxpayer would otherwise be permitted to treat as other than an employee for employment tax purposes under section 530(a) of the 1978 Act requires an examination of all the facts and circumstances, including particularly the activities and functions performed by the individuals." While it is true that "all the facts and circumstances" must be reviewed, there is nothing in Section 530 which focuses the inquiry "particularly" on the "activities and functions" performed by a worker. Even more troubling is the IRS statement from Rev. Rul. 87-41 which follows the above quoted sentence:

Differences in positions held by the respective individuals that result from the taxpayer's treatment of one individual as an employee and the other individual as other than an employee (for example, that the former individual is a participant in the taxpayer's qualified pension plan or health plan and the latter is not a participant in either) are to be disregarded in determining whether the individuals hold substantially similar positions. (emphasis added).

The draft Training Guide issued in February 1996 held out some hope that the IRS might back away from the above erroneous interpretation. On page 3-10, the draft Guide stated:

A substantially similar position exists if the job functions, duties, and responsibilities are substantially similar and the control and supervision of those duties and supervision is substantially similar. (emphasis added).

Rightly so, therefore, the draft Guide looked at how the firm controlled and supervised a worker. Unfortunately, however, elsewhere the draft Guide fell back into the same improper interpretation that was set forth in Rev. Rul. 87-41. Namely, on page 3-12 the draft Guide noted that "Comparison of job functions is an important factor" in determining if positions are "substantially similar"; it failed to refer to the need to compare how or if the firm controlled and supervised workers with similar job functions and, instead, even told auditors not to consider such factors as whether a worker "punches a time clock, receives company benefits, or is covered by workers' compensation". Then, in Example 4 on page 3-13, the draft Guide concluded that there was inconsistent treatment of workers in "substantially similar positions" based on the facts that workers were "all doing the same job" or that they "performed substantially the same job". The language on page 3-12 and the example on page 3-13 undermine the positive statement on page 3-10 that much, much more than "doing the same job" is involved in determining if workers hold "substantially similar positions".

The IRS's narrow emphasis in Rev. Rul. 87-41 on the "activities and functions" performed by a worker, and its own seemingly inconsistent discussion in the draft Guide of the differences in a taxpayer's treatment of workers, do not comport with the letter and spirit of Section 530, nor with the common sense operations of businesses that used both independent contractors and employees prior to the passage of Section 530.

Congress required from the outset that the reasonable basis requirement of Section 530 "be construed liberally in favor of taxpayers." House Ways & Means Committee Report No. 95-1748 at p. 5 (Oct. 10, 1978). See, e.g., *American Institute of Family Relations v. U.S.*, 79-1 USTC ¶9364 (C.D. Cal. 1979)(court reached proper result by broad interpretation of Section 530); *Critical Care Register Nursing, Inc. v. United States*, 776 F.Supp. 1025 (E.D. Pa. 1991)(court reached proper result by broad interpretation of Section 530). Indeed, Congress stated that the "consistency" standard was an "anti-abuse provision" that was intended "to prevent taxpayers from changing the way they treat workers for employment tax purposes solely to take advantage of the relief provisions...." *Id.* at p. 5. The IRS's reading of the "consistency" standard in Rev. Rul. 87-41 is inconsistent with Congressional intent that Section 530 "be construed liberally".

In many typical situations, a worker who is treated as an independent contractor may perform some of the same or similar "activities and functions" as a worker who is treated as an employee; the fact that their "activities and functions" are similar does not mean that these two workers hold "substantially similar positions" with a taxpayer. Similarly, workers who perform very different "activities and functions" might well hold "substantially similar positions" with a taxpayer. What is of major importance is not the job duties themselves, but instead the taxpayer's treatment of the workers, i.e., the relationships between the workers and the taxpayer. Even before Section 530 was enacted, the overwhelming body of judicial precedent recognized that both independent contractors and employees could be performing the very same work for a single service recipient, and that their different relationships with the service recipient – not the nature of their work – would determine their employment status. See, e.g., *Radio City Music Hall v. United States*, 135 F.2d 715 (2d Cir. 1943)(theater owner provided entertainment to its audiences through the use of its own in-house musicians, dancers and actors who were its employees as well as by hiring independent contractors); *United States v. Thorson*, 282 F.2d 157 (1st Cir. 1960)(home improvement company hired workers as independent contractors to install roofing and siding, but if it could not find acceptable independent contractors at an acceptable rate, it would use its own employees to do the installations); *Apaca, Inc. v. United States*, 77-1 USTC ¶ 9139 (D. N.M. 1976)(moving company hired its own employees to assist drivers in the packing, loading and unloading of moving vans, and also hired independent contractors to perform the same exact work in those instances where the company's own employees were not available). Because Section 530 is to be "liberally construed in favor of taxpayers", it makes no sense that a taxpayer can under the more restrictive common law test properly treat some workers as independent contractors who perform the same work as others who are treated as employees yet, at the same time, deny that taxpayer Section 530 relief based on "inconsistent" treatment of workers holding "substantially similar positions".

In short, when Congress first enacted Section 530, it knew that workers did not hold "substantially similar positions" just because they performed similar types of work. For the IRS to interpret this term in the manner set forth in Rev. Rul. 87-41 is inconsistent with prior case law and the common sense, as well as the charitable reading of Section 530 intended by Congress.

The correct approach to interpreting Section 530 was set forth in the decision of the U.S. Court of Appeals for the Fifth Circuit in Lambert's Nursery & Landscaping, Inc. v U.S., 894 F.2d 154 (5th Cir. 1990) - a case which the IRS did not even cite in the draft Guide. In the Lambert's Nursery case, the taxpayer started his business in Louisiana by using independent contractors to do landscaping for customers. An IRS employment tax audit upheld his classification of the landscape workers. He later expanded his business to provide janitorial services to customers by using independent contractors. In addition to these independent contractors, the taxpayer also employed some landscape and janitorial workers as his employees, though he treated them differently. When the IRS audited his business because of his classification of the janitorial workers as independent contractors, the taxpayer claimed the "prior audit" safe haven under Section 530(a)(2)(B). The IRS denied his claim, noting that the janitorial workers did not hold "positions substantially similar to the position[s] held by" the landscape workers. The Court rejected the IRS view and commented on the reference to "substantially similar position" in Section 530:

The IRS ... has provided no authority to support its assertion that the type of work done, rather than the structure of the relationship between the taxpayer and his workers, should be the preeminent interpretive factor for section 530(a)(2)(B). Neither does the plain wording of the provision provide support for the IRS position. The "reasonable basis" requirement of section 530(a)(1) to which section 530(a)(2)(B) is directly linked, has been broadly interpreted in favor of taxpayers. General Investment Corp. v United States, 823 F.2d 337, 340 (9th Cir. 1987). The relationship of the taxpayer to his workers is the most important element of the section 530(a)(2)(B) analysis, and a taxpayer may reasonably rely on a prior [employment tax] audit pursuant to a section 530(a)(2)(B) even though he later employs substantially similar workers in a different industry.

The Lambert's Nursery court reached the correct result because, in interpreting the words "substantially similar position", it looked primarily at the worker's service relationship with the taxpayer and not at the worker's job duties. See also REAG, Inc. v. United States, 92-2 USTC ¶ 50,475 (W.D. Okl. 1992)(Court rejected the IRS's argument that REAG inconsistently treated its non-owner appraisers as independent contractors and its owner-officer appraisers as employees because the relationship between the taxpayer and the owner-officer appraisers was different -- i.e., involving management control and substantial additional duties - than the relationship between the taxpayer and the non-owner appraisers); Reinhardt v. Commissioner, 85 T.C. 511, 522 n. 16 (1985)(Tax Court emphasized with approval the fact that the IRS had issued a letter to the taxpayer/doctor in which the IRS granted Section 530 relief where a clinic had continuously treated its shareholder doctors as employees and its non-shareholder doctors as independent contractors even though both groups of doctors perform the very same type of services).<sup>V</sup>

For example, suppose there are three workers: the first worker is an accountant, the second worker is a lawyer, and the third worker is also an accountant. The first worker is treated as an employee of the taxpayer, i.e., the taxpayer withholds and pays over taxes, under a relationship that includes the following: the worker is legally guaranteed to be paid by the taxpayer for the time worked, even if the quality of the work is unsatisfactory; the worker may be reassigned by the taxpayer to perform other work or to work in other locations; the worker is subject to review and promotion in accordance with the taxpayer's general staff policies; the worker is eligible to receive paid training from the taxpayer; the worker may not perform the same type of work for others without the taxpayer's permission; and the worker can resign at will, even in the middle of a project.

Even though the second worker may perform a totally dissimilar job -- e.g., the lawyer -- under the rationale of Lambert's Nursery he or she would hold a "substantially similar position" to the first worker if the above factors applied to both because the structure of the relationship between the lawyer and the taxpayer was the same as the structure of the relationship between the accountant and the taxpayer. Likewise, under this same rationale, even though the third worker performed the same type of job as the first worker -- e.g., both were accountants -- the two accountants would not hold "substantially similar positions" if the above factors applied only to the first worker and not the third worker. In short, the taxpayer would not lose the safe haven on the ground that the two accountants performed similar services because the structures of their relationships to the taxpayer were not substantially similar.

In conclusion, it is essential that Congress affirm the rationale of Lambert's Nursery and the pre-Section 530 common law cases, and reject the IRS position in Rev. Rul. 87-41 and the draft Guide.

C. **Congress Should Clarify What Constitutes a "Reasonable Basis".** To qualify for relief under Section 530, a taxpayer must demonstrate that it had a "reasonable basis" for treating the workers as independent contractors. Although the Congressional mandate has consistently been to construe the reasonable basis requirement "liberally in favor of taxpayers", the IRS response has been simply to pay "lip service" to this admonition. See Rev. Proc. 85-18, 1985-1 C.B. 518; . In practice, the IRS generally advances a very restrictive interpretation of the reasonable basis requirement.

1. **Revision of "Judicial Precedent" Safe Harbor.** Under Section 530, reliance on "judicial precedent" will constitute a reasonable basis for treating the worker as an independent contractor. Despite the Congressional mandate of liberal construction, the IRS recently has applied a very restrictive

<sup>V</sup> Interestingly, in the draft Guide at page 3-13 the IRS noted that it has nonacquiesced in the REAG decision; it cited, without explaining its view, two other conflicting decisions on this issue, i.e., World Mart, Inc. v. United States, 93-1 USTC par. 50,304 (D. Ariz. 1992) and In re Compass Marine Corp., 146 B.R. 138 (Bankr. E.D. Pa. 1992); and it also referenced the decision in Lowen Corp. v. United States, 785 F.Supp. 913 (D. Kan. 1992). Lowen and other cases not cited, but which found inconsistency, are unexceptional in that they determined that purported distinctions in how taxpayers treated their workers were insignificant. Moreover, a "liberal" interpretation of the consistency standard should likely have led to a different result in Lowen.

position on what constitutes judicial precedent, requiring nearly identical facts before a taxpayer can rely on this safe harbor. See TAM 9443002. The taxpayer should be able to rely on judicial precedent which is generally similar to the facts in the taxpayer's situation.

**2. Revision of "Prior Audit" Safe Harbor.** The term "audit" is not defined in Section 530. The IRS has narrowly construed what it means by the term "audit". Indeed, the IRS often has -- without opening a formal employment tax "audit" -- actually engaged in an examination of a taxpayer's use of independent contractors to avoid the prior audit safe haven.

For example, many corporate income tax audits now include an IRS inquiry into a taxpayer's treatment of workers as independent contractors and the reasons for such treatment; they also result in IRS review of independent contractor agreements and other documents which relate to the workers' status -- all of this being done as part of an income tax audit. Only sometimes is a separate formal employment tax audit opened in addition to the income tax audit; in fact, if no formal employment tax audit is opened, the IRS will not issue a written statement to the taxpayer that it correctly classified the contractors.

In many other cases, even when no income tax audit is pending, the IRS will contact a taxpayer and conduct an employment tax "compliance check" where similar detailed information about worker classification is sought from the taxpayer through interviews or examination of some taxpayer books and records (e.g., contracts and invoices). If the IRS thinks that the information it develops in a "compliance check" will not lead to worker reclassification, then it goes away -- without issuing any formal written statements to a taxpayer that no problems were found. Of course, if the IRS believes that worker reclassification is necessary, then it will open a formal employment tax audit.

In both of these types of cases -- as some IRS officials have admitted to us -- the IRS is intentionally attempting to avoid opening a formal employment tax "audit" so that in the future the taxpayer cannot claim Section 530 relief, even if IRS has required the taxpayer to justify its treatment of independent contractors and even if the taxpayer successfully did so.

For these reasons, we believe that changes should be made to the existing Section 530 "prior audit" safe haven to prevent the IRS circumvention of this safe harbor. The term "audit" should include any IRS written or oral examination of the taxpayer, or review of the taxpayer's books and records, regarding the bases for the taxpayer's treatment of workers as independent contractors. It is not necessary that the IRS shall have opened a formal employment tax audit as long as, through questioning of the taxpayer or review of its books and records, the IRS has required the taxpayer to justify its treatment of workers as other than employees.

**3. Definition of "Long-Standing Recognized Practice of a Significant Segment of the Industry".** As with the definition of "substantially similar position" and the other statutory safe harbors, the IRS has interpreted the reference to "industry practice" in Section 530 in a manner inconsistent with Congressional intent. The IRS approach focuses on four main issues: (i) within what geographic area must the industry practice occur? (ii) what is a "significant" segment of the industry? (iii) when is a recognized practice "long-standing"? and (iv) what type of proof must the taxpayer produce to meet this safe harbor? Any legislative changes in Section 530 should include the following principles.

**First**, taxpayers should have the opportunity to demonstrate that an industry practice exists locally, within a state, regionally within a multi-state area, or even nationally. Taxpayers should be permitted to rely on any one or more of these geographic areas. The changes in the IRS position on this issue demonstrate why Congressional clarification is essential. At one point the IRS argued that taxpayers had to demonstrate a national practice, but this view was rejected by a major court decision. *General Investment Corp. v. United States*, 823 F.2d 337 (9th Cir. 1987) (taxpayer can rely upon "industry practice" in the single county in which it operates, and IRS may not require evidence of nationwide practice). Now, the IRS Manual requires the taxpayer to produce evidence of entities in its industry "for the locality (the locality must be specified, such as, city of \_\_\_\_\_ population)". IRM - Administration, 5(10)26.4(1)(c)1.b. But an IRS restriction on the area for which the taxpayer must produce evidence is inconsistent with a "liberal" interpretation of Section 530. For example, although taxpayers in a particular locality may operate in one manner, the taxpayer under audit may have based its different method of operation on an "industry practice" that exists in the entire state or in that region of the country, or even on a practice that exists only in rural areas of the nation or in "big city" areas which it was trying to emulate -- or on some combination of these areas. In short, as long as taxpayers have a reasonable explanation for the geographic area or areas on which they are relying, they should be permitted to demonstrate an "industry practice" in those areas.

**Second**, many IRS auditors will not recognize a practice as "significant" unless more than 50% of the firms in an area follow the same practice. This IRS position is an unduly cramped view of Section 530, and it finds no support in the legislative history or in case law. Indeed, nowhere in the legislative history did Congress indicate an intention to quantify "significant" as more than 50%. Moreover, significant court cases which have addressed the issue have relied on percentages well below 50%. See, e.g., *REAG, Inc. v. United States*, 92-2 USTC ¶ 50,475 (W.D. Okl. 1992) (Court relied on an industry survey in which only 24% of the relevant market responded and, of that 24%, three-fourths of the respondents stated that they treated non-owner appraisers as independent contractors). In fact, the standard dictionary does not quantify the term as more than 50% either; rather, it defines "significant" as "meaningful" or "an observed departure from a hypothesis too large to be reasonably attributed to chance." See, e.g., Webster's New World Dictionary, Second College Edition. The reference to a "significant" segment of the industry means only that the practice be "meaningful"; to the extent that it is necessary to quantify this term, it should be sufficient for a taxpayer to provide reasonable evidence that at least 20% of the affected firms or workers engage in similar practices, unless the taxpayer can demonstrate why a lesser percentage is "significant".

**Third**, the issue sometimes arises as to what constitutes a "long-standing" practice. Currently, there is little guidance as to what constitutes a "long-standing" practice. The IRS views an industry practice of using independent contractors since 1978 as "long-standing" but suggests that this safe harbor may still be available to businesses that began after 1978. See draft Training Guide. Not surprisingly, the IRS has held that a company which starts a new industry cannot qualify for this safe harbor because there was no industry practice on which it could rely at the time it began business. See TAM 9420002. In this regard, Section 530 should be clarified to define "long-standing" as not limited to industry practices in existence prior to 1978 or to new

industries that developed after that date. Indeed, as new industries have developed, newly-formed practices should be considered "long-standing" after a period of years. For example, when Section 530 was enacted in 1978, the cellular telephone industry had not been developed. But if, several years after its development, a significant segment of the industry uses the services of independent contractors in various sales or technical services capacities, then such practices should be recognized as "long-standing" for purposes of Section 530 relief. Congress did not intend a static view of the types of independent contractors that could or should be recognized.

Fourth, the IRS requires an incorrect level of proof for taxpayers to rely upon the industry practice safe haven. Currently, the IRS requires that the taxpayers identify specific competitors which also use the services of independent contractors and the details about the use and operations of these competitors. See IRS Manual - Administration 5(10)26.4(1)(c). In fact, taxpayers have often complained that even when a taxpayer provides a survey taken by an industry association of the use of independent contractors, the IRS has refused to accept that survey unless the names of firms which also use this class of workers are revealed. Yet, IRS examiners have candidly admitted to many taxpayers that this new list of firms provides a basis for additional audits of those firms. In other words, the industry practice safe haven will be implemented by the IRS only if a taxpayer under audit is willing to "snitch" on its competitors. Justifiably, the courts have not required the degree of proof of industry practice on which the IRS insists in its examinations. In particular, in the above case of General Investment Corp. v. United States, the taxpayer's evidence of industry practice consisted of testimony by the taxpayer's president and by one competitor, both of whom "had extensive familiarity with the operations of a number of other [competitors] through their roles as officers of a county-wide trade association", which involved "meetings with other mine owners and numerous visits to other mines." See also In re Billie Vester Rasbury, 91-USTC ¶ 50,454 (Bankr. N.D. Ala. 1991)(without the aid of any industry survey, the court concluded that there was a widespread industry practice of using independent contractors in the logging industry based on the first-hand knowledge in the testimony of Rasbury, long-time employees, and experts); In re Joey L. Bently, 1994 Bankr. LEXIS 261 (E.D. Tenn. 1994)(the court relied on the experiences and first-hand knowledge of the debtor and the company's bookkeeper to establish the debtor's reasonable reliance on industry practice). These cases properly apply Section 530; the type of evidence offered in these cases, as well as through other means - including trade association surveys which do not identify individual respondents - may be used.

4. **Clarify "Other Reasonable Basis" Safe Harbor.** Despite the expansive language of Section 530 and the mandate of a liberal construction in favor of taxpayers, the IRS has been very reluctant - even in view of contrary case law - to expand the scope of qualifying "reasonable basis" standards beyond the three specifically identified in Section 530 (i.e., judicial and IRS rulings, prior audits, and industry practice). Section 530 should be clarified to specifically include several additional reasonable basis as follows.

There are a number of cases which conclude that a taxpayer's reliance on the advice of tax professionals constitutes a reasonable basis under Section 530. See, e.g., Smokey Mountain Secrets, Inc. v. United States, 76 AFTR2d ¶ 955509 (E.D. Tenn. 1995).

There also are several cases holding that a taxpayer had a reasonable basis for treating workers as independent contractors based on a reasonable belief that the workers were independent contractors under the common law test. See, e.g., Critical Care Register Nursing, Inc. v. United States, 776 F. Supp. 1025 (E.D. Pa. 1991); REAG, Inc. v. United States, 92-2 USTC ¶ 50,475 (W.D. Okl. 1992).

Other cases have concluded that reliance on determinations by state agencies as to the classification of the workers as independent contractors also may constitute a reasonable basis for treating the workers as independent contractors. See, e.g., Overgren v. United States, 91-2 USTC par. 50,459 (W.D. Okla. 1991)(decision by Oklahoma Employment Security Commission that workers were independent contractors might justify Section 530 relief if additional facts about state agency decision are provided); Queensgate Dental Family Practice, Inc. v. United States, 91-2 USTC par. 50,536 (M.D. Pa. 1991)(state dental board statement that dentists must be treated as independent contractors provides reasonable basis under Section 530). See also Sanderson III v. United States, 862 F.Supp. 196 (N.D. Ohio 1994)(reliance on state worker's compensation audit).<sup>2</sup>

In addition, the IRS interprets the "judicial precedent" safe harbor as not applying to precedent (rendered on facts similar to those of the taxpayer's situation) that was decided after the years under audit. Even if this is a correct interpretation of Section 530, Congress should clarify that such precedent can, however, be relied upon by the taxpayer as an "other reasonable basis" for treating the workers as independent contractors (i.e., subsequent judicial confirmation that the taxpayer's classification of the workers as independent contractors was reasonable).

In sum, if the Congressional mandate of liberal construction is to become meaningful at the IRS administrative level, Congress should affirmatively clarify that a taxpayer is permitted to rely on any of the above as well as any other reasonable basis for purposes of qualifying for Section 530 relief.

#### D. **Congress Should Clarify the Burden of Proof Under Section 530.**

There is currently a dispute over whether a taxpayer has the same burden under Section 530 as exists otherwise in employment tax audits. Some cases, like REAG, Inc. v. United States, 801 F.Supp. 494 (W.D. Okla. 1992), explain that a taxpayer need only demonstrate that it has a substantial rational basis for its classification of workers as independent contractors under Section 530. However, in Boles Trucking, Inc. v. United States, 77 F.2d 236 (8th Cir. 1996), the court rejected the REAG analysis of burden of proof;

<sup>2</sup> The draft Training Guide limits the "judicial precedent" safe harbor to reliance on federal court decisions. Even if that is the correct interpretation of the term "judicial precedent", Congress should clarify that state or federal court or agency decisions, particularly those that have applied the more restrictive "ABC" independent contractor test or the even more narrow "economic reality" independent contractor test (as in the FLSA), can at least be relied upon by a taxpayer as an "other reasonable basis" under Section 530 for classifying workers as independent contractors.

nonetheless, the court also confused the issue by stating that under Section 530 the taxpayer had the burden to prove "by a preponderance of the evidence that it had a rational basis for improperly classifying the workers" (italics in original, emphasis added), a standard that does not seem that different from REAG. A middle ground was suggested in *McClellan v. United States*, 900 F.Supp. 101 (E.D. Mich. 1995), where the court found that under Section 530 a taxpayer need only "come forward with an explanation and enough evidence to establish prima facie grounds for a finding of reasonableness....[T]his threshold burden is relatively low, and can be met with any reasonable showing. Once the taxpayer has made this prima facie showing, the burden then shifts to the IRS to verify or refute the taxpayer's explanation."

Congress should not leave taxpayers dangling over what is the correct burden of proof under Section 530. We suggest that Congress adopt the *McClellan* standard and, as importantly, that Congress clarify that the IRS must show not only "unreasonableness" after a taxpayer makes a prima facie case, but also that the IRS must show "inconsistent" treatment of workers in "substantially similar positions". Particularly as to the latter, it is almost impossible for a taxpayer to introduce evidence of the positions of every worker it has ever treated as an employee and to show that such positions were not "substantially similar" to those of workers who were treated as independent contractors. Instead, if the IRS has evidence of "inconsistency", it should come forward with it and prove it affirmatively, rather than having the taxpayer effectively prove a "negative".

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## II. REVISION OF EMPLOYMENT TAX ASSESSMENT PROCEDURES

One of the most unfair aspects of the current employment tax system is how assessments are handled. In the following pages we offer statutory language for a proposal to eliminate assessments in employment tax exams involving worker misclassifications until after the taxpayer has had a chance to take its case to court and has lost in court. This new procedure — modeled almost entirely on how income, estate and gift, and excise taxes are handled — would provide for a "notice of employment tax deficiency" in lieu of an assessment. However, this new procedure would not be available if the taxpayer either misclassified its workers through intentional disregard of the law (which is the standard for denying the taxpayer a reduced assessment under § 3509(c)) or withheld the taxes from the workers but did not pay them over to the IRS. Also, the new procedure is intended to give taxpayers greater rights against the IRS, not to provide the IRS with more rights against taxpayers.

A. **Current Law is Unfair.** Under current law, IRS examiners or auditors "recommend" an employment tax assessment in IC misclassification cases. The taxpayer can then appeal to the IRS Appeals Office. If the Appeals Office agrees that the taxpayer has misclassified, and owes employment taxes, it demands payment from the taxpayer. If the taxpayer refuses to pay and wants to appeal further, by law under the IRC the tax that is due is immediately assessed and becomes a lien on the taxpayer. Typically, the IRS then files a notice of lien and begins to collect the assessed taxes. However, even if the IRS does not take any action beyond making the mere assessment, banks and other lenders will usually stop making loans to the taxpayer because the assessment itself is an automatic lien.

After an employment tax assessment under current law, the taxpayer must pay the tax on 1 worker for 1 quarter, then file a refund claim, and then generally wait 6 months for IRS action. If the IRS denies the refund claim, or fails to act, the taxpayer may sue for a refund in district court or in the Court of Federal Claims. At that point, the IRS will counter-claim for assessed taxes based on to the other misclassified workers.

B. **Congress Should Enact Changes to Current Law Assessment Procedures.** Under the new proposal that is attached, when a taxpayer's misclassification of workers is not due to intentional disregard of the law or the taxpayer did not withhold taxes and then fail to pay them over to the IRS, the IRS would have to do what it does in all other types of tax cases — i.e., the IRS would have to issue a notice of tax deficiency (we've called it a notice of employment tax deficiency). If the IRS was in danger of losing the ability to collect because, for example, the taxpayer was siphoning funds from its accounts, the IRS still could — as it can with regard to other taxes — make a jeopardy assessment. After a notice of employment tax deficiency is issued, the taxpayer will have the opportunity to sue in the district court or the Court of Federal Claims, as is now the case (however, employment tax suits could not be brought in the Tax Court, where all other deficiencies are adjudicated). Only after the court issues a final decision would the IRS be able to make an assessment.

The following are proposed amendments to Chapter 63 of Subtitle F to permit a taxpayer to contest in the U.S. District Court or Claims Court certain proposed employment tax deficiencies prior to assessments:

- Section 6201(d) of Chapter 63 shall be amended to add the following:  
"For special rules applicable to deficiencies of certain employment taxes, see subchapter E."
- The following subchapter shall be added to Chapter 63:

### "SUBCHAPTER E. DEFICIENCY PROCEDURES IN THE CASE OF CERTAIN EMPLOYMENT TAXES

#### SEC. 6251. DEFINITION OF A EMPLOYMENT TAX DEFICIENCY.

(a) In General. — For purposes of this title in the case of employment taxes imposed by chapters 21 through 25 of subtitle C with respect to any worker by reason of treating such worker as not being an employee for purposes of such chapters, the term "employment tax deficiency" means the amount by which the taxes imposed by chapters 21 through 25 of subtitle C exceeds the excess of—

- (1) the sum of
    - (A) the amount shown as the tax by the taxpayer upon his return, if the return was made by the taxpayer and an amount was shown as the tax by the taxpayer thereon, plus
    - (B) the amounts previously assessed (or collected without assessment) under chapters 21 through 25 of Subtitle C, over —
  - (2) the amount of rebates, as defined in subsection (b)(1), made.
- (b) Rules For Application of Subsection (a). — For purposes of this section —

(1) For purposes of this section, the term "rebate" means an amount of an abatement, credit, refund, or other payment, as was made on the ground that the taxes imposed by chapters 21 through 25 of subtitle C were less than the excess of the amount specified in subsection (a)(1) over the rebates previously made.

(2) Section Not To Apply In Case of Intentional Disregard. — This section shall not apply to a determination of the taxpayer's liability for tax under chapters 21 through 25 of subtitle C if such liability is due to the taxpayer's intentional disregard of the requirement to deduct and withhold such tax or the taxpayer has withheld and failed to pay over such tax.

#### SEC. 6252. NOTICE OF EMPLOYMENT TAX DEFICIENCY.

(a) In General. — If the Secretary determines that there is an employment tax deficiency concerning any taxes imposed by chapters 21 through 25 of subtitle C with respect to any worker by reason of treating such worker as not being an employee for purposes of such chapters, the Secretary is authorized to send notice of such employment tax deficiency to the taxpayer by certified mail or registered mail.

(b) Address For Notice Of Employment Tax Deficiency. — In the absence of notice to the Secretary under section 6903 of the existence of a fiduciary relationship, notice of an employment tax deficiency in respect of taxes imposed by chapters 21 through 25 of subtitle C if mailed to the taxpayer at his last known address, shall be sufficient for purposes of chapters 21 through 25 of subtitle C, and this chapter even if such taxpayer is deceased, or is under a legal disability, or, in the case of a corporation, has terminated its existence.

(c) Further Deficiency Letters Restricted. — If the Secretary has mailed to the taxpayer a notice of employment tax deficiency as provided in subsection (a), and the taxpayer files a complaint in the U.S. District Court or the Claims Court within the time prescribed in section 6253(a), the Secretary shall have no right to determine any additional employment tax deficiency for the same taxable year with respect to the taxpayer's treatment of a worker as not being an employee, except for fraud, and except as provided in section 6862 (relating to the making of jeopardy assessments).

(d) Authority To Reconsider Notice Of Employment Tax Deficiency. — The Secretary may, with the consent of the taxpayer, rescind any notice of employment tax deficiency mailed to the taxpayer. Any notice so rescinded shall not be treated as a notice of employment tax deficiency for purposes of subsection (c) (relating to further deficiency letters restricted), section 6253(a) (relating to restrictions applicable to deficiencies; complaints in U.S. District Court and Claims Court), and section 6512(e) (relating to limitations in case of complaints filed in U.S. District Court or Court of Claims), and the taxpayer shall have no right to file a complaint with the U.S. District Court or Claims Court based on such notice. Nothing in this subsection shall affect any suspension of the running of any period of limitations during any period during which the rescinded notice was outstanding.

#### SEC. 6253. RESTRICTIONS APPLICABLE TO CERTAIN EMPLOYMENT TAX DEFICIENCIES; COMPLAINTS FILED IN U.S. DISTRICT COURT OR CLAIMS COURT.

(a) Time For Filing Complaint Restriction On Assessment. — Within 90 days, or 150 days if the notice of employment tax deficiency is addressed to a person outside the United States, after the notice of employment tax deficiency authorized in section 6252 is mailed (not counting Saturday, Sunday, or a legal holiday in the District of Columbia as the last day), the taxpayer may file a complaint with the U.S. District Court or Claims Court for a redetermination of the employment tax deficiency. Except as otherwise provided in section 6862, no assessment of an employment tax deficiency in respect of tax imposed by chapters 21 through 25 of subtitle C and no levy or proceeding in court for its collection shall be made, begun, or prosecuted until such notice of employment tax deficiency has been mailed to the taxpayer, nor until the expiration of such 90-day or 150-day period, as the case may be, nor, if a complaint has been filed with the U.S. District Court or Claims Court, until the decision of such court has become final. Notwithstanding the provisions of section 7421(a), the making of such assessment or the beginning of such proceeding or levy during the time such prohibition is in force may be enjoined by a proceeding in the proper court. The U.S. District Court and the Claims Court shall have no jurisdiction to enjoin any action or proceeding under this subsection unless a timely complaint has been filed and then only in respect of the employment tax deficiency that is the subject of such complaint.

#### (b) Exceptions To Restrictions On Assessment. —

(1) Intentional Disregard. — If a determination of the taxpayer's liability for tax under chapters 21 through 25 of subtitle C is based on the taxpayer's intentional disregard of the requirement to deduct and withhold such tax or on the taxpayer's withholding but failure to pay over such tax, such underpayment shall be assessed.

(2) Assessment Of Amount Paid. — Any amount paid as a tax or in respect of a tax may be assessed upon the receipt of such payment notwithstanding the provisions of subsection (a). In any case where such amount is paid after the mailing of the notice of employment tax deficiency under section 6252, such payment shall not deprive the U.S. District Court or the Claims Court of jurisdiction over such deficiency determined under section 6251 without regard to such assessment.

(c) Failure To File Complaint. — If a taxpayer does not file a complaint with the U.S. District Court or the Claims Court within the time prescribed in subsection (a), the employment tax deficiency, notice of which has been mailed to the taxpayer, shall be assessed, and shall be paid upon notice and demand from the Secretary.

(d) Waiver Of Restrictions. — The taxpayer shall at any time (whether or not a notice of employment tax deficiency has been issued) have the right, by a signed notice in writing filed with the Secretary, to waive the restrictions provided in subsection (a) on the assessment and collection of the whole or any part of the employment tax deficiency.

#### (e) Coordination With Title 11. —

(1) Suspension Of Running Of Period For Filing Complaint In Title 11 Cases. — In any case under title 11 of the United States Code, the running of the time prescribed by subsection (a) for filing a complaint in the U.S. District Court or the Claims Court with respect to any employment tax deficiency shall be suspended for the period during which the debtor is prohibited by reason of such case from filing a complaint in the U.S. District Court or the Claims Court with respect to any employment tax deficiency, and for 60 days thereafter.

(2) Certain Action Not Taken Into Account. — For purposes of the second and third sentences of subsection (a), the filing of a proof of claim or request for payment (or the taking of any other action) in a case under title 11 of the United States Code shall not be treated as action prohibited by such second sentence.

#### The following are proposed amendments to Chapter 66 of Subtitle F:

• Section 6503(a)(1) of Chapter 66 shall be amended to read as follows (the new language is underlined):

"(a) Issuance Of Statutory Notice Of Deficiency Or Notice Of Employment Tax Deficiency. —

(1) General Rule. — The running of the period of limitations provided in sections 6501 or 6502 (or section 6229, but only with respect to a deficiency described in section 6230(a)(2)(A)) on the making of assessments or the collection by levy or a proceeding in court, in respect of any deficiency as defined in section 6211 (relating to income, estate, gift and certain excise taxes) or in section 6251 (relating to certain employment taxes), shall (after the mailing of a notice under section 6212(a) or under section 6252(a)) be suspended for the period during which the Secretary is prohibited from making the assessment or from collecting by levy or a proceeding in court (and in any event, if a proceeding in respect of the deficiency is placed on the docket of the Tax Court, the District Court, or the Claims Court, until the decision of such court becomes final), and for 60 days thereafter."

• Section 6512 of Chapter 66 shall be amended to read as follows:

#### SEC. 6512. LIMITATIONS IN CASE OF DEFICIENCY PROCEEDINGS IN COURT.

(a) [Same language as current provision]

(b) [Same language as current provision]

The current subsection (c) shall be redesignated as subsection (e). There shall be added new subsections (c) and (d) as follows:

(c) **Effect Of Deficiency Proceeding In U.S. District Court or Claims Court.** -- If the Secretary has mailed to the taxpayer a notice of employment tax deficiency under section 6252(a) (relating to deficiencies of certain employment taxes) and if the taxpayer files a complaint with the U.S. District Court or the Claims Court within the time prescribed in section 6253(a), no credit or refund of employment tax for the same taxable year with respect to which the Secretary has determined the deficiency shall be allowed or made and no suit by the taxpayer for the recovery of any part of the tax shall be instituted in any court except --

(1) As to over payments determined by a decision of the U.S. District Court or the Claims Court which has become final; and

(2) As to any amount collected in excess of an amount computed in accordance with the decision of the U.S. District Court or the Claims Court which has become final; and

(3) As to any amount collected after the period of limitation upon the making of levy or beginning a proceeding in court for collection has expired; but in any such claim for credit or refund or in any such suit for refund the decision of the U.S. District Court or the Claims Court which has become final, as to whether such period has expired before the notice of employment tax deficiency was mailed, shall be conclusive.

(d) **Overpayment Determined By U.S. District Court or Claims Court.** --

(1) **Jurisdiction To Determine.** -- Except as provided by paragraph (3), if the U.S. District Court or the Claims Court finds that there is no employment tax deficiency and further finds that the taxpayer has made an overpayment of employment taxes for the same taxable year with respect to which the Secretary has determined the deficiency, or finds that there is a deficiency but that the taxpayer has made an overpayment of such tax, the U.S. District Court or the Claims Court shall have jurisdiction to determine the amount of such overpayment, and such amount shall, when the decision of the U.S. District Court or the Claims Court has become final, be credited or refunded to the taxpayer.

(2) **Jurisdiction To Enforce.** -- If, after 120 days after a decision of the U.S. District Court or the Claims Court becomes final, the Secretary has failed to refund the overpayment determined by such court, together with the interest thereon as provided in subchapter B of chapter 67, then the U.S. District Court or the Claims Court, as applicable, upon motion by the taxpayer, shall have jurisdiction to order the refund of such overpayment and interest.

(3) **Limitation On Amount Of Credit Or Refund.** -- No such credit or refund shall be allowed or made of any portion of the tax unless the U.S. District Court or the Claims Court determines as part of its decision that such portion was paid --

(A) after the mailing of the notice of employment tax deficiency,

(B) within the period which would be applicable under section 6511(b)(2), (c), or (d), if on the date of the mailing of the notice of employment tax deficiency a claim had been filed (whether or not filed) stating the grounds upon which the U.S. District or the Claims Court finds that there is an overpayment, or

(C) within the period which would be applicable under section 6511(b)(2), (c), or (d), in respect of any claim for refund filed within the applicable period specified in section 6511 and before the date of the mailing of the notice of employment tax deficiency --

(i) which had not been disallowed before that date,

(ii) which had not been disallowed before that date and in respect of which a timely suit for refund could have been commenced as of that date, or

(iii) in respect of which a timely suit for refund could have been commenced as of that date and within the period specified in section 6532.

The following are proposed amendments to Chapter 67 of Subtitle F:

• Sections 6601(e) and 6601(1) of Chapter 67 shall be amended to read as follows (the new language is underlined):

"(e) **Suspension Of Interest In Certain Income, Estate, Gift Tax Cases And Certain Excise and Employment Tax Cases.** -- In the case of a deficiency as defined in section 6211 (relating to income, estate, gift, and certain excise taxes) and as defined in section 6251 (relating to certain employment taxes), if a waiver of restrictions under section 6213(d) or section 6253(d) on the assessment of such deficiencies is not made within 30 days after the filing of such waiver, interest shall not be imposed on such deficiencies for the period beginning immediately after such 30th day and ending with the date of notice and demand and interest shall not be imposed during such period on any interest with respect to such deficiency for any prior period."

"(e) **Applicable Rules.** -- Except as otherwise provided in this title --

(1) **Interest Treated As Tax.** -- Interest prescribed under this section on any tax shall be paid upon notice and demand, and shall be assessed, collected, and paid in the same manner as taxes. Any reference in this title (except subchapter B and E of chapter 63, relating to deficiency procedures) to any tax imposed by this title shall be deemed also to refer to interest imposed by this section on such tax."

• Sections 6665(b) of Chapter 68 shall be amended to read as follows (the new language is underlined):

"(b) **Procedure For Assessing Certain Additions To Tax.** -- For purposes of subchapter B and E of chapter 63 (relating to deficiency procedures for income, estate, gift, and certain excise and employment taxes), subsection (a) shall not apply to any addition to tax under section 6651, 6654, 6655, except that it shall apply --

(1) in the case of an addition described in section 6651, to that portion of such addition which is attributable to a deficiency in tax described in 6211 or 6251, or"

The following are proposed amendments to Chapter 76 of Subtitle F:

• Section 7421(a) of Chapter 76 shall be amended to read as follows (the new language is underlined):

"(a) **Tax.** -- Except as provided in section 6212(a) and (c), 6213(a), 6252(a) and (c), 6253(a), 6672(b), 6694(c), 7426(a) and (b)(1), and 7429(b), no suit for the purpose of restraining the assessment or collection of any tax shall be maintained in any court by any person, whether or not such person is the person against whom such tax was assessed."

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The above are the primary amendments to title 26 that are necessary to allow a taxpayer to contest most proposed worker reclassification cases (i.e., where there is no intentional disregard of the rules) in the U.S. District Court and Claims Court using deficiency procedures prior to the assessment of additional employment taxes. In addition, amendments may be necessary to title 28.

Chairman JOHNSON. Thank you.  
Ms. Horton.

**STATEMENT OF DEBBI-JO HORTON, CPA, OWNER, DJ HORTON & ASSOCIATES, EAST PROVIDENCE, RHODE ISLAND; AND NEW ENGLAND REGIONAL TAXATION IMPLEMENTATION CHAIR, WHITE HOUSE CONFERENCE ON SMALL BUSINESS**

Ms. HORTON. Thank you, Madam Chairman and Members of the Subcommittee. I think I am the only nonattorney on the panel. I am also the New England Regional Taxation Implementation Chairman to the 1995 White House Conference on Small Business, and I represent the National Taxation Implementation Chairs at today's hearing.

The two bills referenced in my testimony are H.R. 1972 and S. 1610. Representatives of the Taxation Implementation Team have been asked to clarify these two bills by this Committee in earlier hearings, members of the House and Senate Small Business Committees, the IRS, and Treasury.

The legislation should be a clear general rule that will address the majority of independent contractors and not the exceptions. We will never satisfy all cases, and we shouldn't be attempting to do so. Those that do not meet a clear general rule will still fall under the 20-factor test in section 530.

Changes to the current bills that the Taxation Implementation Chairs have proposed are outlined in my written testimony. The essence of these changes is to close many of the loopholes that would allow the employer to force an employee to become an independent contractor, eliminate contractual language that should be left to the two parties to draft and execute themselves, force the independent contractor to comply with other points to show an intent to be in business and maintain independence, and not place a burden on States and their agencies to make additional provisions available.

In addition, we would like to propose to add language that would directly address the issue of control. All of these provisions should be a requirement of being an independent contractor in addition to meeting the other tests provided in the bills. If this Congress can pass a clear general rule that practitioners and small businesses can follow, there will be greater compliance.

Many service recipients currently do not file Form 1099s for fear of audit. If they are certain that they are correct in their classification, they will be confident and comply.

We Taxation Chairs feel, however, that the bills could go a little further to assure this. So, in addition to technical corrections to the bills, the Taxation Chairs would also propose that the following be considered. First, service recipients should pay increased penalties for failure to issue Form 1099s. Second, service recipients should pay increased penalties for fraudulently misclassifying employees as independent contractors to evade the payment of taxes.

Additionally, there is a misconception that using an independent contractor is cheaper than hiring an employee. This is not true, and as practitioners, the Tax Chairs could argue this for years, but instead we offer these suggestions. Institute an employee referral

program. A general guideline is outlined, again, in my written testimony.

Also, with a clear definition, the interpretation of the current business relationships may need to change. The Tax Chairs ask that reclassification be allowed in the following manner. First, that the service recipient can obtain approval from the IRS to reclassify from an employee to an independent contractor, there should be a period of time when this would be allowed when it is clear that with the new rules they should be treated in this manner. Second, service recipients can reclassify from an independent contractor to an employee; A: without penalty or back taxes if the independent contractor has paid their self-employment taxes or; B: without penalty but back taxes paid by the independent contractor if the independent contractor is not current with paying their self-employment taxes.

If the service recipient has filed their Form 1099, there should be no penalty imposed on the service recipient, and a correction period for the independent contractor who hasn't paid their self-employment taxes should be instituted allowing them to pay their tax without penalty or interest. This will get them into compliance.

If the service recipient didn't file a Form 1099 and the independent contractor didn't file or pay their self-employment taxes, then they would not be entitled to this correction period. It is crucial to clarify this issue. It is equally crucial to do it without adding a tremendous paperwork burden to either the service recipient or the service provider.

Madam Chair, I thank you and your Subcommittee for pursuing this issue, and I appreciate your attention to the White House Conference recommendations.

As this congressional session comes to a close soon, I ask that you act swiftly and definitively on clarifying the definition of independent contractor. I hope that the recommendations made in this testimony will allow you to accomplish that, and the Taxation Implementation Chairs offer their expertise and assistance in providing any additional information to facilitate the task before Congress pertaining to this issue.

[The prepared statement follows:]

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Testimony of Debbi-Jo Horton, CPA  
 New England Regional Taxation Implementation Chair to  
 the 1995 White House Conference on Small Business  
 Before the Subcommittee on Oversight  
 of the  
 House Committee on Ways & Means  
 June 20, 1996

Madame Chair and Members of the Committee, I am Debbi-Jo Horton, a CPA and owner of an accounting firm in East Providence, Rhode Island. I am the New England Regional Taxation Implementation Chair to the 1995 White House Conference on Small Business and represent the National Taxation Implementation Chairs at today's hearing.

The two bills referenced in this testimony are HR 1972 and S 1610. Representatives of the White House Conference Taxation Implementation Team have been asked to clarify these two bills from this Committee in earlier hearings, Members of the House and Senate Small Business Committees, the Internal Revenue Service, and the Department of Treasury.

Additional points I would like to cover are:

1. There is a lack of understanding by independent contractors on how the lack of clarity of the current laws affect them.
2. Definitions of an independent contractor are different for federal classification and for each state's classification. States have their own interpretation of the federal definition.
3. The calculation of the estimated cost assessed by General Accounting Office (GAO) on the legislation to clarify the definition of the independent contractor may be incorrect. The Taxation Chairs are concerned that the estimated cost of this bill has been placed at \$1.1 billion over the next 7 years and may include items in the calculation that should have been omitted.
4. There is a need for a clear general rule rather than trying to define every possible scenario that might occur.

Point 1.

There is a lack of understanding by independent contractors on how the lack of clarity of the current laws affect them. Often when discussing the issue of independent contractor vs. employee it is viewed to be the "employer's" or "service recipient's" problem. What many fail to see is that it is equally the "employee's" or "independent contractor's" problem as well.

Let me give you an example. I spoke to a group of entrepreneur's that owned home based businesses. They were not very interested in the independent contractor vs. employee issue because they felt it didn't affect them. They indicated that this was so because they did not use independent contractors. When I asked if they considered themselves to be independent contractors their response of a resounding "OF COURSE!"

I then asked if they would be concerned if a company that used their services was audited and all of their independent contractors were reclassified as employees. They suddenly realized that this would directly affect them.

I am afraid that there are many more people in this country that have not looked at this issue as closely as they should. When they do, you will be hearing many more voices added to those already crying out for clarity.

The majority of businesses in this country either use independent contractors or are independent contractors. Most often they are independent contractors and use independent contractors. The job growth in the country has been attributed to small business (independent contractors make up the majority of this sector). Home based business and service are some of the fastest growing industries in the country. This issue is a concern to ALL of those companies.

Women represent the largest and fastest growing sectors of the small business community. Women account for a majority of the start up small businesses in this country, and a majority of them are independent contractors. This means that more women are entering the arena as independent contractors than ever before. The National Association of Women Business Owners views the independent contractor issue as their top concern. The Business and Professional Women's Federation/USA has also seen an increase in membership of women business owners. The independent contractor issue has been a topic of concern to their members and was included as one of the topics at their National Conference July, 1995.

Point 2.

Definitions of an independent contractor are different for federal classification and for each state's classification. Because of the lack of clarity, states have their own interpretation of the federal definition. We need to have clarity and consistency. If the federal government has clear guidelines, the state will follow them. States need to be able to start with the federal definition and be more consistent in its interpretation to define who is an independent contractor for state purposes. Currently this does not exist.

As an example, Rhode Island's law to identify an independent contractor is too restrictive. The State's law does not allow for an independent contractor to provide services to a company for which those services are part of that company's usual trade, occupation, profession or business. This type of independent contractor would be classified as an employee. For example, if an accounting firm wished to engage the services of my firm, they could not contract with my firm as an independent contractor. They would have to hire my firm (me) as an employee because of the State of Rhode Island's independent contractor law. They would be able to classify me as an independent contractor for federal purposes, but not for state purposes. This would put them at risk of reclassification if they were to be audited by the IRS because of the inconsistency in their treatment of that same individual.

The independent contractor becomes that company's employee for Rhode Island tax purposes. Income taxes, unemployment and temporary disability insurance is submitted to the State. In addition if that independent contractor has employees of their own, those employees become the service recipients employees as well under Rhode Island's law.

This affects the calculation of unemployment taxes for federal reporting. The federal form 940 requires the amount of wages that unemployment is being calculated on for each state. Rhode Island's wages will differ from the amount being reported to the IRS and could trigger an inquiry or an audit.

Rhode Island is collecting unemployment taxes, but the independent contractor is not entitled to the benefits afforded under the unemployment laws. I operate my business as a sole proprietor and as such do not receive wages from my company. I am not subject to unemployment taxes on either a state or federal level. However, if an accounting firm uses my services and pays me a "wage" for Rhode Island taxing purposes I am not allowed to collect unemployment when I no longer perform services for that company. Rhode Island is collecting the tax for a benefit they will never have to pay.

I have been trying to facilitate changes in the Rhode Island laws. My efforts have been an attempt to bring Rhode Island into conformity with federal laws. The legislature has been unwilling to change these laws because they can't interpret the federal definition, and indicate that the federal laws are too vague. In communications with the Director of the Rhode Island Department of Employment and Training (RIDET), he has consistently shown an unwillingness to discuss the issue with an open mind. I will share with you some of his direct comments made in letters to me. He opposes clarifying the definition of independent contractor because,

"Liberalizing the time tested and court test definition of independent contractor would allow thousands of employees to slip through the safety net of coverage for both unemployment insurance

and temporary disability insurance. Please understand that one of our primary purposes for being is to provide safety net insurance coverage for employees in Rhode Island."

The Director insists that Rhode Island and the federal government are consistent in their laws. His Department has indicated a willingness to work with the employer community providing rulings on employer/employee or independent contractor status if they receive a written statement of the facts and circumstances. This would mean that I need to write for a ruling each and every time I perform work for another accounting firm. The Director of RIDET insists that the federal and state governments are listening, but goes on to say,

"Although DET is not willing to support changes, which we do not believe are in the best interest of the diverse employer and employee constituency we serve, we will continue with a demonstrated willingness to work for both employer and employee alike."

Point 3.

The calculation of the estimated cost assessed by GAO on the legislation to clarify the definition of the independent contractor may be incorrect. The Taxation Chairs are concerned that the estimated cost of this bill has been placed at \$1.1 billion over the next 7 years and may include items in the calculation that should have been omitted. We have been unable to get a clear picture of how that estimate was calculated.

The IRS doesn't determine if the independent contractor has already paid their share of the tax when they assess the service recipient under reclassification. Does the estimated cost of the bill take into consideration that the taxes may be being collected twice? The IRS certainly doesn't attempt to contact the independent contractor and inform them that they were reclassified as an employee and they may be due a refund for taxes paid. The estimate might be reduced by this refunded amount due if they did in fact count the collection twice.

In discussions with the IRS, the Taxation Chairs indicated that we were concerned that penalty and interest may have gone into the calculation. We were told by representatives of the IRS that the IRS doesn't assess penalties in the case of reclassification. They only assess taxes and interest. We were told that interest did not go into the calculated estimate. The doubling of taxes in the case where intentional misclassification is determined we are told is not a penalty, rather it is an additional tax. Intentional misclassification does not need to be proven by the IRS, and they can double the tax amount due.

Call it what you will, but it is clearly **not** tax due. You are being penalized! If the IRS provided the amounts for the calculation, I am sure that there is "penalty" included. An independent contractor with a contract, who has been reclassified as an employee by the IRS and a determination was made that is was intentional misclassification would result in the following:

- 1) 100% of the employer's FICA & Medicare and 100% of the employee's FICA & Medicare; 100% of the income taxes that would have been withheld assuming the contractor was single with one exemption.
- 2) A penalty would be assessed at 100% of the tax.
- 3) In addition the IRS could assess penalties for failure to file employment forms, failure to make timely deposits, accuracy-related penalty for negligence or substantial understatement of taxes, penalty for civil fraud, and even aiding and abetting the understatement of tax liability.

Personal liability exists for "trust fund" portions of these taxes and 100% penalty for failure to file cannot be discharged in bankruptcy.

An example, is what happened to a Smithfield, RI company. They were contacted by an IRS Agent. He asked if he could stop by to discuss the independent contractor vs. employee issue. They were assured that this was not an audit. It was an informative interview only.

They cooperated and were very forthcoming in their interview with the agent. Shortly after completion of the interview, they were again contacted and informed that a payroll and subcontractor audit would be conducted.

The IRS reclassified ALL of their subcontractors as employees for the years 1986-1988 and assessed penalty, interest and all portions of payroll taxes for both employer and employee. They were assessed a total of

\$72,000 and were told that a certified check must be delivered within 24 hours or a one and one half times penalty would be assessed bringing the total to \$108,000.

This company hired legal council and spent the next two years fighting this assessment, incurring \$10,000 in attorney fees. The IRS settled for \$38,000, and required that affidavits signed by each independent contractor certifying that they had paid their self-employment taxes. The IRS refused to access their own databases to determine if the independent contractor had filed a Schedule C. They required that this company contact each individual independent contractor on their own to ascertain if the proper taxes had been paid.

The IRS claims that it doesn't care how people are classified so long as everyone is paying their taxes, yet they don't look at the independent contractor to see if they are paying their taxes before they reclassify and assess taxes and interest to the service recipient. They have tremendous matching capabilities and can access a Form 1040 quicker and at a lesser expense than the service recipient can contact that independent contractor (whom they may not be doing business with any longer) and obtain an affidavit from the independent contractor that they have paid their self employment taxes. This contradicts the IRS's claim.

The Taxation Chairs are also concerned that the GAO calculations include unemployment taxes. Besides the fact that independent contractors are not entitled to unemployment benefits, it is not clear if the calculation offset the collection of unemployment tax by the expense of providing unemployment benefits. In essence, we argue that the cost estimate may not be valid.

Point 4

There is a need for a clear general rule rather than trying to define every possible scenario that might occur.

The current legislation would allow too many workers to be reclassified from employees to independent contractors when they should be classified as employees. The legislation should be a clear general rule that will address the majority of independent contractor scenarios not the exceptions to the norm. We will never satisfy all cases, nor should we be attempting to do so. Those that do not meet a clear general rule will look to the current 20 factor test rules and the section 530 safe harbor for additional review and determination.

**Recommendations to proposed legislation:**

Current changes that the Taxation Implementation Chairs to the 1995 White House Conference on Small Business propose are as follows:

- 1) Delete from HR 1972: 3(b)(3) "agrees to perform the services for a particular amount of time or to complete a specific result and is liable for damages for early termination without cause,"

Delete from S 1610: 3(b)(3) "agrees to perform the services for a particular amount of time or to complete a specific result and is liable for damages for early termination without cause,"

This is contractual language and should be left to the parties involved in drafting and executing their contract and not be part of the general rule.

- 2) Change in HR 1972 in 3(b)(5): "purchases products for resale" to "primarily purchases products for resale".

Change in S. 1610 in 3(b)(5): "purchases products for resale" to "primarily purchases products for resale".

The current wording would allow an individual to purchase minimal products for resale and meet one of the tests when they would not be able to meet any of the other investment tests. The reasoning for making this a point in the test was to include resellers. An example would be an Agway or Avon representative and these are clearly examples of an independent contractor and not an exception.

- 3) Add in HR 1972: 3(c)(1) "(D) operates primarily from equipment not supplied by the service recipient; and"

Change in S 1610: 3(c)(1)(D) "or" to "and"

- 4) Change in HR 1972: 3(c)(2)(A) "and" to "or"  
Change in S 1610: 3(c)(2)(A) "and" to "or"
- 5) Add in HR 1972: 3(c)(2)(B)(ii)(II) "or" after "solicitations,"  
Add in S 1610: 3(c)(2)(B)(ii)(II) "or" after "solicitations,"
- 6) Delete in HR 1972: 3(c)(2)(B)(IV) "other similar activities, or "  
Delete in S 1610: 3(c)(2)(B)(IV) "other similar activities, or "

These changes would force the independent contractor to comply with other points that show an intent to be in business and maintain independence. It also closes many loopholes that would allow an employer to force an employee to become an independent contractor.

- 7) Change in HR 1972: 3(c)(B)(iii) "with" to "as required by"  
Change in S 1610: 3(c)(B)(iii) "with" to "as required by"

Not all states or municipalities require that a license be obtained or that a sole proprietor register under a business name. If there is no provision to do these things then they would not be classified as an independent contractor. Rather than put an additional burden on states and their agencies to make these provisions available, we would rather leave these requirements to the states to administer in their current manner.

- 8) Add to HR 1972: The service provider must be free from ongoing direction or control over the means and manner of providing the labor or service, other than through general performance specifications, and basic project specific variables such as the workorder, job site, date, or date. In addition the service provider has the right to hire employees to help perform the labor or service, and is responsible for employer taxes and required reporting for workers who they hire or supervise on a regular basis, except in the circumstances where specific services are required without substitution. Lastly, the service provider does not receive from the contracting party any of these benefits which are normally associated with an employment relationship; payment for holidays, vacation time or weekly overtime; and the service provider cannot participate in the service recipient's employee benefits programs such as employer retirement programs, health or life insurance benefits, or other benefits normally available only to employees.

Add to S 1610: The service provider must be free from ongoing direction or control over the means and manner of providing the labor or service, other than through general performance specifications, and basic project specific variables such as the workorder, job site, date, or date. In addition the service provider has the right to hire employees to help perform the labor or service, and is responsible for employer taxes and required reporting for workers who they hire or supervise on a regular basis, except in the circumstances where specific services are required without substitution. Lastly, the service provider does not receive from the contracting party any of these benefits which are normally associated with an employment relationship; payment for holidays, vacation time or weekly overtime; and the service provider cannot participate in the service recipient's employee benefits programs such as employer retirement programs, health or life insurance benefits, or other benefits normally available only to employees.

These provisions directly address the issue of control. All of these provisions should be a requirement of being classified as an independent contractor in addition to meeting the other test requirements.

In addition to these technical corrections to the bills outlined above, the Taxation Chairs would also like to propose that the follow be added to these bills:

- 1) Service recipients should pay increased penalties for failure to issue 1099s to their independent contractors.
- 2) Service recipients should pay increased penalties for fraudulently misclassifying employees as independent contractors to evade the payment of taxes.

If this Congress can pass a clear general rule that practitioners and small businesses can follow, there will be greater compliance. Many service recipients currently do not file 1099s for fear of audit. If they are certain that they are correct in classifying their independent contractors, they will be confident in their compliance and will file the appropriate forms. We, Taxation Chairs, feel however, that the bill could go a little further to assure this.

A misconception that many people have is that using independent contractors is cheaper than hiring an employee. This is not true. An independent contractor charges a rate that incorporates their costs. These costs include overhead, benefits, and the cost of doing business (which includes paying their taxes). Because of this misconception and other factors there are people who fear that the passage of a clear general rule to define an independent contractor will allow employers to fire their employees, and make them sign contracts as independent contractors to regain their job. As practitioners, the Taxation Implementation Chairs could argue for years on this point, but instead we offer these suggestions:

3) Institute an Employee Referral Program.

This would allow an employee to contact the IRS to discuss whether a reclassification by their employer is justified. Currently Form SS8 is supposed to be used for such an instance, but the form is too cumbersome and too complicated to be useful. We would recommend that the form either be made simpler to use or a hotline be instituted where an employee can call when they feel a reclassification is unjustified by their employer and the IRS employee can take down pertinent information and have a determination rendered.

4) Reclassification:

A) Service recipient can obtain approval from the IRS to reclassify from employee to independent contractor.

Because of the unclear definition that we currently have, many companies make it standard procedure to only hire employees. They do this out of fear of reclassification under audit and the hardship they have seen others endure because of the subjective nature of the current laws. Once we pass a clear general rule everyone will reassess the current classifications they have and some may find that they have an independent contractor relationship rather than an employee relationship. When this is the case they should be allowed to reclassify without fear of retribution.

Allow a period of time where the service recipient can obtain approval from the IRS to reclassify from employee to independent contractor when it is clear that with the new general rule they should be treated in this manner.

B) Service recipient can reclassify from an independent contractor to employee;

1) without penalty or back taxes if the independent contractor is current in paying their self employment taxes.

With a clear definition a service recipient may determine that they have an employee relationship. That service recipient relied on current law and interpreted their business relationship to be one of independent contractor, but now that the definition is more clear, they believe that the relationship is one of employer/employee. Circumstances in the relationship need not change to change the interpretation, but the clarity of the definition and as a result the interpretation leads to the change.

If both the service recipient and the service provider agreed they had a service recipient/independent contractor relationship, they would have been complying with the law. Form 1099 would have been filed and the independent contractor would have paid their taxes. Therefore the reclassification should be allowed without penalty or back taxes to either party.

- 2) without penalty, but back taxes paid by the independent contractor if the independent contractor is not current with their self employment taxes.

In this scenario the service recipient has interpreted the current law to indicate that the relationship is that of service recipient/independent contractor and under the new clear definition sees that it would be classified as an employee. If the service recipient has filed their form 1099, there would be no penalty imposed.

Institute a correction period for reclassification from independent contractor to employee where the independent contractor hasn't paid their self-employment taxes. Allowing them to pay the taxes without penalty and interest.

New Jersey has just completed a very successful amnesty period that brought many taxpayers into compliance and brought revenues into the state.

If the service recipient did not file form 1099 and the independent contractor did not pay their self employment taxes, they would not be entitled to the correction period and would fall back into the 20 factor test and Section 530.

It is crucial to clarify this issue. It is equally crucial to do it without adding a tremendous paperwork burden to either the service recipient or the service provider.

Madame Chair, I thank you and your Committee for continuing to pursue this issue. As this Congressional session comes to a close soon, I ask that you act swiftly and definitively on clarifying the definition of an independent contractor. I hope that the recommendations made in this testimony allow you to accomplish that. The Taxation Implementation Chairs offer their expertise and assistance in providing any additional information to facilitate the tasks before Congress pertaining to this issue.

Chairman JOHNSON. I thank the panel.

Ms. Horton, your suggestions in regard to an employee referral program, are very interesting. There were quite a few parts of your testimony that were interesting. I especially like the suggestion to develop a system whereby there can be better communication between the taxpayer and the IRS in the course of making these changes in both directions.

Mr. Shulman, you acknowledged that there is concern that if Congressman Christensen's legislation were enacted that it might actually allow employers to coerce their workers into being treated as independent contractors. Do you have any suggestions for fine tuning the language in the congressman's bill to prevent this coercion?

Mr. SHULMAN. Well, I have heard that said, and I think there are a number of ways it can be handled. One way that I have heard talked about is actually exempting some categories of workers or some industries from the test in the Christensen bill.

So, for example—and I do not mean to prejudice this because I do not know a lot about this industry—but in past years, there have been hearings about migrant laborers who have been coerced into being independent contractors. I think Congress can do with that group of workers as it has done historically with other groups who it felt were potentially being abused and say you make or break your case under the common law test, you do not get the Christensen standard. That is one way to do it.

I know the other provisions of the bill can be fine tuned, but again, Madam Chair, my concern is, with all due respect to the other witnesses, we are moving into the 21st century. We have lots of jobs that we need to think about in different ways. We need to empower people, particularly those who are not being abused, knowledgeable workers, our programmers/analysts, and people in the high-tech community who want to work self-employed to be able to do that, and whatever changes we make in any of this legislation, we must not only look backward and see who we want to continue to protect, but we must look forward and make sure that whatever test we come up with allows the workers who we want to encourage to be self-employed to have that opportunity.

Chairman JOHNSON. I think that is a very legitimate point.

You also mentioned that we should change the assessment process in employment tax audits. Can you describe the problems you see with the current assessment process a little more in depth?

Mr. SHULMAN. I think, Madam Chairman, that this is one of the most outrageous aspects of this problem that never gets discussed, and that is if Donald Trump were found to owe \$100 million in income taxes, the IRS would issue a notice of tax deficiency and Mr. Trump would have his day before a judge in court and be able to show he did not owe a penny before the IRS could impose a lien or assessment on him. However, if a small business is found by the IRS to have misclassified, even in good faith, and that small business wants to go to court to contest that, and let us just say it is a \$100,000 assessment that could put that business out of business, under the current law, the IRS is required to make an assessment, and that becomes an immediate lien on the business. And you know something, there are very few small businesses that have

the wherewithal to survive that lien and go to court and fight the IRS no matter how correct they may be.

My testimony has a lot of details on changing that procedure. I was glad to hear Treasury suggest maybe it should be in the Tax Court. I do not think it should be in the Tax Court, but we have got to change the assessment procedure or all of the other things you are doing here are almost going to be meaningless because if you disagree with the IRS, they are going to hang you before you ever get a chance to prove your case.

Chairman JOHNSON. Thank you. That has been a significant problem, and we heard a lot about that last session.

Mr. Kleczka.

Mr. KLECZKA. Thank you, Madam Chairman.

Let me ask Mr.—is that Campagna?

Mr. CAMPAGNA. Campagna.

Mr. KLECZKA. Campagna.

What is your view of the Christensen bill that is currently pending before this Subcommittee? I am going to ask that of the New York folks, also.

Mr. CAMPAGNA. I can only answer personally because the Section has not taken a formal position on the bill.

The first point I would make to you, Mr. Kleczka, is I do not think there would be as many wholesale reclassifications of workers as might be expected, and the reason is the Criteria C of the Christensen bill which requires either a principal place of business or true liability if the worker walks off the job.

It is very difficult for me to see where that allows big companies to just start willy nilly reclassifying people because they would have to have one of those two things, and they wouldn't have it in the typical case.

Mr. KLECZKA. Have you had a chance to review the GAO criteria that was presented today, along with, I think, the New York State Bar, also with four criteria? Have you reviewed either one of those?

Mr. CAMPAGNA. I have reviewed the GAO bill in the past, and I have heard Ms. Kraus' definitions this morning. I have disagreements with just about every objective criteria that have been drafted.

As I mentioned in my written statement today, we are not here pushing even the objective criteria that were proposed by the American Bar Association in 1982 because times have changed, and there are some minor details in there that we would change if we were asked today for objective criteria.

Mr. KLECZKA. Let me ask either Sherry or Mr. Reinhold their views on the Christensen bill.

Mr. REINHOLD. Mr. Kleczka, We were of the view that the criteria are sensible criteria, but because of the limited nature of the criteria used, taxpayers could effectively elect classification as either employees or independent contractors under the bill. We gave a couple of examples in our statement about workers that, in all respects, appeared to resemble traditional employees, except they might hold themselves out as available to third parties and briefly work for third parties during a year or might work from a facility adjacent to their home using a PC, not terribly unusual things in 1986, certainly in the second category and possibly in the first, and

thereby put themselves in a position where they would be able to claim independent contractor status. We had some concern that there would be substantial erosion of the employee concept if it were so readily elective.

Mr. KRAUS. Sir, if I could just add to that comment. In our report, we actually give an example of what we believe would be one of the problems with the Christensen bill.

For example, if you had a worker who simply could show some investment in training, maybe trade school, college or whatever, got a DBA—this costs about \$20 to do—and entered into a written agreement with his employer agreeing to be treated as an independent contractor, that is all you would have to meet. That would be one example of how simple it would be to meet independent contractor criteria under that bill. That is only one, but that is the kind of thing we are talking about in that we are worried that the pendulum will swing too far the other way and undermine employee status.

Chairman JOHNSON. Would the gentleman yield?

Mr. KLECZKA. Surely.

Chairman JOHNSON. I see heads nodding in disagreement. Would you mind if others commented to that point so we get some discussion between them?

Mr. KLECZKA. Sure, briefly. Go ahead.

Chairman JOHNSON. I am going to allow you time.

Mr. KLECZKA. Sure.

Chairman JOHNSON. Mr. Campagna, you were shaking your head, and, Mr. Shulman, I wondered if you had any comment.

Mr. CAMPAGNA. On the example just given, I fail to see how that worker would have his or her own principal place of business or would be liable at termination of the contract. I just do not see how that person would satisfy criterion C of H.R. 1972.

Chairman JOHNSON. Ms. Kraus.

Ms. KRAUS. If I could respond. As I understand the bill, I read it sometime ago, there is actually a rather complicated test under the Christensen bill, and under the second test you would have to show that you had a principal place of business or paid fair market value for the business premises, but if none of those conditions were met, you would then be given an opportunity to meet yet another test which is to show that you had offered to perform services for others or provided services under a registered business name, which is where I got the DBA example.

So, unless I am misinterpreting the either/or aspect of that second test, which is I believe what the gentleman was referring to, it looks as though it gives you an alternative if you cannot show you have a principal place of business.

Chairman JOHNSON. Any other comments?

Mr. KLECZKA. Mr. Shulman, do you want to respond briefly?

Mr. SHULMAN. Yes. I agree with Mr. Campagna that there are situations, and let us use a computer programmer or an accountant as an example. These people may take on a project which is on a customer's premises—because, by example, that is where huge amounts of records are kept in the case of an accountant, or for a programmer, there is a \$100-million computer there, and that person may literally have paid for their own continuing education,

their own self-training, they have an advanced degree. They do not need a principal place of business because they are not going to have a million-dollar computer in their home, but they will agree to finish the project and not walk off the project early. Now, that person would satisfy the Christensen test, but would not satisfy the test in a lot of these other bills. That is my point about looking at it from both sides. We want to prevent abuses, but we have to come up with something that works in the 21st century and that lets workers who are well educated, well paid, not abused, and who pay their taxes, to choose a working relationship with a firm that allows them to be young entrepreneurs.

So, I agree with Mr. Campagna. Under the Christensen bill in certain circumstances, people who take on that liability to complete a project would be an independent contractor, and I do not see anything wrong with that in the circumstances I have just set forth.

Chairman JOHNSON. Thank you.

Thank you, Mr. Kleczka.

Mr. KLECZKA. OK. Ms. Kraus, you are correct that a test to the Christensen bill starts with the principal place of business, and it goes through numerous other points. That clearly is not the defining criteria.

In your testimony, Ms. Kraus, you have a statement here, and I will just extrapolate from it. In the employer-worker relationship, there is a significant risk of undermining treatment of workers as employees. Do you want to expand on that? I think I made mention of that earlier in today's testimony that it is just not a case of whether or not the IRS and the Federal Treasury will be held harmless. There is a human side to this, and I think that is what you might be referring to. So, if you could briefly respond as to your thoughts on that.

Ms. KRAUS. Yes, I would be very happy to.

Again, I am a practitioner, and I see a lot of these cases, including, I might add, I have handled a case very similar to the one you discussed early on today on the educational systems, hiring out buses to owner drivers, which I won't go into but would be happy to expand upon later if you would like.

Basically, there is a tremendous financial incentive to employers, especially small business employers who have thinner margins of profit, to try to find ways to reduce their worker cost.

I often see in my practice situations in which actually workers are coerced or they cannot get the job unless they agree to be treated as an independent contractor or there would be a somewhat quasi-collusive arrangement that I will not send you a Form 1099, so you can not worry about the payment that I make.

One thing that concerned us in doing this report, the beginning of this report actually was several years ago with the health security bill because that bill knew that we had to clean up this area because they were trying to address who had to pay health benefits, and that all turned on whether you are an employee or not. That was going to put enormous pressure on the worker classification issue because suddenly if an employer has to pick up \$4,000 a year or more per worker to include them in a health plan, yes, there is going to be an additional incentive to define that worker, by the way, that should be treated as an independent contractor.

What I see a great deal in my practice is the workers end up not able to pay the full amount, meaning their own self-employment taxes as well as their fringe benefits, like health care cost and so on.

Empirically, based on my own experience, I believe many of these audits start with workers who actually file returns, report the income, but cannot pay, and then we deal with an offer and compromise or whatever, but there are tremendous losses to this system with the independent contractor status in many cases, even when there has been full compliance by everyone, employers and workers alike.

So, the issue is that if everything suddenly shifts to making independent contractor status more easily available, you do have to take into account monumental shifts not just in the tax area, but in the benefit area as well.

Mr. KLECZKA. Let me ask my last question of Ms. Horton. In your testimony, you indicated that independent contractors aren't cheaper than regular employees. What is your basis for that, based on the fact that a regular employee would carry a whole bunch of benefits along with him or her, where an independent contractor would get one payment, fee for service?

Ms. HORTON. Most independent contractors will make sure that they have those benefits.

Mr. KLECZKA. From who?

Ms. HORTON. From themselves.

Mr. KLECZKA. Oh, provide it themselves. OK.

Ms. HORTON. I am a sole proprietor, but I have employees. My employees are entitled to health benefits. I also have health benefits. They have SEP contributions. I have SEP contributions. If I were to work for a CPA firm, I might get \$25 to \$30 an hour, and they would supply me with some benefits. As an independent contractor, I get \$150 an hour. Where is it cheaper to use an independent contractor versus an employee?

Mr. KLECZKA. OK, but that is an independent contractor who is a professional. Let us take a person who is a trades person versus a professional. Would the same be true?

Ms. HORTON. Should be.

Mr. KLECZKA. \$150 an hour?

Ms. HORTON. Well, they might not get \$150 an hour, but they probably wouldn't get paid \$25 an hour as an employee either.

Mr. KLECZKA. Thank you very much.

Chairman JOHNSON. Just to pursue that issue, Ms. Horton, do you have any idea what percentage of the independent contractors are people like you who have employees and what percent is that sort of little tiny person who may not be able or willing to charge enough to provide benefits for either themselves or their employees?

Ms. HORTON. I do not know what the statistics are on a national basis, but Rhode Island is made up of almost 95 percent small business, and of that—

Chairman JOHNSON. In Rhode Island?

Ms. HORTON. Rhode Island.

And of that 95 percent, more than 50 percent of them have five or fewer employees.

Chairman JOHNSON. Thank you.

Does anyone else have any comment on the point just made?

Mr. Shulman.

Mr. SHULMAN. If I may, Madam Chairman. In the computer industry, our employers make more money when we use employees than when we use independent contractors. We must pay, like Ms. Horton said, independent contractors more money because they pay for all their own benefits. They get their own liability insurance. So, again, you cannot make generalizations here.

I do admit to bristling when I hear a generalization that it costs more to use employees. It is absolutely not the case as a general proposition.

Now, beyond that, Congressman Kleczka's point, which I agree with and I am very concerned about, we have got to distinguish between tax issues and other issues. This is a Ways and Means matter. We are not talking about OSHA. We are not talking about Title VII for equal employment. There is nothing uncommon about a worker being an independent contractor for some purposes and being an employee for other purposes. So, let us, again, strip away the rhetoric about—and I do not mean from the Congress, but from among many in the business community—about when someone becomes self-employed for tax purposes, they are going to lose all of these other protections. It just is not the case because the EEOC and the Labor Department and OSHA and everybody else is out there.

I think as we move forward, I urge you to keep those distinctions in mind.

Chairman JOHNSON. It would be useful, and we will try to get information from the GAO and others as to how many independent contractors have employees because, of course, any workplace would be covered by all of these other laws. If 95 percent of independent contractors actually have workplaces, then the points brought up earlier about lack of worker protection simply are not relevant, but I am concerned, Ms. Kraus, with your comment that there are tremendous financial incentives to reduce worker cost.

What I am hearing from Mr. Shulman and Ms. Horton is that what they bring to the table to a business—and I see this. I represent a district of small businesses, and that small manufacturer does not have the computer expertise, and the IRS didn't have the computer expertise to upgrade. They needed to hire that expertise from outside.

These little companies cannot hire the expertise they need, even on a short-term basis. They cannot reorganize their computer capability, upgrade their machinery, or redesign the layout of their plant. There are just so many things now that running a sophisticated business requires that small businesses cannot do. It would be dumb for them to hire someone. So, they need to hire an independent contractor, and this is a very legitimate role in our economy. Of course, that is driven by the desire to reduce cost.

You need to help us clarify because your statement is no more true than their statement. There is truth to both sides of this argument. You have to help us clarify this situation about what kinds of situations produce the coercion. Otherwise, we will have to draw

bright lines without regard to what kind of protection we ought to be able to provide.

Do you have a comment?

Ms. KRAUS. Madam Chairman, certainly your point is absolutely correct. Probably, in most instances where a business or an employer hires a worker and treats that worker or group as an independent contractor, I do not know the statistics. My bet is in most cases, they are correct.

I mean, my goodness, especially in small business areas, the need to go outside and outsource that expertise is very frequently there. In those cases, they are probably going to be OK. They are probably going to have no problem.

The only way they might have a problem is if the worker does not include it in income, and the IRS may come back and just make sure that they have complied with the Form 1099 requirements. Clearly there are many, many situations where it is perfectly legitimate.

Let us hope so. I am an independent contractor for every client I serve, and we are talking about this subsector, this tax gap sector where there are unscrupulous or uninformed, or whatever the reason, workers or pressured workers where they may have to agree.

Chairman JOHNSON. I understand that. So, how do we get at them without debilitating, in a sense—

Ms. KRAUS. Exactly.

Chairman JOHNSON [continuing]. Legitifying relationships in our economy which at this point is critical to our future that they be flexible? How do we do that?

Ms. KRAUS. Well, again, the report makes a number of suggestions. The main thing is, of course, the reporting, the compliance provisions, pumping up the Form 1099, making sure the IRS has the tools to make intelligent selections of where is there abuse, and where is there not abuse.

Chairman JOHNSON. So, the kinds of things we have been discussing to fine tune this bill language.

Ms. KRAUS. Exactly.

And also, on audit, then if we can eliminate some of the vague criteria and have more bright-line tests, which this is just a guess, but I am going to guess, if you put in some bright-line employee tests and bright-line safe harbor tests, people are going to structure. This will determine how they structure their relationships with the workers that they want to treat as independent contractors or that they want to treat as employees, and you are going to have far fewer disputes in that area. but I certainly know, just addressing the points made by my colleagues, that in terms of the cost, I happen to have represented groups similarly situated, like dental groups.

One will treat them as independent contractors. It is a corporation. Another will treat them as employees. They are audited. They get adjustments.

When we talk about the cost of employee versus the cost of independent contractors, those companies bitterly complain when they have to treat these workers as employees. They claim competitive disadvantage, what you had talked about with Mr. Lubick this morning, because the costs to them are greater.

Again, when we talk about this issue of is it more expensive to keep them as employees or to treat them as independent contractors, certainly you see bitter complaints in many areas. Some workers and companies are under the protection of section 530—

Chairman JOHNSON. Let us come back to that because I think that is a relevant thing to talk about, but I have taken more time than I should have when Mr. Hancock has not had a chance to question.

Mr. Hancock.

Mr. HANCOCK. Thank you very much.

Because of the incentive, which I addressed a little bit earlier, which is out there to actually go with an independent contractor, what we are hearing today in front of this Subcommittee is primarily addressed at whether there is a tax advantage or disadvantage, and we are talking about Internal Revenue collecting the income taxes or the payroll taxes. Is that the number one reason for the drive in the marketplace now is to try to go with independent contractors? Does it have to do with the tax law whatsoever? Shouldn't we consider the other governmental regulations, which Mr. Shulman approached, such as the potential litigation if, in fact, you want to terminate an employee?

Let us face it. There is a whole industry out there in the legal profession just sitting and waiting for somebody to file a discrimination suit or for somebody to file workman's compensation or unemployment claims. Is there an unspoken and unwritten incentive to try to avoid litigation and having to defend and lose even if you win? Does that have a bearing on whether it is a tax deal, or is it that the employer is scared to death of being sued on something that he does not have any control over?

Mr. CAMPAGNA. Mr. Hancock, if I might, it is impossible to segregate those reasons. When a company decides to treat workers as contractors, all of those matters come into play. It may be less expensive in their industry to have a contractor. It varies from industry to industry whether it is or not. It may be a problem in that industry to deal with workers who are terminated. It is in most. It may be a tax advantage. It just depends from industry to industry, and I think all of these things are intertwined. You cannot say the tax is driving the decision at this point because we are such a service economy now, and the types of professionals and entrepreneurs that we have been talking about are not the people that we need to protect with the very important concerns that Mr. Kleczka is raising, to protect workers from being reclassified.

We shouldn't be thinking about doctors and lawyers and accountants when we think about those things. Those people are getting paid enough wage to go out and get their benefits whether they work as contractors or not.

If we are concerned about reclassification of workers and wholesale reclassifications by big companies, I would suggest that you try to incorporate a prophylactic provision in any of your objective tests that would say that a company could not reclassify a worker if there has not been a change in their true job function or proof that the company was entitled to rely on the section 530 safe harbors and simply hadn't been relying on those because it would have been inconsistent treatment to do so.

If you put those prophylactic provisions in, companies will not be able to wholesale reclassify their workers as contractors just to avoid benefits.

Mr. HANCOCK. There is one item on here that we talked about on this section C. A primary source, is that what it is, that pays a fair market use, rent use for the service recipient's place of business. This means that you have got to have an office. What about the guy that is operating just out of his head? He has got the brains, and he does it over the telephone. Is he not self-employed even though he does not have the primary source? He uses a pay phone, operates out of his car, travels over the country as a consultant. Is he not self-employed?

Mr. CAMPAGNA. I understand, Mr. Hancock, that the trucking industry has a problem with that criteria because they do not know if the owner/operator of a truck is going to have a principal place of business that qualifies under that criteria. It is the same question that you have raised.

Mr. HANCOCK. Quite frankly, Mr. Campagna, I just met with a trucker just a few minutes ago when I stepped out. Thank you.

Chairman JOHNSON. In view of the time, I think we will not be able to pursue our preceding discussion, but this has been a very helpful panel, and you will have a chance to comment as we try to pull your ideas together into a proposal. Thank you very much for your participation today.

Let me move on to the next panel. I am sorry to keep the people waiting, but this is a difficult area, and I do think it is important for the Congress to begin taking on some of the problems that have, in a sense, plagued us for many years, and so it does take some greater time to get a grasp of what people are saying about the interrelationship between the recommendations that presenters are making, and I appreciate the patience of both the Members and those scheduled to testify.

This panel is Kurt Pfothenauer—is that—

Mr. PFOTENHAUER. That is correct.

Chairman JOHNSON. Pfothenauer. All right.

And James Pyles, Clyde Northrop, Lockwood Phillips, and Leonard Doctor. Before we begin, it is a pleasure to have with us Hon. Steny Hoyer.

Mr. HOYER. Thank you very much, Congresswoman Johnson and Congressman Hancock and Congressman Kleczka, who I believe has stepped away.

Chairman JOHNSON. He will be back shortly.

Mr. HOYER. Thank you.

I appreciate this opportunity to appear before you today to introduce one of my constituents, Clyde Northrop, the president of the American Association of Independent Newspaper Distributors.

As he will tell you, Madam Chairman, Clyde has been a newspaper distributor since 1973. He knows the business and its people and will be able to share with the Members of the Subcommittee his insights into the particular egregious situation that has confronted him, his business, and his association members.

Mr. Northrop first came to me, Madam Chairman, in 1994 about a new interpretation of IRS rules that changed their status from independent contractors to that of employees. As the then-chair-

man of the Treasury Postal Subcommittee, I worked with the IRS to correct this misinterpretation. However, as you can tell, my efforts were not successful, and ultimately, the IRS indicated that a legislative solution was needed.

Essentially, Ms. Richardson said that counsel advised her that this was the correct interpretation and, therefore, we had to address it legislatively.

Therefore, I was pleased that the Senate, at the instance of Senator Dole, included in its 1995 reconciliation bill a provision to clarify that under section 3508 of the Tax Code newspaper distributors can be treated as independent contractors under direct seller rules. Furthermore, important language was included in the report to clarify that the provision has no impact whatsoever on the interpretation of the applicability of Federal, State, or local labor laws.

As you may know, Madam Chairman, the Teamsters and others became very concerned about the ramifications this might have as it related to their existing contractors and relationship to various newspapers. In particular, there was a problem in Detroit.

What this simple yet important provision does is return the newspaper distributors to the status quo they had been operating under until recent interpretations by the IRS.

I am grateful that this Subcommittee supported the Senate language and that it was included in the conference report. Although the overall bill was vetoed by the President, I am hopeful that this provision will ultimately be signed into law and would appreciate the Subcommittee's continued support of the important provision.

I might say, Madam Chairman, that I had extensive conversations with the White House last year on this issue because, of course, it was somewhat controversial because of particularly the concerns of some in the labor movement with whom I was very sympathetic.

At the same time, Madam Chairman, you may know that in Kansas, because they had the financial ability to do it and they got some help, I suppose, from the newspaper itself, they took this to the court, and before it was litigated the IRS withdrew, in effect, gave up on its claim in that instance. Obviously, most folks do not have that kind of resource, especially those folks who are very small businesses, mom and pop at best and teenagers.

Clyde was just telling me since this ruling, in Bowie, Maryland, there are no longer any teenaged delivery newspaper people. They are all gone because of the fact of the relationship. You know where Bowie is, just about 15 miles from here, the second-largest town in Maryland. It is about 45,000 people, second only to Baltimore.

In any event, Madam Chairman, it is my pleasure to appear before you today to introduce Clyde Northrop, and I thank the Subcommittee for giving Mr. Northrop the opportunity to further explain the situation that distributors find themselves in.

I told Mr. Northrop, but I will repeat it for the panel, that Chairwoman Johnson, as you may have already learned in your practices, is one of the more thoughtful Members of the Congress of the United States and I am sure will be very sympathetic to the representations you have to make.

Madam Chairman, thank you for giving me this opportunity.

Chairman JOHNSON. Thank you, and thank you for joining us, Congressman Hoyer.

It is of really great concern to me that government should go in and reinterpret relationships and, in a sense, retroactively knock out jobs that used to be available to kids.

Mr. HOYER. Yes.

Chairman JOHNSON. I hope that we will be able to solve at least this problem, but that same kind of retroactive redefining of relationships is having a lot of consequences in other industries that I think are unhealthy and unfair particularly in light of the section 530 safe harbor that explicitly said if there is a long history of classification then we will not disturb it.

So, we do have some good work that we can do in this area. We may not be able to solve every problem, but this is one I hope we will be able to solve—and I think your presence here—and at our first hearing, Senator Gramm came all the way over to our side. We clearly have bipartisan concern with fixing the law in this area, and I am very glad to know that you have had good conversations with the administration, and we may need your help later on to be sure that the communication is complete, but we also had very good testimony from Treasury and the IRS, and I believe we are going to be able to work together to iron out some of these things.

Mr. HOYER. Well, I look forward to working with you, and you let me know what I can do to help.

Chairman JOHNSON. Thank you for being here this afternoon.

Mr. HOYER. Thank you.

Chairman JOHNSON. Let us start with Mr. Pfotenbauer, the vice president of UPS.

**STATEMENT OF KURT PFOTENBAUER, VICE PRESIDENT,  
UNITED PARCEL SERVICE, WASHINGTON, DC**

Mr. PFOTENBAUER. Good afternoon. As the Nation's fifth-largest employer, today's hearing is of significant interest to UPS.

A compelling case has already been made before this Subcommittee that the process by which the IRS determines who is and who is not an employee is overly subjective and produces inconsistent results. Clearly, guidance is needed from Congress.

It is UPS' recommendation that any legislation voted out of this Subcommittee effectively, but narrowly, target the problems of small business while addressing the broader issues associated with worker classification on a more comprehensive basis.

Labor is the key asset in the delivery of our service to the public, and it will always be so. Despite enormous expenditures made annually by UPS for aircraft, fuel, facilities, and technology, about 60 percent of our overall cost is still attributable to labor.

While technology can most certainly enhance the effectiveness of our employees, it cannot replace individuals in providing our core pickup and delivery service.

Our 82,000 drivers serve every community in this country; in fact, every address in this country. As most of the Members of this Subcommittee know from personal experience, our drivers are hardworking, determined, highly motivated individuals.

Experienced UPS drivers earn \$18.80 an hour. They get time and a half for overtime. With benefits, they make nearly \$30 an hour.

These are very good jobs, but if Congress enacts legislation without carefully examining its impact on these jobs and others like them, it could unintentionally shift the direction of our entire industry by offering huge competitive advantages to companies willing to consider replacing their employees with independent contractors.

By replacing its employees with independent contractors, a business can cut its labor costs dramatically. It can do away with the need to pay overtime, unemployment insurance, or worker's compensation. It can sidestep employer's responsibilities for Social Security, for disability benefits, for health benefits, for pension benefits. It can also avoid regulatory compliance requirements which are triggered by threshold numbers of employees.

As an independent contractor, the former employee will enjoy fewer job protections, will probably make less money, will have less medical coverage, and will be less likely to retire with a pension. Taxpayers may end up shouldering the burden for increased social welfare demands, and with such looming economic impacts, businesses would be forced to make very hard choices regarding their employee-based work force in the face of competition from low-cost providers using independent contractors.

More liberal use of independent contractors will inevitably make employees obsolete in certain industry sectors. It seems, then, that there must be a balance. UPS suggests the following principles upon which legislation could be fashioned.

First, the question of whether work is contracted out to independent contractors or is performed by employees of the company, should be a decision which is not significantly distorted by government-mandated requirements, penalties, and rewards. We need a level competitive playingfield.

Second, open and visible decisionmaking by the IRS is needed. If the government's decision will affect an industry and its jobs that needs to be done on an industrywide basis. Existing IRS decisions should also be reviewed and reconsidered for their perspective application under this statute.

Third, the control aspect of the common law test for determining employment status needs to be retained and strengthened, not eroded.

Fourth, because independent contracting affects laws far beyond the Tax Code, corrective legislation should be comprehensive, not narrow.

Finally, small businesses are the incubators for innovative technologies and services and are stepping stones for economic development. Their needs and their resources and their challenge differ both in kind and degree from larger established businesses.

UPS picks up packages from over 1.3 million businesses a day. Most of these are small businesses. The success or failure of small business has a dramatic impact on UPS. Every 50 additional packages a day that a small business feeds into our system creates a job at UPS.

The predominant problems of IRS classification center on small business, and so should the solution. The other issues associated with worker classification should be addressed comprehensively.

Thank you for the opportunity to testify.

[The prepared statement follows:]

**Testimony of Kurt Pfothenhauer  
Vice President  
United Parcel Service**

before the

**Subcommittee on Oversight  
Committee on Ways & Means  
U.S. House of Representatives**

June 20, 1996

Good morning. My name is Kurt Pfothenhauer. I am a Vice President for United Parcel Service. As the nation's fifth largest employer, today's hearing is of significant interest to UPS.

The small business men and women who appeared before this subcommittee in its last hearing make a compelling case that the process by which the IRS determines who is and is not an employee is overly subjective and produces inconsistent results. Clearly, guidance is needed from Congress.

It is UPS's recommendation that any legislation voted out of this subcommittee effectively, but narrowly, target the problems of small business while addressing the broader issues associated with worker classification on a more comprehensive basis.

Though sophisticated information technology and multi-modal transportation systems tend to define the competitive posture of our industry, labor is the key asset in the delivery of our service to the public -- and always will be. UPS serves over 200 countries with a broad-ranging transportation and information network that includes one of the world's 10 largest airlines, and the largest centrally fueled fleet of trucks in America. Last year, we purchased over 730 million gallons of jet and motor fuel. We own and maintain over 2,400 facilities, and utilize the only nationwide cellular network in the country. We made over \$2 billion in capital expenditures in 1995, and we expect to do so again in 1996. And despite these enormous expenditures for aircraft, fuel, facilities and technology, about 60% of our overall cost is still attributable to labor.

Why? Because, while technology can most certainly enhance the effectiveness of our workforce, it cannot replace individuals in providing our core pick-up and delivery service. Our 82,000 drivers serve every community -- in fact, every address -- in America. As most of the members of this subcommittee know from personal experience, our drivers are highly motivated, determined, hardworking individuals.

Experienced UPS drivers earn \$18.80 per hour, plus time and a half for overtime. With benefits they make nearly \$30 per hour. Their employment with United Parcel Service makes it possible for them to buy homes in safe neighborhoods where they can raise their children, send those children through college, cover their family's medical bills, prepare adequately for retirement, and pay their taxes. These are good jobs.

But if Congress enacts legislation without carefully examining its impact on these jobs and others like them, it could unintentionally shift the direction of our entire industry by offering huge competitive advantages to companies willing to consider replacing their employees with independent contractors.

By replacing its employees with independent contractors a business can cut its labor costs dramatically. It can do away with the need to pay overtime, unemployment insurance or workers compensation. By replacing employees with independent contractors a company can sidestep employers' responsibilities for Social Security old age, survivors and disability benefits, health benefits, and pension benefits. It can also avoid regulatory compliance requirements which are often triggered by specific threshold numbers of employees.

As an independent contractor, the former employee will enjoy fewer job protections, will probably make less money, have less medical coverage, and will be less likely to retire with a pension. Taxpayers may end up shouldering the burden for increased social welfare demands. And with such looming economic impacts, businesses would be forced to make hard choices regarding their employee-based workforce in the face of competition from very low cost providers making use of independent contractors. More liberal use of independent contractors will inevitably make employees obsolete in a variety of industry sectors.

It seems then that there must be a balance. The entrepreneurship of small business must be encouraged and nourished. The IRS needs guidance. And good jobs must not be unintentionally discriminated against by an act of Congress.

So, as a threshold matter, before legislative text is adopted, we urge that there be consensus on the fundamental criteria and on the principles involved. UPS suggests the following principles upon which legislation could be fashioned:

**1) The question of whether work is contracted out to independent contractors or performed by employees of the company should be a decision which is not significantly distorted by government mandated requirements, penalties and rewards.**

In a highly competitive, entrepreneurial marketplace, equity becomes crucial. Businesses that provide the same service, in the same markets must do so on a level competitive playing field. That means laws and regulations affecting economic issues, service, rates and safety must impose the same requirements on all competitors in the same industry.

**2) Open and visible decision-making by IRS is needed.**

When an IRS decision on employment status affects an industry and its employees, the affected parties need recourse to a process which allows them to have their views heard and considered. In short, if the government's decision will affect an industry and its jobs, it needs to be done by an open rulemaking process. The impacts of IRS decisions in this area are so fundamental to third parties, and even to other government agencies, that it cannot and should not be resolved across an audit table by the taxpayer and an IRS agent.

The IRS cannot now issue a regulation or a published revenue ruling on employment tax classification. Yet an IRS decision on employment status of one taxpayer may affect an industry and its employees. For years now, the classification of workers has been relegated to a private system of law, in which the IRS can resolve only one case at a time through audits or private rulings. If the government's decision will affect an industry and its jobs, it needs to be done on an industry wide basis with central IRS coordination and industry involvement, and it should result in published guidance that is available to everyone. Existing IRS decisions should also be reviewed and reconsidered for prospective application under this criteria.

**3) The control aspect of the common law test for determining employment status needs to be retained and strengthened, not eroded.**

The legal core, as I understand it, is whether the business has the right to direct and control how the worker performs the tasks undertaken. It is the cornerstone of the law and the business basis for distinguishing self-employed contractors from employees. If in fact an employer exercises, or can exercise, behavioral and financial control of how the worker performs the work, then other formalities should not prevail in the IRS's determination. Easily "gamed" aspects, like "significant costs of training", should not obscure what common law and common sense tells you is an employee.

**4) Because independent contracting affects laws far beyond the tax code, corrective legislation should be comprehensive, not narrow.**

Labor laws affecting benefits, hours and wage rates, discrimination, unfair labor practices, and even important parts of copyright and environmental laws, are based on employment. They do not apply (or they apply differently) to self-employed workers. A solution limited to the tax code leaves small business -- our customer base -- in the position of having a worker classified as independent for one law and an employee for another. Coordination and consistency are needed in the standard and in the implementation. Neither exists now.

The problems of classification go deeper than IRS processes. Until the arbitrary statutory distinctions between the treatment of independent contractors and the treatment of employees are eliminated, legislation will only cure the symptoms, not the cause.

Much of our social policy assumes an employee-employer relationship. If these assumptions are to be changed then it must be accomplished directly and comprehensively. The marketplace should not be distorted with limited exemptions. Public policy decisions that liberalize the use of independent contractors should take into account the impact on all other government and social interests.

**5) Small businesses are the incubators for innovative technologies and services, and are stepping stones for economic development; their needs, resources, and challenges differ both in kind and degree from larger established businesses.**

UPS picks up packages from over 1.3 million businesses a day, and delivers to many more. Most of these are small businesses. The success or failure of small business has a profound effect on UPS. Every 50 additional packages a day that small business feeds into our system, creates a new job at UPS.

The predominant problems of IRS classification center on small business. Legislative solutions should address those problems on a small business specific basis; the other issues associated with worker classification should be addressed comprehensively.

Thank you for the opportunity to testify. UPS will be pleased to provide whatever assistance would be helpful as the subcommittee proceeds on this matter.

Chairman JOHNSON. Thank you.

Mr. Pyles, Home Health Services and Staffing Association from Alexandria, Virginia, on behalf of the Coalition for Fair Worker Classification.

Mr. Pyles.

**STATEMENT OF JAMES C. PYLES, COUNSEL, HOME HEALTH SERVICES AND STAFFING ASSOCIATION, ALEXANDRIA, VIRGINIA, ON BEHALF OF THE COALITION FOR FAIR WORKER CLASSIFICATION, WASHINGTON, DC**

Mr. PYLES. Thank you, Madam Chairman.

I am James C. Pyles. I represent the Home Health Services and Staffing Association. We are made up of small and large businesses that provide supplemental nursing staff to health care facilities and home health care services directly to patients. HHSSA is also a member of the Coalition for Fair Worker Classification, which includes representatives of associations of large and small businesses, management and labor, who feel that legislation is needed in this area to curb the intentional abuse of the independent contractor designation.

The Coalition does not oppose the legitimate use of independent contractor status, but is opposed to the pervasive and growing practice by which some businesses ignore the law or exploit its ambiguities in order to gain a competitive advantage over law-abiding companies.

Certainly, the anecdotes of individuals that have been subjected to heavy penalties for misclassifying workers generate sympathy, but what about the concerns of the vast majority of companies that comply with the law, collect and pay employment taxes, incur other overhead costs associated with the designation of workers as employees?

For example, what about the concerns of the building service contractor in the deep South who has to lay off 4,000 workers and loses \$5 million a year to competitors who misclassify workers as independent contractors? What about the manufacturers in the garment industry in Dallas, Texas, who have been driven out of business by companies that produce clothing at cut-rate prices by using illegally classified independent contractors? What about the company that loses a multimillion-dollar government shipbuilding contract on Groton, Connecticut, because its competitor reclassifies all of its workers as independent contractors and is thereby able to submit a lower bid? What about the small supplemental medical staffing company in Parma, Ohio, that loses its principal hospital contract because a competitor offers to provide the same services through independent contractors in violation of the IRS' consistent rulings? What about the concerns of workers who are deprived of health insurance, overtime pay, protections of the child labor law, worker's compensation and unemployment laws by employers who misclassify them as independent contractors without their approval and against their will? Where do the concerns of these individuals in businesses get taken into account? These are truly what I view as the silent majority.

No one would dispute that the current test for distinguishing between employees and independent contractors is ambiguous and

difficult to apply consistently. Enforcement of that law, however, is made virtually impossible by section 530 of the Revenue Act of 1978 which imposes a perverse burden of proof on the IRS, establishes safe harbors that ensure arbitrary application of the law, and forbids clarification of the definition of employee. Accordingly, this hopelessly ambiguous area of the law has not been clarified because section 530 prohibits it.

H.R. 1972 and section 582 do little to make the law more understandable and enforceable. H.R. 1972, for example, does not clarify the definition of employee or repeal section 530, but rather simply adds a definition of workers who will be deemed to not be employees. All of the ambiguities and inequities of the existing law are allowed to remain intact.

Although H.R. 1972 professes to clarify the existing law through the addition of objective standards, the criteria contained in the bill are vague and would be impossible to equitably enforce.

Further, the criteria completely ignores the issue of control which has been the core principle used in this country for over 200 years for distinguishing between employees and independent contractors.

For example, a worker could be classified as an independent contractor even though the worker's every movement was controlled by the employer if the worker paid for his own education or had school loans. This creates a novel legal concept, the totally dependent independent contractor.

Accordingly, the effect of H.R. 1972 would make the classification of most workers completely discretionary for most employers. In effect, it would say, "raise your hand if you use employees."

In addition, H.R. 1972 does not incorporate a consistency principle which appears even in section 530. Accordingly, employers would be permitted to treat some or all of their workers as employees today, independent contractors tomorrow, and employees again the next day. Such manipulation of the work force is likely since it would enable businesses to qualify for certain contracts and loans for small businesses regardless of the size of their actual work force. It also is going to be significant in who can avail themselves of a medical savings account if the Kennedy-Kassebaum bill goes through.

We also do not favor H.R. 582 because it incorporates the safe harbors of section 530 of the Internal Revenue Code and retains the illogical and inequitable prior audit safe harbor.

A recent study performed by the accounting firm of Coopers and Lybrand concluded that misclassification of workers under the current law will cost the government approximately \$35 billion over 9 years. The cost would obviously be higher if the employment tax laws were liberalized as proposed in these bills. This kind of revenue loss is difficult to defend at a time when Congress is contemplating cutting approximately \$200 billion over 7 years from the Medicare Program.

Rather than legitimizing the abuse that is currently occurring at the cost of billions of dollars in tax revenue, we recommend a more moderate approach that still addresses the concerns identified in the White House Conference on Small Business. We recommend the approach taken in H.R. 510, a bipartisan bill sponsored by Republican Congressman Christopher Shays and Democratic Con-

gressman Tom Lantos. We believe this bill will generate moderate savings and will clarify the rules for distinguishing between employees and independent contractors in a manner that is equitable, understandable, and consistent with other Federal and State laws.

The bottom line is the approach taken by H.R. 1972 and 582 is like solving the drug problem by legalizing hard drugs. It is too radical, it is too liberal, and it is too costly.

Thank you.

[The prepared statement follows:]

HOUSE COMMITTEE ON WAYS AND MEANS  
SUBCOMMITTEE ON OVERSIGHT

HEARING ON EMPLOYMENT CLASSIFICATION ISSUES

JUNE 20, 1996

Submitted by: James C. Pyles, J.D.,  
Counsel for the Home Health Services and Staffing Association

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Madam Chairman and members of the Subcommittee, I am James C. Pyles, counsel for the Home Health Services and Staffing Association ("HHSSA"), which is an association of small and large businesses providing supplemental nursing staff to health care facilities and home health services directly to patients. HHSSA is a member of the Coalition for Fair Worker Classification, which includes representatives of associations of large and small businesses, management and labor, who feel that legislation is needed to curb the intentional abuse of the independent contractor designation. The associations that are members of the Coalition represent thousands of businesses and millions of workers nationwide.

The Coalition represents the businesses that take the trouble to determine how the employment tax laws apply to their activities and comply with the law. The Coalition does not oppose the legitimate use of the independent contractor status but is opposed to the pervasive and growing practice by which some businesses ignore the law or exploit its ambiguities in order to gain a competitive advantage over law-abiding companies.

We certainly do not favor the arbitrary enforcement of the law by the IRS, but we believe that a much greater danger to small and large business is the intentional abuse of the employment tax laws as a corporate strategy to gain a competitive advantage and maximize profits.

Certainly, the anecdotes of individuals that have been subjected to heavy penalties for misclassifying workers generate sympathy. But what about the concerns of the vast majority of companies that comply with the law, collect and pay employment taxes, and incur the other overhead costs associated with the designation of workers as employees? For example:

1. What about the concerns of the building service contractor in the deep South who has to lay off 4,000 workers and loses \$5 million a year to competitors who misclassify workers as independent contractors?
2. What about the manufacturers in the garment industry in Dallas, Texas who have been driven out of business by companies that produce clothing at cut rate prices by using illegally classified independent contractors?
3. What about the company that loses a multimillion dollar government shipbuilding contract in Groton, Connecticut because its competitor reclassifies all of its workers as independent contractors and is thereby able to submit a lower bid?
4. What about the small supplemental medical staffing company in Parma, Ohio that loses its principal hospital contract because a competitor offers to provide the same services through independent contractors in violation of the IRS' consistent rulings?

5. What about the concerns of workers who are deprived of health insurance, overtime pay, and protections of the Child Labor, workmen's compensation, and unemployment compensation laws by employers who misclassify them as independent contractors without their approval or against their will?

Where do the concerns of these individuals and businesses get taken into account?

The sponsors of H.R. 1972 and 582, as well as delegates to the White House Conference on Small Business, are to be congratulated for bringing the issue of fair worker classification to the forefront of the 104th Congress' agenda. Unfortunately, however, the solutions proposed in those bills fail to address the underlying problems and, in fact, will make those problems worse.

No one would dispute that the common law test, which is required by statute to be used to distinguish between employees and independent contractors, is based on a 20 factor test which is ambiguous and difficult to apply consistently. Enforcement of that law is made virtually impossible by § 530 of the Revenue Act of 1978, which imposes a perverse burden of proof on the IRS, establishes safe harbors that ensure arbitrary application of the law, and forbids clarification of the definition of employee. Accordingly, this hopelessly ambiguous area of the law has not been clarified because § 530 forbids it.

Section 530 produces numerous anomalous results. For example, a business that has had an IRS audit for any reason since 1977 can misclassify workers with impunity forever into the future. Businesses that have misclassified workers in violation of the law and can cite examples of significant similar misclassifications among their colleagues also receive lifetime immunity. Section 530 also imposes a virtually impossible burden of proof on the IRS by establishing a presumption that an employer has a reasonable basis for not treating the worker as an employee unless the IRS can prove the negative -- that no such reasonable basis exists.

H.R. 1972 and 582 do little to make the law more understandable and enforceable. H.R. 1972, for example, does not clarify the definition of employee or repeal § 530 but rather simply adds a definition of individuals who will be deemed to not be employees. All of the ambiguities and inequities of the existing law are allowed to remain intact.

Although H.R. 1972 professes to be intended to clarify the existing law through the addition of "objective" standards, the criteria contained in the bill are vague and would be impossible to equitably enforce. For example, the bill would permit workers to be classified as independent contractors if they had a "significant" investment in assets or training or had "significant" unreimbursed expenses or agreed to perform the service "for a particular amount of time." None of these key terms is defined and, with the prohibition on clarification in § 530 unrepealed, no clarifying regulations could be issued.

Further, the criteria completely ignore the issue of control which has been the core principle used in this country for over 200 years for distinguishing between employees and independent contractors. For example, a worker could be classified as an independent contractor even though the workers' every movement was controlled by the employer if the worker paid for his or her own education or had school loans. A worker under a similar degree of control could also be classified as an independent contractor if he agreed to complete a job in ten years or within his lifetime, since that would clearly be "a particular amount of time."

Accordingly, the effect of H.R. 1972 would be to make the classification of most workers completely discretionary for most employers.

In addition, H.R. 1972 does not incorporate a "consistency" principle, which appears even in § 530. Accordingly, employers would be permitted to treat some or all of their workers as employees today, as independent contractors tomorrow, and as employees again the next day. Such manipulation of the work force is likely, since it would enable businesses to qualify for certain contracts and loans as small businesses regardless of the size of their actual work force.

Even though H.R. 1972 is ostensibly directed at an issue identified by the small business community, the provisions of the bill apply equally to big business. Thus, it would appear that the bill may trigger massive reclassifications on an initial and continuing basis.

H.R. 582 is a somewhat better piece of legislation in that it is less vague and repeals § 530. We do not favor this legislation, however, because it incorporates the safe harbors of § 530 into the Internal Revenue Code and retains the illogical and inequitable "prior audit" safe harbor.

Both bills suffer from the problem that they are likely to cost the government billions of dollars in lost tax revenue. We understand that H.R. 582 has already been scored by the Joint Committee on Taxation as costing nearly \$600 million over 5 years. That amount is likely to increase to nearly \$1 billion over the 7 year planning horizon used for budgeting purposes. We believe the cost of H.R. 1972 will be much higher, because the criteria are more liberal and it contains no funding source, such as increased fines for failure to file information returns, as does H.R. 582.

A recent study performed by the accounting firm of Coopers and Lybrand concluded that misclassification of workers under the current law will cost the government approximately \$35 billion over nine years. The cost would obviously be higher if the employment tax laws were liberalized, as proposed in these bills. This kind of revenue loss is difficult to defend at a time when Congress is contemplating cutting approximately \$200 billion over 7 years from the Medicare program on which many of our nation's frail elderly depend.

Rather than legitimizing the abuse that is currently occurring at the cost of billions of dollars in tax revenue, we recommend a more moderate approach that still addresses the concerns identified at the White House Conference on Small Business. We recommend the approach taken in H.R. 510, a bipartisan bill sponsored by Republican Congressman Christopher Shays and Democratic Congressman Tom Lantos. That bill provides for the following:

1. It removes the prohibition on the issuance of regulations clarifying the distinction between employees and independent contractors.
2. It allows an amnesty period for employers to properly classify workers without penalty.
3. It provides for notification of workers of the consequences of being classified as independent contractors so they can make informed decisions about where they work.
4. It narrows the "prior audit" safe harbor to apply only in cases of prior audits that actually considered the employment tax issue.

We believe this bill will generate moderate savings and will clarify the rules for distinguishing between employees and independent contractors in a manner that is equitable, understandable, and consistent with other federal and state laws.

I would be glad to answer any questions.

Chairman JOHNSON. Thank you.  
Mr. Northrop.

**STATEMENT OF CLYDE NORTHROP, PRESIDENT, AMERICAN ASSOCIATION OF INDEPENDENT NEWSPAPER DISTRIBUTORS**

Mr. NORTHROP. Thank you, Madam Chairman and Members of the Subcommittee, for this opportunity to speak to you this afternoon.

My name is Clyde Northrop, and I represent the American Association of Independent Newspaper Distributors. The AAIND was founded 25 years ago to further the welfare and education of independent newspaper carriers and distributors throughout the United States. I personally have been an independent newspaper distributor since 1973 in the State of Maryland and currently serve as president of our association.

For over 200 years, newspaper distribution in the United States has been handled predominantly by independent carriers and distributors. In recent years, the Internal Revenue Service has begun an effort, national in scope, that could destroy this traditional means of newspaper distribution by reclassifying carriers and distributors from independent contractors to employees.

Newspaper carriers and distributors are the real mom-and-pop small businesses of our country. Many grew up delivering newspapers with their parents, their brothers, their sisters, and went into the newspaper distribution business as adults. It is not unusual to find second- or third-generation people in this very special business.

The business includes youth carriers getting their first taste of the free enterprise system, adults who deliver newspapers on a part-time basis to supplement their otherwise modest incomes, and adults who deliver newspapers on a full-time basis. These people are classic entrepreneurs.

Both carriers and distributors enjoy the ability to set their own hours, work with whom they wish, and build their individual businesses as they choose. They have always operated as independent contractors. They do not want to be employees.

They cannot understand why the IRS is attempting to put them out of business as independent contractors, even though they've followed the rules and paid all their taxes.

These are not individuals that have lawyers and accountants on retainer. These are the smallest businesspeople that are the easiest for the IRS to intimidate.

In Kansas City, distributors refused to be intimidated when they got letters from the IRS saying that they owed extra taxes since they were wrongly classified as independent contractors and the IRS said they should have been employees.

The distributors, with the help of the newspapers Congressman Hoyer alluded to, in fact, filed some cases in U.S. Tax Court. In one of the cases, the IRS took the position that the distributor was an employee for one newspaper he delivered, but allowed him to be treated as an independent contractor for another newspaper that he had a similar contract with.

On the eve of the trial that was scheduled for May 15, 1996, actually on May 6, 1996, just a few weeks back, the IRS abruptly

dropped the cases conceding that the taxpayers in the test case and all the cases were, in fact, independent contractors. This was after more than 2 years of wasteful IRS audits and distributors threatened with financial ruin. The reclassification audit should have never been started since the IRS conceded that it didn't have a case.

The Kansas City situation is by no means an isolated situation. The IRS has challenged the independent contractor status of distributors and carriers throughout the United States. At this moment, the IRS is challenging the independent contractor status of carriers in Illinois, Florida, California, Minnesota, New Jersey, Pennsylvania, New Hampshire, Massachusetts, and Texas, and those are just the cases that our association is familiar with.

The pattern is clear. If an independent contractor or distributor alone or with the help of his newspaper can afford to hire a major law firm to sustain a legal challenge of 2 years, then, in fact, its classification will be upheld. Otherwise, he is going to be reclassified by the IRS and put out of business as an independent businessperson.

We asked for some clarification from the Congress, and fortunately in 1995, we got just that in the budget reconciliation bill.

This year, just recently, the Senate Finance Committee reported out in their small business package additional clarification language which simply states that newspaper carriers and distributors fall under the direct seller rules of the Tax Code and that they, in fact, under the direct seller rules are independent contractors.

We are calling this a clarification because it is the direct seller rules that all of the carriers and distributors in this country have operated under for the last 16 years, since there has been direct seller rules, and that the IRS has had no problem with up until 1994 when they reinterpreted their Code.

I thank the Subcommittee for your support of the Direct Seller Clarification amendment. I also thank other Members for helping us to preserve the entrepreneurial dream of newspaper carriers and distributors that independently operate their own small businesses.

Thank you.

[The prepared statement and attachments follow:]

**STATEMENT OF CLYDE NORTHROP,  
PRESIDENT, AMERICAN ASSOCIATION OF  
INDEPENDENT NEWSPAPER DISTRIBUTORS**

**BEFORE THE HOUSE COMMITTEE ON  
WAYS AND MEANS**

**SUBCOMMITTEE ON OVERSIGHT  
JUNE 20, 1996**

Chairwoman Johnson and Members of this Subcommittee:

My name is Clyde Northrop, President of The American Association of Independent Newspaper Distributors (AAIND). AAIND was founded to further the welfare and education of, and communication between, independent newspaper distributors and carriers throughout the United States. I also have been a newspaper distributor for 23 years. I am presenting this testimony on my own behalf and on behalf of AAIND and its members.

This testimony discusses the IRS's attempt to reclassify newspaper distributors and carriers as employees rather than independent contractors and addresses the need for legislation to clarify the status of distributors and carriers as independent contractors. AAIND strongly supports enactment of the direct seller amendment that was part of the Balanced Budget Act of 1995 which passed both Houses of Congress. That legislation would clarify that newspaper distributors and carriers can qualify as statutory independent contractors under section 3508 of the Internal Revenue Code.

IRS Challenge to Independent Contractor Status

For over two hundred years, newspaper distribution in the United States has been handled predominantly by independent distributors and carriers who now number over 600,000.

Newspaper distributors and carriers are the real "mom and pop" small business people of our country. Many grew up delivering newspapers with their parents, brothers and sisters, and went into the newspaper distribution business as adults. It is not unusual to find second and even third generation men and women in this special business.

The business includes youth carriers acquiring their first taste of the free enterprise system, adults who deliver newspapers on a part-time basis to supplement their otherwise modest incomes, and adults who deliver newspapers as a full-time business.

These people are classic entrepreneurs. Both distributors and carriers enjoy the ability to set their own hours, work with whom they wish, and build their businesses as they choose. They have always been independent contractors; they don't want to be employees. They can't understand why the IRS is taking actions against them that may put them out of business, even though they've followed the rules and paid the taxes they would owe as independent contractors.

In recent years, the IRS has begun an effort, national in scope, that could destroy this traditional means of newspaper distribution by reclassifying distributors and carriers from independent contractors to employees. At this moment, the IRS is seeking to reclassify distributors and carriers in Illinois, Texas, New Hampshire, Massachusetts, New Jersey, Pennsylvania, Florida, Minnesota, and California.

The newspaper company itself may have no exposure because it qualifies for section 530 relief under the Revenue Act of 1978, which permits the company to treat workers as independent contractors for employment tax purposes as long as it had a reasonable basis for its position and satisfies certain other tests. But section 530 does not provide any protection to the worker. Where the IRS has been stopped from collecting employment taxes at the company level because of the availability of section 530 relief, it has initiated wide-scale audits of individual newspaper distributors and carriers. In many of these cases, the distributors and carriers are mere pawns in the IRS fight to coerce the newspaper to convert its workforce to employees.

These distributors and carriers are not individuals who have lawyers and accountants on retainer. For small businessmen who deliver the paper, the prospect of an IRS audit challenging their status as an independent contractor is an intimidating experience because of the power of the IRS and the expense of defending the audit. The taxes that the IRS seeks to collect would put many distributors or carriers out of business. In reclassifying the distributor or carrier as an employee, the IRS often disallows any deduction for the distributor or carrier's substantial cash expenses of delivering the paper (gas, insurance, vehicle maintenance and supplies) and imposes an alternative minimum tax that can be confiscatory.

If the IRS asserts additional FICA tax, that tax must be paid before it can be contested. A small businessman generally does not have the resources to pay the tax in advance, and the IRS can seize his property to satisfy that tax.

Here are some recent examples of IRS actions that show the need for clarifying legislation:

- Beginning in 1994, the local IRS offices in Kansas City began a special audit program to reclassify distributors of The Kansas City Star Company as employees rather than independent contractors. The IRS individually audited over 100 distributors during a two-year period, causing distress, distraction and disruption among the distributors who didn't know how they should file their returns in light of conflicting IRS approaches and didn't know how they would pay their tax bill if the IRS found them to be employees. At first, the IRS took the position that all distributors were employees. As the audits and the appeals process progressed, the IRS began to take the position that some distributors were employees while conceding that others were independent contractors. Without drawing any clear line, the IRS seemed to be saying that smaller distributors are employees but that larger distributors are independent contractors even though all operated under the same contracts. That left the IRS taking the anomalous position that one larger carrier was an independent contractor, but that other family members who also were distributors under similar contracts were employees simply because their routes and scale of operations were somewhat smaller. In another case, the IRS took the position that a distributor was an employee of The Kansas City Star while allowing him to be an independent contractor for another newspaper under a similar contract.

In order to end the controversy, two carriers filed test cases in the Tax Court to establish their independence and the independence of other similarly-situated distributors. Trial was scheduled to begin on May 15. On the eve of trial, the IRS conceded that the two distributors (and two additional distributors who had filed Tax Court petitions) were independent contractors. In addition, the IRS indicated that it was conceding the classification issue in all pending and open cases involving Kansas City Star distributors and that it had

terminated the special audit program to reclassify Kansas City Star distributors as employees.

The controversy ended with the right result, but look at the cost: two years of wasteful and costly IRS audits that threatened distributors with financial ruin. Those audits should never have been started since the IRS later conceded that it didn't have a case.

- In September of 1994, the IRS District Director in St. Paul, Minnesota issued a newsletter called "Tax Topics" (copy attached) which took the position that newspaper carriers who met five criteria would be treated as employees. The criteria were that the carriers were paid a specified amount for the newspapers delivered; were not involved in billing and collection; delivered the newspaper to a place specified by the customer; used their own equipment to deliver the newspaper (we always thought ownership of equipment was a strong factor in favor of independence); and did only a limited amount of work to prepare the newspaper for delivery. That newsletter was given by the IRS to local tax return preparers who were cautioned that they should not assist carriers in filing tax returns as independent contractors if they met the stated criteria. As a result, carriers found it difficult to even get assistance in filing their tax returns as independent contractors.

- In 1995, four carriers of the Rochester Post-Bulletin in Minnesota were told that they each owed back taxes and interest of thousands of dollars as a result of the IRS' determination to reclassify them as employees. If they did not have the money, the IRS told them they should consider taking a second mortgage on their homes. An IRS Appeals Officer has now upheld the reclassification. In response to the carriers' submission of a 1990 written decision of the National Labor Relations Board which held that the carriers were independent contractors, not employees, under the same legal standard being applied by the IRS, the IRS simply stated that it was not bound by and disagreed with the decision. Although the carriers presented detailed evidence in support of the twenty common law factors of independent contractor status, the IRS turned a deaf ear. For example, the carriers produced evidence that they are responsible for the payment of all expenses in connection with their delivery services, including the printing of business cards with home and car telephone numbers in the event of renewals or complaint calls from customers, and including the cost of customer gifts such as ballpoint pens advertising the distribution services of a carrier. The Appeals Officer rejected these practices as evidence of independent contractor status, stating that "[t]he purchasing of these items may be nothing more than an ego trip by the carrier." Most recently, the carriers have been told by the Appeals Officer that there is nothing that they could do to revise their relationship to make it one of independent contractor status as "it is IRS national policy" to treat them as employees. Although the IRS may disavow it, its policy in many parts of the country appears to be that newspaper distributors and carriers automatically are employees irrespective of the common law test.

Direct Seller Clarifying Legislation

The need for legislative clarification is clear. To avoid continuing conflict with the IRS and needless expense in debating whether newspaper distributors and carriers are independent contractors under the common law test, AAINND supports enactment of a provision that would clarify that newspaper distributors and carriers can qualify as independent contractors if they meet the direct seller test of section 3508 of the Internal Revenue Code as an alternative to the common law test. Congress has already once approved such an amendment as part of the budget reconciliation proposed legislation in 1995. The amendment received bipartisan support and was scored by the Joint Committee on Taxation as having a "negligible" effect on the federal budget.

Even the IRS has acknowledged that the direct seller amendment would provide needed clarification. In an October 31, 1995 letter to Senator D'Amato, Assistant Commissioner (Examination) of the IRS, L.E. Carlow, stated, "The Service recognizes that this [the independent contractor classification] is a difficult and contentious issue. We agree that, if enacted into law, the proposed legislative change to Internal Revenue Code section 3508 [the direct seller provision] will add clarification to this issue for many carriers and distributors."

There is still a pressing need for that amendment. In the absence of that clarification, the IRS will continue its attack on independent newspaper carriers and distributors across the country. Left unaddressed, the IRS may succeed in removing the opportunity for generations of small business people who want to be their own boss.

The independent newspaper carriers and distributors in this country are people who work hard daily and have followed the rules. They look to the people they have voted for all these years to correct what is unquestionably an out-of-control situation. They need this clarification now, as every month that goes by sees more carriers and distributors subject to unnecessary and costly IRS audits and the threat of being forced out of business if they are reclassified as employees.

AAIND thanks the Chair of this Subcommittee and other members of this Committee for their past support of the direct seller clarifying amendment. You are helping to preserve the entrepreneurial dream of newspaper distributors and carriers to own and independently operate their own small businesses.

For all these reasons, AAINND strongly supports the clarifying amendment that newspaper distributors and carriers may qualify as "direct seller" independent contractors.

Respectfully submitted,

Clyde Northrop



# TAX TOPICS

St. Paul  
District

FROM THE DESK OF THE IRS DISTRICT DIRECTOR

SEPTEMBER, 1994

## COMPLIANCE POLICY

The Service has taken a number of initiatives in recent years to be more responsive to taxpayers who want to voluntarily resolve their compliance problems. Such initiatives include streamlined installment agreements, closing agreements, simplified offer-in-compromise procedures, and the implementation of the non-filer program. These initiatives help taxpayers who want to comply and are in the best interest of long term compliance and the United States Government.

However, the Service does not intend that their more responsive posture towards taxpayers who are trying to comply be construed as a signal that appropriate enforcement actions should or will not be taken when circumstances warrant.

IRS Commissioner Richardson clarified our compliance philosophy in her remarks before the meeting of the National Association of Enrolled Agents on August 26, 1993.

"An up-front approach to preventing compliance problems is the solution and I believe that the Internal Revenue Service's efforts in recent years to rethink our approach to enforcement programs have been correct. The concept of emphasizing education and information reporting to prevent noncompliance is sound. However, some have misunderstood this new emphasis to mean we will forego enforcement programs. Let me be crystal clear and assure that this is not the case! A tax system based on self-assessment would not be viable without strong civil and criminal enforcement programs to ensure compliance."

Noncompliance adversely affects everyone; each taxpayer is forced to pay a share of the taxes of those noncompliant businesses and individuals who do not pay their proper share. Noncompliant businesses have direct, unwarranted and unfair competitive advantage over their compliance counterparts. Enforcement action will be taken promptly in accordance with Internal Revenue Manual guidelines against taxpayers who have not shown a good faith effort to comply voluntarily. Timely actions in our interventions with taxpayers is a major factor in ensuring compliance.

### St. Paul District Tax Topics

The Service is strongly committed to the success of the Electronic Filing Program and its continued growth. Seminar topics will include 1995 changes, 1040PC and Electronic/Magnetic Media filing of business returns (940, 941, 1041, 1120-A(PC), 5500 series). In addition to the format above, which is geared to the experienced filers, two seminars will be specifically held for new filers. The application process, shopping for software, equipment needs, suitability, testing procedures, balance due, and direct deposit will be covered in a much greater detail, as well as the above subjects held for experienced filers. All current applicants will automatically receive an invitation, as well as anybody contacting our office asking to be placed on the mailing list.

You will see many changes this year with the program. The Service will begin a strong marketing approach to educating the public and encouraging individuals to ask for "Electronic Filing". Some alternatives include filing from your home computer, expansion at volunteer sites (VITA/TCE), IRS offices, and employers offering this service to their employees. Due to many pending changes, including asynchronous or standard modem filing, there will be no July update of Pub. 1345, Electronic Filing Handbook. Be sure to attend one of the scheduled seminars to plan a successful year before the December revision is distributed. For information about any of the above topics, you may contact Michelle Benson, District Electronic Filing Coordinator, at (612) 290-3379.

<u>Date</u>	<u>Time</u>	<u>Location</u>
September 27	8:30 - 11:00 a.m.	St. Paul Galtfer Plaza
* September 27	12:00 - 3:00 p.m.	MN Dept. of Revenue Bldg.
October 4	9:00 - 11:30 a.m.	Hennepin Tech. College Brooklyn Park
** October 5	9:00 - 12:00 noon 8:00 a.m. - 1:00 p.m.	Normandale/Pentagon Park Exhibitors
October 6	9:00 - 11:30 a.m.	Duluth Technical College
October 11	9:00 - 11:30 a.m.	MN Riverland Tech College Rochester
October 13	9:00 - 11:30 a.m.	St. Cloud Tech College
October 14	9:00 - 11:30 a.m.	South Central Tech College - Mankato

\* For new participants

\*\* For new participants, exhibitors will also be present from 8:00 a.m. - 1:00 p.m.

### EMPLOYMENT STATUS REQUESTS

The St. Paul District has received a number of requests for a determination of the employment status of adult newspaper carriers. These

## St. Paul District Tax Topics

## carriers:

- \* were paid a specified amount directly by the newspaper for each newspaper delivered,
- \* were not involved in the collection process (the billing and collection process was done through the newspaper office),
- \* delivered the newspaper to the individual customers either by placing the newspaper in a newspaper holder near the customer's residence or by placing the newspaper near the front door of the customer (or a similar place specified by the customer),
- \* used their own transportation to deliver the newspaper, and
- \* did only a limited amount of work to prepare the newspaper for delivery, such as place the newspaper in a plastic bag, wrap it in a rubber band, or place advertising inserts in certain issues of the newspaper.

If the newspaper carrier meets the above criteria, the Internal Revenue Service has determined that the carrier is an employee of the newspaper, as defined by Internal Revenue Code Section 3121(d)(2). However, even though we have determined that these delivery people are employees for the purpose of Federal taxes, the newspaper may not be required to treat these carriers as employees because it has an exemption from doing so under Section 530 of the Revenue Act of 1979. Because of this exemption, the newspaper is not required to withhold Federal income tax or deduct Social Security Tax, and it is not required to issue a Form W-2. Rather, it issues a Form 1099-Misc. These employees should report their delivery income and related expenses as follows:

1. Report the amount shown in Box 7 of the Form 1099-Misc. on Line 7 of the 1993 Form 1040;
2. Complete a Form 4137 and report the employee's share of the Social Security tax on Line 50 of Form 1040 (you need to alter this form slightly - cross out "Tip Income" at the top of the form and write in "Wages"), and
3. Claim any related delivery expenses on Form 2106. Expenses which are allowed after completing Form 2106 are transferred to Line 19 of the Schedule A and are subject to a 2% limitation based on adjusted gross income.

If you have any questions on how to complete the forms properly, please call our Taxpayer Service Division at 644-7515, toll free at 1-800-829-1040 or toll free for hearing impaired at 1-800-829-4059.

Chairman JOHNSON. Thank you very much. Your examples were very powerful.

Mr. Phillips.

**STATEMENT OF LOCKWOOD PHILLIPS, ASSOCIATE PUBLISHER, CARTERET COUNTY NEWS-TIMES, MOREHEAD CITY, NORTH CAROLINA, ON BEHALF OF THE NATIONAL NEWSPAPER ASSOCIATION**

Mr. PHILLIPS. Thank you, Madam Chairman.

I appreciate this opportunity to speak with you today, but reflecting on the remarks made just moments ago by Mr. Northrop, I must also confess to you that I am fearful of being here today because my presence in this hearing definitely raises my profile as a taxpayer.

While I and my staff take great care to pay all taxes and classify our staff properly, the current case history of audits and compliance checks in the newspaper industry leads me to conclude that aggressive audits, similar to those details in my written reports to you, my written comments, and also, those of Mr. Northrop would be onerous and financially destructive to me and my business and my employees.

In most cases, these arbitrary aggressive and harassing audits are requiring tens and hundreds and thousands of dollars to right, in spite of the historical precedence that independent contractors have served the newspaper industry, and it is interesting to note that section 530 provides safe harbor for independent contractor status applying to conditions existing since 1978.

According to my records, we have been in the business of newspapering since approximately 1778. So, therefore, you would think that we would fall under the Safe Harbor Act of section 530. That does not seem to be the case, as detailed in my comments, but let me just digress for a moment and tell you who I am.

I am the owner, along with my brother, of a triweekly, started as a weekly on the coast of North Carolina. It has grown from 5 employees to 60 employees. It is a family enterprise begun by our parents.

We have grown from 5 little merchants to 20 independent adult carriers. If we were to face the financial burden brought on by the demands and penalties being levied in our industry, we do not have a large enough experienced legal staff, such as those provided to the Washington Post or the New York Times, to fight such an audit or compliance check. We are a small newspaper providing local news, doing what larger papers have no interest in doing. We pay our taxes and file Form 1099 forms as required. We have neither the time, the money, or interest in avoiding our responsibilities by esoteric and imagined defilings. All we want to do is run a good newspaper, and in the process provide a voice and forum for our community, and through the circulation of our paper a chance for independent contractors and carriers to earn money.

Carriers of country correspondence are the people that are making a living from our enterprise. Who are these independent contractors, you may ask. They are entrepreneurs. They are high school students. They are mothers who want to stay home with their children, but want to supplement their family income. They

are retirees who are bored and want something to do to get out of the house, to make contact with others, and they are the Roy Cannons of the world, who as a teenager contracted polio, permanently crippling him and making it almost impossible to get a job in a small coastal community like Morehead City.

While he lacked the physical skills to succeed in the normal business environment, he had the courage, spirit, and mental ability to start a route in an area not serviced by any of our carriers, creating the single-largest route both geographically and in the number of customers served.

We are a small enterprise. We are attempting to provide business for others. We are growing. We have no interest in avoiding our responsibilities or our taxes. All we are asking for is clear definitive steps for classifying our staff.

As far as hiring independent contractors versus employees, we would much prefer to have employees especially in technical trades. They are people we would have control over and direction with.

In the case of carriers, it makes good sense, common sense. They are working on an average of 9 hours a week. There is no reason for them to be employees. They couldn't qualify as full-time employees.

I would like to just conclude by saying that we believe that the Christensen bill, H.R. 1972, is an excellent starting point for resolving our concerns. However, to resolve our current concerns, any legislation should solve the following three elements.

We need to discuss the issue of compensation per piece per unit. While some carriers do contract on a commission basis, there are many others that are paid on a flat fee, significant new investment including equipment. A newspaper carrier's investment usually includes primarily their cars that enables them to do their job, be it a car or a bicycle. For a photographer, it is his or her photographic equipment and studio.

Then, last, the requirement to have fixed facilities, we feel that to have a fixed facility is unreasonable and it is onerous and, in many instances, impossible, as was discussed in the previous panel.

Thank you very much for listening to my comments.

[The prepared statement and attachments follow:]

**TESTIMONY OF LOCKWOOD PHILLIPS  
PUBLISHER OF THE *CARTERET COUNTY NEWS-TIMES*  
MOREHEAD CITY, NORTH CAROLINA  
ON BEHALF OF THE NATIONAL NEWSPAPER ASSOCIATION  
BEFORE THE HOUSE SUBCOMMITTEE ON OVERSIGHT  
JUNE 20, 1996**

**Introduction**

I want to thank Chairman Nancy Johnson and other members of the House Ways and Means Subcommittee for Oversight for granting me the opportunity to present the community newspaper view of the independent contractor problem on behalf of the National Newspaper Association. I am the publisher and manager of the *Carteret County News-Times*, in Morehead City, North Carolina. I am also a member of the Board of Directors of the National Newspaper Association.

The National Newspaper Association was established in 1885 and has more than 4,000 community newspapers as members. These include most of the weeklies and more than one-third of the daily newspapers in the country with a focus upon newspapers serving smaller markets and communities. Most of our 4,000 members utilize independent contractors to carry out tasks that cannot be handled by employees. These contractors include newspaper carriers, stringers, "country correspondents," photographers, and others whose work is developed upon an arms' length agreement with the publisher. The IRS is targeting newspapers in an effort to change the long-standing industry tradition of contractor work.

At the outset, I want to stress to the Subcommittee that we are seeking to clarify what we believe is an already existing relationship. Our goal is not to reclassify employees as contractors any more than to reclassify contractors as employees. The issue is that a newspaper as a business in a local community, and an independent contractor as a local entrepreneur are each doing their best to follow the obscure common law 20-factor test and to demonstrate the validity of this industry tradition. Despite this, the IRS is still pursuing our industry with zeal. The IRS has not provided guidance and has instead pursued newspapers and sometimes the contractors themselves on a "gotcha" basis with virtually no bright line for us to follow. Our best option is to seek Congressional action to ensure the IRS has rules that are easy to follow and hard to misinterpret by local auditors.

**Independent Contractors in the Community Newspaper Business**

Allow me to first focus on the IRS's pursuit of newspaper carriers. Many Members of Congress probably had their start in business as newspaper carriers. The time honored "Junior Merchant" program lives on today. But today, newspaper carriers are more often adults. These adults, who are independent businesspersons, are being unfairly targeted by the IRS. The typical newspaper carrier is a classic entrepreneur -- a business person -- not an employee. He or she operates as a business, delivers newspapers on route by contract, files taxes as a business and offers services to a variety of customers. However, the carrier business is threatened by rampant and subjective IRS enforcement. As Daniel Webster said before the Supreme Court in 1819, "An unlimited power to tax necessarily involves the power to destroy." *McCulloch v. Maryland*, 4 Wheaton 316 (1819).

There are other independent contractors utilized by community newspapers. These contractors include writers who serve as stringers or freelancers, sometimes called "country correspondents." A country correspondent can be invaluable to a small town. Due to economic factors, several small towns may be covered by a single newspaper. The residents of each of the small towns around us want to read about local events, so the closest newspaper will seek out a local correspondent who lives in that community to cover local events and who is plugged into the heart of that community. The country correspondent or stringer is usually compensated on a per piece basis, or per story basis-- not at an hourly rate. If there is no news, the stringer doesn't work and the paper doesn't carry an unneeded expense.

Newspapers also will contract with photographers. Photographers in a local community may do wedding portraits, cover local news events, and may offer their services to a variety of customers. Again, a newspaper will compensate the photographer on a per piece or per

photograph basis. There are also other independent contractors such as cartoonists, who may serve as free-lance artists for a variety of customers in a small community, and various delivery or production-related workers, such as desktop publishers who prefer to work at home and do layout on a contract basis.

It is important to understand that these individuals are entrepreneurs who are not interested in a typical, nine-to-five job working for one employer. They want their independence, they want the ability to set their own hours. Some may have family needs to consider or may be retired and are supplementing their retirement income. Others, by the very nature of their duties cannot work for a single employer such as the carrier who delivers several competing products.

We applaud the Subcommittee's efforts to find a solution to a problem that affects nearly every small business in America and is of vital importance to our members. We would like to work with your Subcommittee to find a resolution to the tangled web of IRS interpretations and regulations regarding the definition of an independent contractor and make it clear what the IRS chooses not to see: that the typical independent contractor is a classic entrepreneur -- a business person -- not an employee.

We also wish to stress the importance and value of the small newspaper that may often be the only information provider for America's heartland. Many community newspapers are operating on the thin edge of financial survival. Layers of subjective interpretations and burdensome regulations issued by the IRS regarding independent contractor status will force these important independent voices of America's local community into silence.

#### **Community Newspapers and the Small Town**

Allow me to elaborate. In a small town like Morehead City, North Carolina, where I am from, contractors are vital to the economy and to the financial strength of local newspapers.

These are small communities where everyone knows each other by their first name. Imagine you live in a house in the middle of a small town. You may receive your community weekly delivered by one carrier, a community daily by another carrier, and a weekly shopper by another, and even a metropolitan daily from a nearby city or the *Wall Street Journal* by still another. You also may occasionally get flowers and dry cleaning delivered by someone else. Delivery services make small town life possible, but more importantly, they offer a livelihood to its citizens. Many times there are no large companies offering full-time employment, so you yourself work part-time at the local bookstore, you fix chimneys and deliver wood during the winter, and you take pictures of local events and sell them to the local daily paper for extra money. You may even deliver the Saturday edition. You enjoy living in your small town for the sense of community and the peaceful surroundings. You have made the choice not to seek fortune and fame in a large city. You enjoy the independence of running your own business and you get by, just as many of the small businesses in your town do.

Suddenly, you face a hefty IRS assessment for failing to pay income taxes. The IRS has decided your business isn't really a business and wants you to pay for multiple sins on your tax form. How will you pay? How will this affect your local newspaper since it cannot rely on you to deliver its Saturday edition anymore? The newspaper can also face heavy fines and penalties -- perhaps heavy enough to drive it out of business. What will happen to your community without its newspaper?

#### **IRS Actions Against Newspapers**

Let me give you some examples. Recently, the IRS targeted a newspaper carrier, a man at the end of his working career, with an audit of his business expenses. He was assessed nearly \$10,000 in back taxes for the previous three years, a period when the IRS claimed that the carrier was an employee and that certain expenses were not deductible. Yet the newspaper he delivered, *Rochester Post Bulletin* (MN), had written contracts and followed not only what it thought were IRS rules, but was careful to avoid exercising control over delivery. It appropriately filed 1099's for the carriers as the IRS requires. It treated the carriers in all instances as contractors. The IRS denied the independent contractor status because, among other things, it found that some subscribers pay for their subscriptions at the office, rather than directly to the carrier.

Despite the fact that the carrier was clearly compensated on a contract basis and behaved in all respects as an independent business, the IRS chose to see an employee there and determined the payment arrangement overrode the other factors. Newspapers frequently have Pay in Advance (PIA) systems, or permit payments to be mailed to the company directly, but carriers are still paid on a per-piece basis or on a flat-rate basis, not by a salary or hourly wage. These carriers operate in true independent fashion. Many in fact deliver a daily paper and then go out again to deliver a *competing weekly*, something no employee could do.

Another example comes out of Washington, Pennsylvania. In 1993, the controller of the morning *Observer Reporter* received a call from an IRS agent stating the paper's federal employment tax returns, Forms 940 and 941, had been assigned to him for review. In a follow-up letter, he asked the controller to provide photocopies of the following documents for the tax year 1992: form 1120; Forms W-2, W-2C, W-3, W-3C, W-4, and UC2; contracts between businesses and independent contractors; Forms 941, 1099, 1096; invoices from independent contractors; general-ledger pages; cash-disbursements journal; form 1099 payment journal; and canceled checks.

The newspaper's controller and general manager met with the IRS agent for several hours. Before leaving, the agent told them he was going to classify 50 motor carriers as employees. In the past several years, the newspaper's top managers, accountants, and tax lawyers have spent hundreds of hours struggling with its outcome. Last year, the IRS appeals officer presented the newspaper with a bill for \$60,000 for one year and promised it a "safe harbor." As I am sure the Subcommittee knows, the "safe harbor" generally speaking, since I am not a lawyer, grants the newspaper an exemption from employment taxes if the newspaper has a "reasonable basis" for doing so. A reasonable basis includes a "long-standing practice of a significant segment of the industry," such as newspaper carriers. A \$60,000 harbor is a pretty costly one, something most community newspapers could never afford. The matter is still unresolved after three years. The publisher of the newspaper has detailed his impression of this experience in a letter to the Subcommittee, which I attach to my written testimony.

A third example comes from yet another newspaper in Minnesota, which asked not to be named, as its carrier has been intimidated by the IRS. In this case, the carrier was delivering not only a daily newspaper and a weekly newspaper, but materials for a local bank. He was following the rules, he thought, and the newspapers thought they were also following the rules. Yet his contractor status was denied, and he was ordered to pay \$3,000 in back taxes. Among the grounds of denial was the assertion that he did not participate in the making of the product he was delivering. Presumably, the IRS believes a contractor who delivers cake for a bakery must also bake the cake. We find this example absurd -- particularly after we learned the person's status as an independent contractor for the bank was allowed, even as his status as a paper carrier was denied. We can only assume he was not printing the money he delivered. You can understand why we believe we are being targeted.

There are many such examples that are a result of the IRS's subjective rules on the differences between an independent contractor and an employee, applied arbitrarily. Even the IRS admits it can draw no bright line between a contractor and an employee. If the taxing agency cannot explain the rules, how can a common citizen follow them?

Currently, the IRS follows a 20-factor test based on common law to determine whether a company exercises sufficient control over a service provider to establish an employee-employer relationship.

Now I am not going to take up your time to list these factors, but let's just say they have led to uneven enforcement, at best. Are these separate factors? Are they to be taken as a whole? Does an IRS agent pick and choose which factor to apply? A small business is required to hire a team of attorneys and accountants to figure out the safest approach in dealing with contractors. I don't know of any small business that can afford to do this. Despite a plethora of seminars and workshops to help us as newspaper publishers to figure out what we must do, many of us live in fear of the IRS's power to destroy. What has happened to the time-honored test of lack of control which served this legal question well until recent years? One supposed saving clause is the "safe harbor," but even it comes at a price, as our Pennsylvania colleague found. And it is often a mixed blessing, leading to unanticipated effects in the business.

Even with this safe harbor, the IRS is still pursuing newspapers. As one newspaper attorney said, "It's very simple. They (IRS) adopt a scorched earth policy. They've never met an independent contractor -- they're all employees." Our experts tell us that in about nine out of 10 cases, the IRS finds persons classified as independent contractors should be reclassified as employees. Since about 90% of all daily newspapers and many weekly newspapers use independent contractors to sell or distribute newspapers to home delivery subscribers, it makes a fat target for the IRS.

Has the IRS made any attempt to rectify this situation? Last year, Margaret Milner Richardson, the Commissioner of the Internal Revenue Service, testifying before the House Committee on Small Business, said that the IRS plans to develop training materials for the IRS examiners handling worker classification issues that emphasize that using independent contractors can be a legitimate business practice that will not be challenged by the IRS.

When the first draft of "guidelines" was released, it was over 100 pages long. How is a small newspaper publisher supposed to take time out to try to figure out if he/she is in compliance if the IRS itself needs over 100+ pages to do so? We are also dismayed at the IRS's attempts to settle claims after threatening costly litigation despite the fact that the accused taxpayer may have been following the IRS's own decision in a previous audit. The cost of defense is so imposing that settlements are often cheaper - and that is what the agency intends to convey, I believe.

#### **Congress Needs To Take Immediate Action**

Congress has not taken significant action to resolve this problem since 1978. Additionally, as far as I understand it, the safe harbor, Section 530, was enacted to provide temporary relief until Congress came up with a new test for independent contractors. But as I've stated, even the safe harbor is being chipped away by the IRS.

There are several legislative proposals before Congress at this time. Regardless of the specifics of these proposals, we believe it is time for Congress to take control of the situation and make certain the IRS is objective and fair in its actions against small businesses. A clear test for independent contractor status will go far in this respect.

We believe the Christensen bill, H.R. 1972, is an excellent *starting point* for resolving our concerns. It properly begins to define that all-important bright line to resolve the current uncertainty, discourage rampant harassment of taxpayers and recognize the legitimacy of independent contractors. However, to resolve our concerns, any legislative solution needs to have the following three key elements:

1. *Compensation per piece or per unit*: While some carrier contractors may be paid on a commission basis, most are paid on a flat fee basis or on a per piece basis. We are concerned about covering this method of compensation in the bill.
2. *Significant investment includes equipment*: A newspaper carrier's significant investment -- the very tool that enables him to do his job -- is his vehicle. For a photographer, it is his/her photographic equipment and studio, for the correspondent, it may be their computer. From these viewpoints, such investments are very significant and legislation should recognize its significance. The significance of an investment should be measured against the contractor's capacity, not by an arbitrary measurement.
3. *No need for a fixed facility*: The criterion for maintaining "a principal place of business" would be a problem for many delivery people, especially since the IRS has ruled that the newspaper's delivery area belongs to that newspaper. Their place of business is their car, in most cases, and there is no need for any more fixed facility.

These key elements are present in S. 1610, the independent contractor bill introduced by Senator Don Nickles and Senator Christopher Bond. NNA fully endorses S. 1610 as a good solution.

We would like to emphasize that newspapers typically are zealous in complying with IRS rules as we traditionally understood them. Writing good contracts, filing 1099 forms and adhering to the rules of control have been the subject of many training sessions for newspapers. Encouraging contractors to develop other business -- particularly delivery business -- is something that is almost second nature.

We are diligent taxpayers. In fact, the newspaper business is one of the largest taxpayers, collectively, of any industry in the United States. In this case, we are simply being harassed, and even more sadly, our carriers are being harassed. The community newspaper and its contractors are among those least able to withstand the grueling test of litigation the IRS often forces upon us. As I mentioned earlier, the community newspaper often operates on thin margins. Ours are not the fat cats of the industry. The papers are usually owner-operated and they face many of the same threats of extinction facing the family farm. Litigation threatens the newspaper's survival and the survival of the community's only independent voice.

#### **Conclusion**

We applaud the Subcommittee for its efforts in taking on a terribly important problem. The National Newspaper Association looks forward to working with you to further develop the legislation to bring clarity to what is now a very confusing and threatening situation. We want to make plain what the IRS chooses not to see: that the typical independent contractor is a classic entrepreneur, a business person, not an employee. Contractors are critical to community newspapers and their customers. It is not an exaggeration to say they hold together small communities like Morehead City, North Carolina together. Thank you.

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**Observer & Reporter**

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June 17, 1996  
 House Ways and Means'  
 Subcommittee on Oversight  
 Chairman, Nancy Johnson

As I wrote last July to the House Committee on Small Business' Subcommittee on Taxation and Finance, " The 1993 audit of independent contractors was unlike any audit we have had before." In the year that has ensued, I haven't changed my opinion.

As the issue drags into its third year, there's every indication we will be left with the alternative of accepting an unsatisfactory resolution costing "only" \$20,000 in attorney's fees ; or, face a six figure legal bill defending what has been a basic industry practice that, in our opinion, clearly meets the 20 point test for determining independent contractor status.

It's not unlike the protection racket except the payoff isn't money. It's blind obedience to whim, fancy and internal and external politics, of the Internal Revenue Service. The penalty, of course, is possible fines, penalties, interest and back taxes; expensive legal fees; and/or harassment and continual vulnerability. I call it wrestling the gorilla.

Let me insert that I have been in this business for over 40 years and my family in it for 94. Our relations with the IRS, both corporately and privately, have never been acrimonious or without mutual respect. The 1993 independent contractor audit, apparently a part of a nation wide attack on small businesses, was the converse of that.

Point by point:

1. Although we provided extensive documentation and records about our independent contractors, the auditing agent spent a surprising short time in our office. It was obvious he had predetermined his audit.
2. Subsequent meetings with our staff and our own auditors reinforced this first impression. The 20 point test, including industry practice, was no longer applicable.
3. The auditor declared that if we sought section 530 relief based on a prior audit we would have to admit that everyone involved was an employe. The IRS since then has done an about face.

4. We were told that the service might write letters to our independent contractors informing them that the service considers them employes.

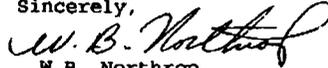
5. It was hinted that our independent drivers might be audited. We provide them with a 1099, by the way.

6. Subsequent discussions with other publishers who were targeted revealed similar patterns.

Obviously the service doesn't have to concern itself with customer relations, sensitivity, fair practices, respect, and so forth. Regulations that apply to bill collecting in the private sector obviously don't apply here, though it is difficult to understand why not.

That's about it.. Thanks for reading and listening.

Sincerely,



W.B. Northrop  
co-publisher

# Daily Herald

June 18, 1996

The Honorable Nancy Johnson  
Chairwoman, Subcommittee on Oversight  
Ways and Means Committee  
House of Representatives  
Washington, D.C. 20515

DANIEL E. DAUMANN, *President*

Dear Chairwoman Johnson:

I understand your committee is reviewing the impact of IRS treatment of independent contractors on small business, and I want the committee to be aware of our experience. It is an example of bureaucratic rulemaking harshness and inconsistency that could threaten the existence of one of a dwindling number of family-owned newspapers left in the United States.

Several years ago we decided to convert our delivery system from youth to adult carriers. The two metropolitan dailies we compete with use adults, and they were able to deliver to their customers an hour or more before our papers arrived. To deliver at a competitive hour, we needed to use adults.

We are family-owned, and we chose not to fire our youth carriers. Rather, we replaced them with adults as the youths left their routes. For more than a year, we operated two delivery systems, at great expense, simply out of loyalty to our youth carriers.

Because we exercised heavy control over the interim adult carriers, we did not believe they qualified under the IRS 20-factors test. Therefore, we treated these interim carriers as employees. Once the conversion was completed, we initiated contracts similar to those used throughout the newspaper industry, and we treated the carriers as independent contractors.

Despite our carefully designed contract, the IRS agent who visited us in 1994 determined that our carriers did not qualify on "status" as independent contractors. He indicated other newspapers treating carriers in an identical fashion would be given Section 530 relief. However, because we had treated the interim carrier force as employees, he said we did not qualify for that form of relief either. If we had brazenly misclassified our interim carriers as independent contractors, we now would have a "pass" from the IRS!

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The Honorable Nancy Johnson - June 18, 1996 - Page 2

*For trying to do the right thing, we must be punished. And punished:*

The agent assessed us for taxes on the amounts paid to the interim carriers. He next imposed a 10 percent fine for "failure to deposit." He added a 20 percent penalty claiming we had acted in reckless disregard of our tax liability, despite the fact that we had filed 1099 forms on all these individuals. In all he assessed us \$5.6 million for two tax years.

We simply cannot afford to pay an assessment like that, and we cannot afford on an on-going basis to operate with employee carriers when our huge metropolitan competitors are allowed to treat their carriers as independent contractors.

Our IRS appeals officer has been unwilling to concede either on status or on Section 530 relief. Our only options appear to be to settle or take the U.S. government to court. We believe the IRS is counting on the exposure of \$5.6 million to scare us into a settlement that will place us at a permanent competitive disadvantage.

We are pleased the subcommittee is considering legislation to rectify situations such as this; the IRS clearly needs to be brought under decent control. We believe the approach that will address our problem, and best meet the newspaper industry's need, is the Senate version, S. 1610.

Sincerely,



Daniel E. Baumann

Chairman JOHNSON. Thank you for your comments.  
Leonard Doctor, president of the National Association of State Farm Agents.

**STATEMENT OF LEONARD DOCTOR, PRESIDENT, NATIONAL ASSOCIATION OF STATE FARM AGENTS**

Mr. DOCTOR. Madam Chairman and Members of the Subcommittee, which Mr.—oh, we have more than one now. OK. Thank you for the opportunity to appear before you today to discuss the independent contractor issue.

My name is Leonard Doctor. I am president of the National Association of State Farm Agents, NASFA, and vice president of the Coalition of Exclusive Agent Associations, CEAA.

NASFA is a 23-year-old national organization which represents State Farm Insurance exclusive agents across the country. The CEAA is a national umbrella association made up of member associations which represent agents of State Farm, American Family, Farm Bureau, Minnesota MSI, Nationwide, and Allstate. These member associations draw their individual agent memberships from over 60,000 captive, exclusive, multi-line agents who serve over 65 percent of America's personalized insurance needs.

We are here today to support the efforts of Congressman Christensen and others to simplify the tax treatment of independent contractors, but also, to raise a critical issue which needs to be addressed in any such legislative initiative, including Congressman Christensen's bill, H.R. 1972.

We firmly believe that any legislation in this area should support the self-evident axiom that independent contractors be treated as truly independent. H.R. 1972 and other similar legislation must be changed to make clear that it will not allow businesses to exercise employee-like controls over agents or other independent contractors nor create other tax opportunities for control.

While these businesses at the same time treat service providers as independent contractors for Federal tax purposes, H.R. 1972 would make it easier for businesses to classify workers as independent contractors for tax purposes.

Importantly, however, these bills that are currently drafted may result in significant adverse non-tax consequences for exclusive insurance agents and others.

Under these bills, a worker can be classified as an independent contractor by meeting three simple tests, including a test which would require a written contract stipulating that the worker will not be treated as an employee for tax purposes. Once met, section 530 relief and the 20-factor test become moot.

In the case of exclusive insurance agents, these tests could be met and classification as an independent contractor would occur merely by showing that agents are: One, paid primarily on a commission basis; two, pay fair market rent for their facilities; and three, have a written contract that provides that agents will not be treated as employees for tax purposes.

By making it so easy to meet the independent contractor tax standard, H.R. 1972 would allow businesses to impose additional significant non-tax employee-like controls on workers without running afoul of the tax laws. For example, businesses could put man-

dates in time, place, and method of business operations, and exercise controls over daily business operations, all without violating the tax standard.

Clearly, these unilateral controls would negatively impact the independence of agents throughout the country. Exclusive insurance agents support the intent of H.R. 1972 to simplify tax treatment of independent contractors, but once change is made to treat independent contractors as truly independent for their business operations, the bill should make clear that it will not allow businesses to exercise employee-like controls over exclusive agents or other independent contractors, nor create other non-tax opportunities for control over such service providers while at the same time enjoying favorable treatment under the Tax Code. This simple goal can be accomplished by amending the written contract test of H.R. 1972 to require that a worker be guaranteed independence and not be treated as an employee for all purposes, both tax and non-tax purposes. This change will recognize the true independence of exclusive insurance agents.

In conclusion, we support the efforts of Congressman Christensen and others to simplify the tax treatment of independent contractors, but urge Congress to modify H.R. 1972 to ensure that independent contractors remain truly independent for both tax and non-tax purposes.

Both NASFA and CEAA stand ready to work with you, Mrs. Johnson, Mr. Kleczka, Mr. Hancock, the Members of this Subcommittee and your staffs to ensure fair treatment of exclusive agents, and I thank you for giving me the opportunity to be here today and to express our views on this important bill.

[The prepared statement follows.]

**STATEMENT OF  
LEONARD DOCTOR  
OF  
THE NATIONAL ASSOCIATION OF STATE FARM AGENTS**

Madame Chairwoman, Members of the Subcommittee, thank you for the opportunity to appear before you today to discuss the independent contractor issue. My name is Len Doctor. I am President of the National Association of State Farm Agents (NASFA) and Executive Vice President of the Coalition of Exclusive Agent Associations (CEAA).

NASFA is a 23 year old National organization which represents State Farm Insurance exclusive agents across the country. The CEAA is a National umbrella association made up of member associations which represent agents of State Farm, American Family, Farm Bureau, Minnesota MSI, Nationwide, and Allstate. These member associations draw their individual agent membership from over 60,000 captive, exclusive, multi-line agents who serve over 65% of America's personal lines insurance needs.

**I. EXECUTIVE SUMMARY**

We are here today to support the efforts of Congressman Christensen and others to simplify the tax treatment of independent contractors but also to raise a critical issue which needs to be addressed in any such legislative initiative, including Congressman Christensen's bill, H.R. 1972. We firmly believe that any legislation in this area should support the self-evident axiom that "independent contractors" be treated as truly independent. H.R. 1972 and other similar legislation must be changed to make clear that it will not allow businesses to exercise "employee-like" controls over agents or other independent contractors, nor create other non-tax opportunities for control; while these businesses at the same time treat such service providers as independent contractors for Federal tax purposes.

**II. BACKGROUND**

Most "exclusive agents" support being treated as independent contractors for tax and other purposes. At present, this tax treatment is achieved under the "Section 530" safe harbor and the "20 factor test." Please note that this treatment is separate and apart from the special statutory exceptions for the life insurance salesforce currently existing under Section 3121(d) of the Internal Revenue Code.

The Section 530 safe harbor was intended to provide relief to service recipients if they have a reasonable basis for their classification of a service provider as an independent contractor. Without this safe harbor, the "20 factor test" would apply to determine if a service provider should be treated as an independent contractor for Federal tax purposes. To the extent "employee-like" controls are imposed, treatment of service providers as independent contractors for Federal tax purposes is jeopardized. This has the result of maintaining practical independence for service providers who are intended to be treated as "independent contractors" for Federal tax purposes. Such service providers, thus, remain truly independent for both tax and non-tax purposes.

### III. H.R. 1972 AND SIMILAR LEGISLATIVE EFFORTS

H.R. 1972 on the House side, and S. 1610 on the Senate side, would make it easier for businesses to classify workers as independent contractors for tax purposes. Importantly, however, these bills as currently drafted may result in significant adverse non-tax consequences for exclusive insurance agents and others.

Under these bills, a worker can be classified as an independent contractor by meeting three simple tests, including a test which would require a written contract stipulating that the worker will not be treated as an employee for tax purposes. Once met, Section 530 relief and the "20 factor test" become irrelevant.

In the case of exclusive insurance agents these tests could be met and classification as an independent contractor would occur merely by showing that agents are: (1) paid primarily on a commission basis; (2) pay fair market rent for their facilities; and (3) have a written contract that provides that the agents will not be treated as employees for tax purposes.

While easier classification as an independent contractor for tax purposes is desirable, it can have unintended non-tax consequences. By making it so easy to meet the independent contractor tax standard, H.R. 1972 would allow businesses to impose additional significant non-tax "employee-like" controls on workers without running afoul of the tax laws. Importantly, for example, businesses could put mandates on time, place and method of business operations; and exercise controls over daily business operations; all without violating the tax standard. Clearly, these unilateral controls would negatively impact the independence of agents throughout the country.

Exclusive insurance agents support the intent of H.R. 1972 to simplify tax treatment of independent contractors, but want changes made to treat independent contractors as truly independent in their business operations. The bill should make clear that it will not allow businesses to exercise "employee-like" controls over exclusive agents or other independent contractors, nor create other non-tax opportunities for control over such service providers, while at the same time enjoying favorable treatment under the tax code.

This simple goal can be accomplished by amending the written contract test of H.R. 1972 to require that "a worker will be guaranteed independence and not be treated as an employee for all purposes (both tax and non-tax purposes)." This change will recognize the true independence of exclusive insurance agents.

### IV. CONCLUSION

We support the efforts of Congressman Christensen and others to simplify the tax treatment of independent contractors but urge Congress to modify H.R. 1972 and other similar legislation to ensure that "independent contractors" are truly independent for both tax and non-tax purposes.

It has been an honor and privilege to be here this morning. Both NASFA and CEAA stand ready to work with you, Ms. Johnson, Mr. Matsui, Mr. Christensen, the members of this Committee, and your staffs to ensure fair treatment of exclusive agents. I will be pleased to answer any questions you may wish to ask.

Chairman JOHNSON. Thank you very much for your comments, and my thanks to the panel.

Mr. Hancock.

Mr. HANCOCK. Thank you.

I would just like to make one comment on especially the newspaper industry. I remember when the Saturday Evening Post was delivered by grade-school kids. I do not guess now under the independent contractor and all of the other rules and regulations they could even do that even if they wanted to, but I do not guess there is anybody on the panel who is old enough to remember that.

One question I have, Mr. Pyles, you mentioned your organization is Coalition for Fair Worker Classification.

Mr. PYLES. That is correct.

Mr. HANCOCK. Could you furnish the Subcommittee with some of the members of your organization?

Mr. PYLES. I would be glad to furnish you a list of all of the members, but I can just tell you it is about evenly split between the employer groups and employee groups. I can tell you about my association, that is, as a member. It is an association of small companies, very small companies—some just have a single office—and some of the largest staffing and home health companies in the country. Other associations that are members have employers of various sizes and some employee groups as well, but it is the only coalition that I know of that cuts across large and small employers and employers and employees.

Mr. HANCOCK. I would appreciate that information, if you would provide that to the Committee.

Mr. PYLES. I would be glad to get it to you.

[The following was subsequently received:]

## 1996 Member List

**Auto Driveaway Company**  
Chicago, Illinois

**Building Service Contractors  
Association International**  
Fairfax, Virginia

**Carpentry Industry Partnership**  
Norwalk, Connecticut

**Fred Codding, Esq.**  
Fairfax, Virginia

**Harry L. Thomas, Inc.**  
Stamford, Connecticut

**Home Health Services and  
Staffing Association**  
Alexandria, Virginia

**Institute of the Ironworking Industry**  
Washington, D.C.

**International Brotherhood of  
Teamsters**  
Washington, D.C.

**International Union of  
Operating Engineers**  
Washington, D.C.

**Metropolitan Limousine**  
Chicago, Illinois

**Naperville Chauffering, Ltd.**  
Naperville, Illinois

**National Alliance for Fair Contracting**  
Washington, D.C. 20001

**National Constructors Association**  
Washington, D.C.

**National Technical  
Services Association**  
Alexandria, Virginia

**Painters & Allied Trades**  
Washington, D.C.

**Service Employees  
International Union**  
Washington, D.C.

**Unions for the Performing Arts**  
New York, New York

**US Cargo and Courier Service**  
Columbus, Ohio

**United Brotherhood of  
Carpenters and Joiners**  
Washington, D.C.

Mr. HANCOCK. Thank you.

Chairman JOHNSON. Mr. Kleczka.

Mr. KLE CZKA. Thank you, Madam Chairman.

We got off on a discussion on the last panel of types of independent contractors, and we used the example of the CPA, Ms. Horton who was with us, who charged \$150 an hour for her firm's work, not necessarily for her own, and then also, the computer person who comes into a small business or any business, and since we are moving into that age very rapidly of massive consulting, those are not the independent contractors that are causing a problem.

In fact, I was a small business person myself. There was no reason I should have a full-time CPA accountant on staff. So, he would do the books on a monthly basis and do the taxes, and that is not what is causing the problem today.

Let me ask you, Mr. Pfothenauer, how many drivers did you say you had with your firm? 82,000?

Mr. PFOTENHAUER. 82,000.

Mr. KLE CZKA. Wow. Now, what would be the effect on your operation should the Christensen bill pass, which is not a possibility, but nevertheless, as an example, what would happen?

Mr. PFOTENHAUER. I think you would find that it would be easier to start a company using independent contractors in our industry sector, and it might become possible to shift from an employee-based work force to a work force using independent contractors.

What you would have in that situation is a market that is extraordinarily competitive, and one in which the margins are thin. You would have a number of competitors who would make use of independent contractor.

Mr. KLE CZKA. High-labor intensity.

Mr. PFOTENHAUER. High-labor intensity. You would have competitors who had a very real cost advantage, probably in the area of about a 50-percent cost advantage when it came to their labor.

As you will recall, labor is about 60 percent of our overall cost, which puts it at around \$13 to \$14 billion a year.

Mr. KLE CZKA. We were told by previous testimony that there is no cost savings between an independent contractor and an employee. What is your reaction to that? I will ask Mr. Pyles, also.

Mr. PFOTENHAUER. It seems to me that the answer has already been provided, if I have heard correctly, because we are talking always about different industry sectors, and if we were to recommend anything, it would be that we become very industry-specific in looking at these issues.

We need to have a process set up by which we can address the issues of independent contracting, its impact on a specific industry sector, in a very open and constructive way.

I think that you would find that different industries would have different stories to tell.

Mr. KLE CZKA. Mr. Pyles.

Mr. PYLES. I think the clearest indication of whether or not there is an advantage is just to look at who is supporting the bill, and look at who is providing what testimony.

It is employers who want to reclassify workers, and I can just tell you from the standpoint of the Coalition that our employer association that it is a part of, various estimates have been given to me

that the cost of doing business through employees versus independent contractors is a differential of about 30 percent in overhead cost of collecting the taxes, of paying the taxes, doing the withholding, providing the benefits, and complying with all of the requirements that go with a worker, a worker being classified as an employee. Our companies feel like they understand the law. The IRS has been absolutely consistent in making interpretations in our area, and I have yet to hear anyone who has had a problem with the IRS on this tell us whether or not they bothered to ask how their workers should be classified.

The IRS in our experience has been extremely forthcoming with information, and you can get an instant determining from them as to whether any particular class of worker under current law should be classified as an employee or independent contractor. Certainly, the law is ambiguous and needs to be clarified, but there are ways to avoid being blind-sided, and even a small business ought to avail themselves of it.

Mr. KLECZKA. One of the questions I asked the Treasury representative, the Assistant Secretary for Tax Policy, was whether or not they look at sector practices in groups.

Let us take UPS for an example. You have competitors in the field. Let us say there are five, off the top of my head, and all of your competitors have employees, and you issue each employee a truck, a uniform, benefits, and all of a sudden, package deliverer No. 6 comes on board, does uniforms, trucks, but also calls them independent contractors. I would think, and you can respond, that should be taken into the mix and somehow looked at when this judgment is being made.

Mr. PFOTENHAUER. Very much so. I think that you would have to go back in and look at what has happened in the industry over the past 20 years and look at new entrants in the industry, and keep in mind that your goal is to neither advantage nor disadvantage a competitor with a law that is put forward out of this body. That retrospective view would be very helpful.

Mr. KLECZKA. Mr. Doctor, I am still trying to get clear on your testimony. I assume that independent insurance agents are today classified as independent contractors.

Mr. DOCTOR. The exclusive agents are termed, exclusive agents being primarily captive to one company, as independent contractors. Yes, that is correct.

Mr. KLECZKA. Is there a problem with IRS in trying to reclassify those workers?

Mr. DOCTOR. No.

Mr. KLECZKA. You are supporting the Christensen bill, I assume, from what you have said, and I am thinking that for your employee group, you do not need any help from Christensen. You are doing fine on your own.

Mr. DOCTOR. That is right. We do not need any help from him, and in fact, if his bill went through as is, it would strip away the protection that we have had for all of these years.

The 20-factor test has been a protective layer for us, and under the new simpler test, that would allow the companies to be in a position to take control of our time, place, and manner of doing business, our whole business operation.

Mr. KLECZKA. So, you currently have a problem with your treatment as independent contractors. However, if the Christensen bill did pass in its current form, that would pose a problem.

Mr. DOCTOR. Yes, it would.

Mr. KLECZKA. So, are you still for the Christensen bill?

Mr. DOCTOR. If we could have it amended, as I said in my talk here, if we could amend it to include tax and nontax purposes, we would take a much harder look at it, yes.

Mr. KLECZKA. One of your comments was you do not want to be treated as employees for tax purposes. Is that accurate?

Mr. DOCTOR. We are—no, we do not want to be treated as employees in any manner.

Mr. KLECZKA. OK, but you did mention tax purposes specifically. Is there additional liability if you are treated as an employee versus an independent contractor? The FICA tax would be the same.

Mr. DOCTOR. Additional liability to us if we were an employee?

Mr. KLECZKA. For tax purposes, what is the difference between being treated as an employee?

Mr. DOCTOR. We would actually pay less. We would pay more in taxes as an independent contractor than we would as an employee. The respective companies, I doubt would want to pick up the 50 to 60 percent overhead that we pay. They appear to be going in the direction. The Christensen bill would allow them to keep the in connection facade or title while opening up the control factor to them to treat us as employees legally under the new law that would pass.

Mr. KLECZKA. Your problem is the control aspect.

Mr. DOCTOR. Yes.

Mr. KLECZKA. OK. Thank you very much.

Chairman JOHNSON. Thank you.

Mr. Pyles, it appears that you are mostly concerned with intentional reclassification of workers and inappropriate classification of workers, but wouldn't you agree that where there is a long history of independent contractor status and where it seems rational that those companies, those independent contractors ought to have some protection under the law?

Mr. PYLES. Before I answer, let me just say I would like to second Mr. Hoyer's comments about your thoughtfulness, and certainly in the home health area, it has been very much appreciated. I am glad you are working on this issue.

As far as longstanding practice in an industry, there is a safe harbor there right now that does provide a safety valve for longstanding industry practice. The problem, though, is that section 530, as been used as a weapon by those who seek to gain a competitive advantage in the marketplace.

What we are seeing is that it is being abused not in the areas where there has been some longstanding practice. I am not aware of any case where the IRS has refused to acknowledge some longstanding practice. There might be one, but I haven't seen it.

Chairman JOHNSON. Actually, there are a lot. I mean, this is one of the things we are concerned about.

Mr. PYLES. OK. If that is true, then the IRS is disobeying the law, it's just that simple, and the courts, apparently. If that law has not been upheld in courts, then the courts have not been rec-

ognizing the law, but there are remedies. There are rights there, and there are remedies currently on the books for that, but where the abuse occurs is where a company gets a prior audit, for example, and then intentionally, can intentionally stand on a soap box in Times Square and say I am purposefully and intentionally misclassifying my workers and you cannot lay a glove on me.

Chairman JOHNSON. Yes, I appreciate that, and we did have some very good testimony about how we need to fine tune that.

Mr. PYLES. Well, that and also—

Chairman JOHNSON. But you do not object to the underlying concept of section 530 that does provide some certainty to industries that have long used an independent contractor structure?

Mr. PYLES. I am sorry. What was your question?

Chairman JOHNSON. That you do not object to—in other words, one of the problems in this area of the law is that you have government coming back into it. I mean, the newspaper carriers are a perfect example. You traditionally have done business this way.

We had a lot of testimony from people who lay cable. The cable-laying business has always been an independent contractor business.

So, one of the goals of section 530 was to protect people from the government arbitrarily going in for their own purposes, and partly because when they go in, they go in with much more power than any individual has to respond to that, and we just have had endless stories about that.

Mr. PYLES. That happens in almost any area of the law. It happens certainly in the health area, but I can tell you I think you have to back up one step. I think you have to back up and look at what is the fundamental premise of the distinction between employees and independent contractors in not only the tax law, but every law that has made such a distinction. The one element throughout the entire 200-year history of this country has been right to control.

If there is an industry that has been in existence a long time and absolutely the employers control every single nuance of what that employee does, then you would think the industry doing business in the area and having to apply this principle, and they must have had to apply it in many circumstances, would have some knowledge of a 200-year-old principle.

Now, I suppose I have some sympathy if they haven't been investigated and penalized by the IRS in 200 years as with the newspaper industry down here, but I have to say that the law does require this distinction to be made on the basis of control, and at least that element in the law has been pretty consistent.

So, you might want to go back now and change the law, but if you do go back and change this law to take control as an element out as of the distinction between employee and independent contractor, then you are putting the tax laws completely out of step with every other law that has ever tried to distinguish between employees and independent contractors.

Chairman JOHNSON. I appreciate your concern about the issue of control I do not think it is as simple as taking it out because, for example, the whole purpose of section 530 is to say people have always done it this way. Carriers have always worked for a news-

paper. If a newspaper wants their newspapers delivered three times a day instead of once a day, they do it, wouldn't you agree?

So, they do have control. Nonetheless, the history of this industry is——

Mr. PYLES. Well, I think the issue is how do you craft a rule that you can apply across all industries because it is not always easy to distinguish between industries.

Chairman JOHNSON. Well, of course, that has been a fundamental problem.

Mr. PYLES. I personally represent mostly business, mostly employers, and what employers want more than anything is consistency. They want to know what the rules are. I mean, they would like to have less rules, but they want to know what the rules are.

Chairman JOHNSON. That is absolutely true. Absolutely.

Mr. PYLES. I think we would agree, everyone agrees we need clearer rules here, but I think if you have a rule here where you distinguish between employers and independent contractors based on control, then you need to apply it consistently. It needs to apply to the newspaper industry. It needs to apply to the trucking industry. It needs to apply to the health industry.

[The following was subsequently received:]

## HOME HEALTH SERVICES &amp; STAFFING ASSOCIATION



Established in 1978

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July 9, 1996

Congresswoman Nancy L. Johnson  
Chairman, Subcommittee on Oversight  
House Ways and Means Committee  
1102 Longworth Building  
Washington, D.C. 20515-6348

Re: Hearing on Worker Classification Issues

Dear Chairman Johnson:

At the June 20 hearing on Worker Classification, you asked me a question for which time did not permit a complete answer. You correctly noted that the association I represent is principally concerned with the intentional abuse of the employment classification laws, and particularly § 530, by those who seek an competitive advantage over law-abiding companies. Tr. at 191.

You asked me, however, whether I thought some protection should be made available to companies that have a long history of treating workers as independent contractors. Tr. at 191-193. My response was that § 530 currently offers protection for longstanding industry practice but that the public policy analysis must start one step earlier. Tr. at 193.

The first question must be "What is the fundamental concept for distinguishing between employees and independent contractors?" If it is "right to control the means and method of performing the work" as it has been throughout the 200-year history of this country, then that criterion should be applied consistently.

If exceptions are to be granted, they should be granted sparingly, and the burden of obtaining an exception should be on the one seeking it. Otherwise, the exceptions will be used as a weapon by those who seek to gain a competitive advantage, and the law will slide into arbitrary enforcement, as has been the effect of § 530.

It would not seem to be sound public policy to provide that a company could successfully defend its misclassification of workers on the grounds that it had done so for many years. This approach would send the message that if you violate the law often enough, long enough, you can get away with it.

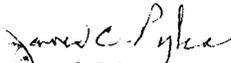
Thus, the question for Congressman Gilchrest's bus company and for Congressman Hoyer's newspaper is, did they control the means and method by which the jobs were performed? If so, the next question should be, what basis did they have for concluding that the workers were properly classified as independent contractors, given the extent of the control? If it is determined that they found the law unclear, what efforts did they make to obtain clarification?

In the absence of this type of analysis, Congress ignores the interests of the bus company that might have lost the county contract because it treated its drivers as employees. It also ignores the interests of the drivers who may have lost their health insurance, retirement, and other fringe benefits when they were reclassified without their consent.

The current state of the law is untenable because it is ambiguous and § 530 prevents the IRS from clarifying it. Based on past history, it is unlikely that Congress will be able to draft criteria that equitably and reliably distinguish between employees and independent contractors. Accordingly, we recommend that Congress repeal the § 530 ban on clarifying regulations, circumscribe the IRS' authority to issue such regulations, require the IRS to clarify the law through a rule making in which the entire public can participate and the IRS can bring its technical expertise to bear, and phase out the § 530 safe harbors once the law has been clarified.

We appreciated the opportunity to testify and look forward to working with you to resolve this difficult issue.

Sincerely,



James C. Pyles

Chairman JOHNSON. Of course, the problem is that if control hasn't been the key issue over decades, is it in society's interest to make it the key issue now? One of the points of section 530 is to recognize that the same criteria does not necessarily exist across the board.

It is just like many of you have made the argument that independent contractors put you at a competitive disadvantage, and yet, today we have had good testimony that independent contractors get paid more than some employees, and both are true.

Mr. PYLES. Two different issues, yes. Two different comments.

Chairman JOHNSON. Both are true.

Mr. PYLES. Right, both are true.

Chairman JOHNSON. So, you cannot write a law based on the assumption that independent contractors are solely a way to lower labor cost because that isn't true. Independent contractors are often a way to get expertise, and they have nothing to do with lowering labor cost.

So, we do have to be careful that we do not proceed to reform this area of the law with any single, simplistic concern as our guide, and we will table our proposal in such a way that we hope everybody who has taken the time and effort to be here and to give us their thoughts will have a chance to comment.

Now, clearly, it is not going to satisfy everybody. It is not going to be a bright line. This is a difficult area. Common sense tells you that common law in this area is not easy, but we do hope to be able to offer some clarifications and some clearer structure that will give the majority of those who are affected by this sector of the Code greater confidence and a greater protection and a greater security, and I personally hope that we can prevent problems like that from developing in the school district of Maryland because that kind of action on the part of the government is destabilizing to both the economy and to the society in a way that seems to have very little net economic benefit and very little net public value in the sense that we are not going to collect a lot more money and it is not going to be a lot fairer.

So, we want to look at all of those groups that aren't reporting at all, how do we make this a better, fairer, and more consistent system, and we thank you for your input today. Thank you.

Chairman JOHNSON. The meeting stands adjourned.

[Whereupon, at 3:43 p.m., the hearing was adjourned.]

[Submissions for the record follow:]

SUBMITTED STATEMENT OF THE  
 AMERICAN FEDERATION OF LABOR AND  
 CONGRESS OF INDUSTRIAL ORGANIZATIONS  
 TO THE SUBCOMMITTEE ON OVERSIGHT OF THE  
 HOUSE COMMITTEE ON WAYS AND MEANS ON H.R. 1972 AND H.R. 582

July 22, 1996

The American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) appreciates this opportunity to present its views on H.R. 1972 and H.R. 582; Section 530 of the Revenue Act of 1978; and the principles that should guide any legislative effort to clarify the distinction between "employees" and "independent contractors" for federal tax purposes. The AFL-CIO approaches this issue from a longstanding conviction that the tax laws' current treatment of employee classification is untenably imprecise and subject to employer manipulation and other abuses; and that the influence of tax code principles on federal employment law statutes warrants considerable care in any legislative response.

The Problems Under Current Law

Section 530(b) of the Revenue Act of 1978, PL 95-600, currently precludes the issuance of regulations or revenue rulings regarding the "employment status of any individual for purposes of the employment taxes" governed by the Internal Revenue Code until Congress enacts a statute clarifying that status. Section 530 was originally enacted as a one-year, temporary measure while Congress devised a permanent solution to the employee-independent contractor issue. Instead, Congress has failed to achieve one and Section 530 has been extended indefinitely, and so for 18 years now has tied the hands of the Department of Treasury, including the Internal Revenue Service, in providing guidance to taxpayers other than in private letter rulings that lack precedential force.

This unwise legislative restraint has persisted despite the significant changes that have marked the American workplace during this period. There has been a fundamental evolution in the relationships between enterprises for which services are performed -- that is, "employers" in a broad and non-statutory-specific sense -- on the one hand, and those who provide these services -- "employees," again in a broad and non-statutory-specific sense -- on the other hand. Part-time, temporary, contractual and other "contingent" jobs have exploded in number. Many of these positions did not exist in 1978; but an overwhelming number are simply new arrangements for the same work that both the law and common sense ordinarily considered to be performed in the relation of employer and employee.

For purposes of both the Internal Revenue Code and other statutes that regulate workplace relations, important legal consequences depend upon whether jobholders are defined as employees or independent contractors. Increasingly, workers are classified -- usually at the behest of enterprises for which services are performed -- as independent contractors. There are now construction industry companies that treat every one of the craftpersons who perform work for them as an independent contractor; taxi companies that "discharge" all their drivers and then require that they lease their cabs for a week at a time if they wish to continue to work, now as independent contractors; offices that "lay off" executives and other personnel and then contract for their services as "consultants," again with the independent contractor label; and even agricultural employers that call the migrant farmworkers who pick their produce independent contractors, despite the fact that these workers are as completely dependent upon these employers for their livelihoods as they were when they were "employees."

The minimal changes such reclassifications bring in the actual, day-to-day relationships between enterprises and job performers stands sharply contrasts with the radically different treatment accorded them by the tax code and federal employee protection laws. In most respects these laws make it cheaper and administratively simpler for enterprises to classify employees as independent contractors. These are powerful incentives that more and more employers choose not to resist. Unfortunately, the expense resulting from this definitional sleight of hand is borne

by the U.S. Treasury in the form of lost revenue, and by the workers and their families in the form of higher costs, economic insecurity and foregone benefits and legal protections.

Under the tax laws, which the proposed bills would affect most directly, the independent contractor-employee distinction governs whether enterprises must withhold income tax, withhold and pay Social Security and Medicare contributions, and pay federal and state unemployment taxes: businesses must do so for employees, but not for independent contractors. Independent contractors, but not employees, are fully responsible for the calculation and payment of federal income tax, Social Security and Medicare contributions, and they may deduct from their income certain business expenses not available to employees -- all burdens not easily carried, particularly by misclassified workers who are not skilled or professional persons.

The adverse impact of erroneous and intentional misclassification of employees as independent contractors on revenue collection and tax code administration is severe. In 1990 the House Government Operations Committee issued a report estimating that the misclassification of workers under the federal tax laws results in annual revenue losses in the billions of dollars.<sup>1</sup> Meanwhile, from 1979 to 1994 the number of annual IRS audits of employment tax returns declined by 38%. Yet a 1984 IRS audit focusing on employee misclassification determined that nearly 15% of employers misclassified employees as independent contractors.<sup>2</sup> The IRS survey found that when employers classified workers as employees, the employers reported more than 99% of their wage and salary income, but when they classified workers as independent contractors, only 77% of gross income was reported, and only 29% was reported when the appropriate IRS form (Form 1099) was filed.

The adverse consequences under national employee protection laws of misclassification as independent contractors are equally, if not more, troubling. Virtually all federal statutes that protect workers -- including the National Labor Relations Act, the Fair Labor Standards Act, the Occupational Safety and Health Act, the Civil Rights Act, the Americans with Disabilities Act and many more -- protect employees, not independent contractors. State laws that provide additional workplace protections, such as workers' compensation statutes, also usually apply only to the employer-employee relationship. And the same is true under other basic worker protection statutory arrangements under which federal and state law complement each other, such as unemployment insurance laws. In short, the employee-independent contractor distinction can make all the difference to those performing the work.

Additionally, employee benefits such as health insurance and pension plans are customarily provided by employers, if at all, only to employees, and when employers reclassify their employees as independent contractors these coverages ordinarily terminate. These workers must then -- usually with no increase in actual take home-pay -- finance such coverage themselves; but this is often an impossible task by reason of expense, complexity or both. The resulting social costs are heavy on these workers, their families and society. And a related problem arises under the Employee Retirement Income Security Act requirement concerning coverage of all employees where a pension plan is adopted; that rule is subject to evasion by misclassification.

#### Principles to Guide a Legislative Solution

Because the federal tax code so potently influences how employers structure their business operations and their relations with those who provide services to them, the AFL-CIO

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<sup>1</sup> House Committee on Government Operations, "Tax Administration Problems Involving Independent Contractors," H.R. Rep. 101-979, 101st Cong., 2d Sess. (1990). This report in turn was based on three studies by the General Accounting Office.

<sup>2</sup> Internal Revenue Service, Strategic Initiative on Withholding Non-Compliance (SVC-1) Employer Survey Report of Findings (June 1989).

believes that only legislative action can fix the misclassification mess.

Since the Supreme Court's decision in Nationwide Mutual Insurance Company v. Darden, 503 U.S. 318 (1992), the common law distinction between employee and independent contractor has been understood to apply under every federal statute that uses the term "employ" (or a variation of it) without defining this term. But pressing this common law distinction into such broad statutory service has failed for several reasons.

First, the common law distinction was developed primarily to determine the circumstances in which a business would be held vicariously liable for injuries caused by individuals performing work on its behalf. Consistent with that purpose, the common law test turns principally upon factors relevant to an enterprise's ability to direct or control the individual performing services for it. But as Judge Frank Easterbrook of the United States Court of Appeals for the Seventh Circuit has noted, while this emphasis upon direction and control makes sense in the vicarious liability context, it should not necessarily govern elsewhere. Secretary of Labor v. Lauritzen, 835 F.2d 1539, 1544 (7th Cir. 1987) (Easterbrook, J., concurring).

As Judge Easterbrook observed, where the question is "who is answerable for a wrong (and therefore, indirectly, to determine who must take care to prevent injuries)," the emphasis on direction and control is appropriate because that approach focuses upon "[who] is in the best position to determine what care is appropriate, to take that care, or to spread the risk of loss." But "[t]he reasons for blocking vicarious liability at a particular point [may] have nothing to do with the functions of" the various federal statutory schemes into which the common law concept has been incorporated. *Id.*

For example, the federal withholding and Social Security and Medicare tax schemes are primarily concerned with collecting revenue due to the government. While so-called "independent contractors" are themselves liable for paying their income and FICA (but not federal or state unemployment) taxes, the practical consequence of creating incentives for businesses to treat workers as "independent contractors" and placing a compliance obligation on individuals who are not well-equipped to shoulder that burden is to drive more and more of these individuals into the underground economy, and to make it more and more difficult for the government to ascertain compliance with the tax laws. It is surely relevant, in devising and administering a federal tax collection enforcement scheme, that businesses ordinarily can easier undertake to withhold income taxes and pay part of the FICA tax than can individual workers who are classified as independent contractors. Fairly defining work relationships in a manner that enhances reporting and collection of taxes lessens the likelihood of taxpayer compliance problems and removes opportunities for out-and-out evasion of tax obligations. The common law, tort-oriented approach to this issue, of course, takes none of these considerations into account.

Second, in spelling out the common law distinction, the courts and agencies have tended toward standards that are both complex and subjective. For example, the IRS guideline (Revenue Ruling 87-41) enumerates 20 relevant "factors" ranging from how the individual is trained to how the individual is paid to whether the individual works on or off the employer's premises. In any given situation these factors will almost always pull in more than one direction, although most of them are certainly relevant to ascertaining the actual nature of an employment relationship. But the IRS test assigns no weight to any factor, and the absence of a unifying theme or principle results in their highly subjective and uncertain application.

Indeed, the IRS standard easily lends itself to manipulation by businesses seeking to minimize their tax burden. The business can set up the relationship with its workers so as to meet a substantial number of the criteria for independent contractor status -- by altering, for example, the mode of pay, work hours, or degree of direct supervision of job performance -- and do so without varying the underlying realities of entrepreneurial control, capital investment and economic dependence.

In light of these grave problems with the current criteria for determining employee status

and of the broad-ranging impact of the misclassification problem, the AFL-CIO believes that Congress should abandon the common law test for distinguishing "employee" from "independent contractor" status for determining tax obligations and, indeed, for all purposes unrelated to the tort liability analysis function for which that test was created. At the very least Congress must adopt a simpler and more consistent approach than the 20-factor test that Congress has effectively mandated due to Section 530. And any such approach must continue to be national in scope.

In recent years, several federal and state courts, applying employee protective statutes, have articulated a standard that focuses not on direction and control considerations, but on considerations related to the working person's economic dependence on the enterprise that purchases his or her services. The ultimate question to be answered under such standards is whether the job performer is a discrete, economically independent enterprise, or a provider of services operating within another's enterprise. A standard directed toward this end would stress factors such as opportunity for profit and loss; investment in equipment or materials; partnership or other economic association with others; degree of continuity of the relationship; liability for task completion; and whether the service rendered is an integral part of the employer's business.

These factors are considered in federal and state cases applying the Fair Labor Standards Act and workers' compensation laws, and also appear in the "statutory employee" standards of 26 U.S.C. § 3121(d)(3), which provides that individuals performing certain services are employees as long as they personally perform the services, have no substantial investment in facilities other than transportation, and have a continuing relationship with the business, irrespective of other common law factors.

Such factors go to the core of the relationship between the business and the service provider. They address matters that are directly connected to the question whether or not an individual is a discrete economic enterprise, and they raise fewer and less subjective considerations than the 20-factor test that has proven so inadequate.

To this extent the AFL-CIO agrees with the conclusion of the 1995 White House Conference on Small Business that "realistic and consistent guidelines" must govern the employee-independent contractor issue. We are pleased that the Treasury Department, as reflected in the statement to this committee on June 20, 1996, by Acting Assistant Secretary for Tax Policy Donald C. Lubick, also supports scrapping the 20-factor test, although the AFL-CIO and the Treasury Department may diverge regarding the standard that most appropriately would replace it.

In the AFL-CIO's view, any statutory definition should contain a presumption in favor of a determination that a work relationship is that of employer and employee unless the worker's status satisfies a relatively rigorous definition of independent contractor status. Although we are not prepared now to propose an alternative formula, the FLSA and workers' compensation experience suggest the proper direction. We commend in particular to the Committee's review the enactments of the legislatures of Minnesota and Wisconsin, which have defined independent contractors for purposes of their respective workers' compensation laws, requiring that, for purposes of satisfying an independent contractor definition, individuals satisfy each of nine specified elements. See Wis. Stat. § 102.07(b); 1996 Minn. Statutes 1995 Supplement § 176.042.<sup>3</sup>

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<sup>3</sup> These statutes define an independent contractor as one who:

- (1) Maintains a separate business with the independent contractor's own office, equipment, materials and other facilities;
- (2) Holds or has applied for a federal employer identification number;

Because the reclassification of workers from employees to independent contractors often results in less cost to the employer, the existence of vague and manipulable standards provides a potent temptation to employers to gain a competitive advantage by going the independent contractor route, while punishing employers who act in good faith and behave in accordance with ordinary and responsible norms by classifying those they employ as the employees they are.

Section 530 of the Revenue Act of 1978

The AFL-CIO also recommends that the so-called "safe harbor" provisions of Section 530 be abandoned. Section 530 fosters tax treatment and tax benefits on the basis of happenstance by permitting employers to treat a worker as an independent contractor for employment tax purposes (albeit not for income tax purposes) regardless of the person's actual status under the common law test if the employer has consistently treated the individual as an independent contractor for tax purposes, unless the employer "had no reasonable basis for not treating such individual as an employee." Section 530(a)(1). In order to satisfy this standard, Section 530 permits the employer to continue treating an individual as an independent contractor so long as it relied on judicial precedent, published rulings or IRS advice; underwent an IRS audit that resulted in no employment tax assessment for similarly situated individuals; there is a longstanding recognized practice of such classification in the employer's industry; or there exists some other reasonable basis.

In the AFL-CIO's view, it is long past time to treat all businesses in the same manner and end the patchwork of tax compliance that Section 530 preserves. Because Section 530's safe harbor rules were never intended to be permanent provisions, their distortions of the tax code and employer practices have simply become more extreme and unjustifiable over time. Nothing short of repeal will restore uniformity and equity to this critical aspect of our tax laws. We cannot continue to treat persons as non-employees who, all concede, are employees merely because they satisfy what was intended as a stop-gap exception to the tax code, but which has now persisted for 18 years without any principled basis.

We recognize that in H.R. 3448, the Small Business Job Protection Act of 1996, the Senate recently passed an amendment to Section 530 that would partially tighten it by limiting the safe harbor audits to those that actually examine the classification of employees for

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- (3) Operates under contracts to perform specific services or work for specific amounts of money and under which the independent contractor controls the means of performing the services or work;
  - (4) Incurs the main expenses related to the service or work that the independent contract performs under contract;
  - (5) Is responsible for the satisfactory completion of work or services that the independent contracts to perform and is liable for a failure to complete the work or service;
  - (6) Receives compensation for work or service performed under a contract on a commission or per-job or competitive bid basis and not on any other basis;
  - (7) May realize a profit or suffer a loss under contracts to perform work or service;
  - (8) Has continuing or recurring business liabilities or obligations; and
  - (9) The success or failure of the independent contractor's business depends on the relationship of business receipts to expenditures.

employment tax purposes. But in addition to that somewhat salutary change, H.R. 3448 takes several steps backward.

First, it provides that the industry practice safe harbor may be satisfied by a showing that not more than 25% of the industry is so engaged. But application of this threshold, even if it were determinable as a practical matter in a particular instance, could be highly inappropriate. And it could reflect widespread industry misclassification, thereby making lawlessness the justification for its own perpetuation.

Second, H.R. 3448 provides that the longstanding industry practice may not be required to have lasted for more than ten years' duration. This limitation too can only tilt in favor of a finding of independent contractor status and is again insensitive to variations among different sectors of the economy.

Third, H.R. 3448 provides that in applying any of the safe harbor factors, the burden of proof shifts from the business to the IRS once the business establishes a *prima facie* case that it was reasonable not to treat an individual as an employee for tax purposes and the business has cooperated with reasonable requests from the Treasury Department. We perceive no justification for putting the onus on the Treasury Department rather than on the employer for the latter to secure its preferred classification.

Fourth, H.R. 3488 provides that the Section 530 safe harbors are available regardless of whether the individual involved is otherwise an employee. This provision's only apparent purpose is to enable an employer to enjoy Section 530 benefits without risking coverage by non-tax laws that protect "employees." The tax code should not afford employers a safe harbor that serves no tax-related purpose.

Finally, in another apparent attempt at tightening these requirements, H.R. 3448 requires a written agreement between the enterprise and the individual stating that the individual will not be treated as an employee for tax purposes. But such a requirement could be easily met where classification abuse occurs, since the inequality of bargaining power between employer and worker renders this a matter largely of form rather than substance. Also, this requirement hardly provides useful notice to employees; most workers already understand the basic difference between paychecks that are subject to federal and state mandated withholdings and those that are paid in lump sum without them.

We now turn to the two bills under consideration.

#### Independent Contractor Tax Simplification Act of 1995, H.R. 1972

The AFL-CIO agrees with the stated purposes of H.R. 1972, namely, to simplify the tax rules and create "fair and objective rules for determining who is an employee and who is an independent contractor." Unfortunately, H.R. 1972's attempt to update and rationalize these definitions for employment tax purposes falls short of what is necessary to address the problems we have identified.

H.R. 1972 creates a menu of indicia for independent contractor status, directing that a so-called "service provider" shall not be treated as an "employee" (and so, although the bill does not use the phrase, will be considered an "independent contractor") so long as there is a written contract so stating, and so long as the service provider satisfies at least one factor on each of two lists of alternatives.

As we have just described in connection with H.R. 3448, the requirement of a written contract has little practical value. As for the menu, the options that need to be satisfied in order to secure independent contractor status are so limited that H.R. 1972 will make it easier than it is under current law for an employer to structure its employment relationships so as to produce independent contractors in its work force. For example, the first group of factors, in bill section

3511(b)(1), requires that the worker have "a significant investment in assets and/or training." The term "significant" is undefined and easily susceptible to imaginative readings. So then, a worker who has gone through an apprenticeship program, taken some relevant community college courses, or majored in a particular subject in college might qualify under the training factor, and a worker who owns a vehicle or tools that are used in the course of his or her work might satisfy the "assets" criterion.

Among the second group of factors, in section 3511(c)(1)(B), is one requiring that the worker "does not primarily provide the service in the service recipient's place of business." The phrase "place of business" is undefined, so any company that performs its services on the premises of customers could easily qualify under this description. Other matchings from the two menus in H.R. 3448 likewise produce combinations that are insufficiently demanding for a determination of independent contractor status, despite the important tax and other consequences of that classification.

We recognize that H.R. 1972 attempts to address a major deficiency in our tax laws by seeking to replace the current framework with a simpler and more comprehensible approach. But we submit that it fails to provide a definition that will achieve the necessary goals of simplicity, clarity, fairness and non-susceptibility to manipulation and evasion. Accordingly, the AFL-CIO oppose this bill.

#### The Independent Contractor Tax Fairness Act of 1995, H.R. 582

Like H.R. 1972, H.R. 582 requires a written agreement, but one that specifies more detail about the nature of the services to be provided, the accounting for those services and the tax consequences of the arrangement. While this version is better, again it may be easily satisfied by an unscrupulous employer.

H.R. 582 also would grant non-employee (independent contractor) status if, in addition to such an agreement, any of four factors were present, namely: (a) potential for realization of profit or loss; (b) maintenance of separate principal place of business; (c) making services available to the general public; or (d) receiving payment on a commission basis. The statute then elaborates how each of these alternatives may be satisfied.

Again, the AFL-CIO does not believe that these minimal standards will present much of a problem to an employer intent on achieving the manipulation that the law must be crafted to prevent. We are also concerned that H.R. 582 postpones to a later day a final legislative resolution of this issue by requiring the Secretary of the Treasury to propose within 180 days of enactment legislation that specifies objectively measurable criteria for determining whether a worker is an employee or an independent contractor for federal tax purposes. Of special concern is the bill's directive that such proposed legislation allow employers maximum latitude in determining worker classification. Again, that is precisely the opposite of what should be the case.

H.R. 582 is also deficient in that it would largely preserve Section 530. And this bill includes some revisions like those in H.R. 3448 -- for example, the 25% limit on the requisite industry practice -- that would worsen Section 530, although it would strengthen the audit safe harbor in a more stringent manner than would H.R. 1972. But, again, Section 530 should be repealed, not tinkered with. Accordingly, the AFL-CIO opposes H.R. 582 as well.

#### Conclusion

The AFL-CIO favors a legislative effort to rectify the deeply flawed treatment of the employee - independent contractor distinction under the Internal Revenue Code. Because so much is at stake in any legislative solution, we urge that Congress approach this matter with considerable deliberation and a clear understanding of the practical consequences that will ensue. These consequences may include a direct impact by a revised tax code on judicial treatment of the employee-independent contractor distinction under current employee protection laws. For these reasons we urge that any legislation that treats these issues be presented in a free-standing bill, and not simply attached to greater and unrelated legislation, such as a reconciliation bill, that the Congress might feel constrained to pass regardless of what other legislation adorns it.

**STATEMENT OF JOSEPH M. HARRISON  
ON BEHALF OF  
THE AMERICAN MOVERS CONFERENCE**

My name is Joseph M. Harrison. I am President of the American Movers Conference (AMC.) This statement is submitted on behalf of nearly 3,000 household goods movers who are members of AMC. AMC is affiliated with the American Trucking Associations (ATA) and supports ATA in their statement to the Committee. AMC is the principal national trade association for the household goods moving industry, representing movers before Federal and State legislative and regulatory bodies. AMC members include small local moving companies often affiliated with a van line, independent van lines with regional or national markets, and national van lines with an agency network. In turn, these companies contract with van operators to drive, load and deliver household goods. Many of these van operators are treated as and have been deemed to be independent contractors.

AMC urges the Committee to consider five issues before proceeding with independent contractor legislation:

- Section 530 has worked well for many taxpayers, particularly small businesses and should therefore not be eroded in the guise of a "small business fix",
- the 20-factor common law test is often arbitrary, but the Market Segment Understanding (MSU) method can be cumbersome and time consuming and therefore will not prove to be a panacea for either the IRS or business,
- the compliance with government regulations should not cause workers to be reclassified,
- the IRS has recently developed some new directions and should be encouraged to continue their efforts but should not be allowed to proceed with regulations and
- withholding for independent contractors should not be imposed as a solution.

**Section 530 Should Not be Eroded**

Section 530 "audit protection" is crucial to the moving industry as well as to many other industries. It is also part of the problem. Section 530 is not itself completely objective and disagreements about its application and availability have caused a good portion of the current controversies. AMC believes some of the modifications to Section 530 proposed by the Senate Finance Committee will prove helpful to small business.

AMC does not support the changes proposed by the Finance Committee to the prior audit safe harbor. An audit is a time-consuming and expensive proposition for small businesses. Without an internal accounting and legal staff, small moving companies must rely on outside auditors and attorneys during an IRS audit. This safe harbor was designed to protect businesses from repeated audits. Although this change would only apply prospectively, it could create a situation whereby small businesses could be subjected to repeat audits. To erode the notion of audit protection is to potentially open up the small companies to added expense and less clarity. Many AMC members have come to rely on the prior audit safe harbor and AMC believes it should be retained intact.

AMC does support the clarifications to Section 530 regarding long-standing industry practice. The Senate Finance Committee would specifically allow a long-standing industry practice if it had been in place for 10 years. AMC believes that this change will assist both the taxpayer and the IRS in defining this safe harbor.

Finally, AMC is concerned about the effect the written agreement requirement may have on other industries. Moving companies rely heavily on written agreements which are also necessitated by other Federal regulations. However, without a fact-finding opportunity it is difficult to assess the effect this change will have on other small companies in other industries.

### **The Market Segment Understanding (MSU) Program and the 20-Factor Common Law Test**

Because of their extensive use of independent contractors, movers have long been subject to IRS employment audits. Many of AMC's members have found the audit process and the use of the 20-factor common law test to be a long, costly and arbitrary process. Since so many moving companies are small businesses, this process has necessitated the use of outside attorneys and auditors. Only after incurring substantial expenses can AMC members come away from an audit with workers classified as independent contractors. While AMC strongly supports the appropriate classification of workers, the battle for independent contractor status is unnecessarily laborious and resource consuming. Perhaps the biggest stumbling block with the 20-factor common law test is the inconsistency in its application. Movers are faced with proving the validity of either all, most or some of the factors depending only upon the individual auditor. Movers have never been sure what, if any, individual factor might force workers to be reclassified, even in the absence of other concerns.

In the Fall of 1992, the IRS approached AMC and requested that the industry participate in a Compliance 2000 project to develop guidelines for tax classification of van operators which was later referred to as the "Moving Industry MSU." While AMC initially had reservations about entering into such a joint venture, we were assured throughout our discussions with the IRS that the aim of this project was to build a consensus through mutual trust and understanding which would result in the development of realistic criteria to aid in determining whether a van operator would be classified as an independent contractor or an employee.

AMC recruited volunteer representatives from all segments and organizations of the industry to participate in a joint venture with the IRS to reach a consensus on independent contractor criteria. An enormous amount of time was spent by these volunteers and AMC working on guidelines with IRS. Almost four years and numerous meetings later, the joint AMC/IRS Compliance 2000 Committee reached a consensus and in July 1995 IRS field representatives forwarded a draft MSU to the IRS national office. The industry group did not receive a response until January 24, 1996.

At the January meeting, we were told for the first time that the rules under which our joint Committee had been operating were no longer viable and in essence, the moving industry MSU document would no longer be a joint and mutually agreed upon product. According to the IRS, the changes were required at this time because of statutory provisions of the Federal Advisory Committee Act (FACA) of 1972. In addition, we were further dismayed to learn that in the future, industry would be dealing with a new IRS negotiating team from the Chief Counsel's office which had not been a participant during the three-year developmental period and thus were not acquainted with the industry, and that a key portion of the draft would be completely overhauled.

Since that time, we have been endeavoring to work with the new IRS negotiators to build a better understanding of industry issues and attempt to influence the development of realistic, workable audit guidelines. However, our experience with the MSU process suggests that it is a flawed procedure that will not be a viable alternative to the 20-factor common law test for most industries. The time commitment is huge, the process takes too long, and the IRS FACA interpretation does not permit a negotiated solution. Rather an industry may spend years providing input only to find that IRS issues guidelines with which it does not agree. This leaves industry in an extraordinarily vulnerable position.

#### **Compliance with Governmental Regulations**

One of the major areas of discussion between the moving industry and the IRS is the effect compliance with governmental regulations has on the control element. This has not been extensively addressed during these deliberations but should be a consideration of the Committee. Governmental regulations play a particularly sensitive role industries, like movers, that remain heavily regulated. Moving companies, like all trucking companies, must ensure the safety of the equipment

and drivers under contract to them. In addition, moving companies remain subject to interstate and intrastate economic regulation. There are numerous state and federal mandates which must be complied with regardless of whether a worker is an independent contractor or an employee. The IRS continues to view companies efforts to insure compliance with governmental regulations as control of the workers and therefore an element of the 20-factor common law test which tilts the workers toward employee status. AMC encourages the Ways and Means Committee to review this issue with the IRS. This issue should be addressed within the training materials in a more equitable manner. It is absurd for businesses to find workers reclassified only on the grounds of instructions or training necessitated by compliance with equally important regulations from other governmental entities.

#### **Legislative Solutions and the IRS Initiatives**

AMC has followed with great interest the various legislative solutions that have been proposed over the last several years for resolving the difficulties experienced by taxpayers and the IRS with the independent contractor vs. employee classification issue. Both H.R. 1972 and H.R. 582 would revise the standards for determining employee status, replacing the 20-factor test presently relied upon. H.R. 582 would repeal existing Section 530 and replace it (in part) with revised requirements.

We recognize that the 20-factor common law test for resolving the worker classification issues is subjective and uncertain to work well or to be applied easily to the wide variety of work arrangements that exist today. However, AMC believes this system is preferable to legislation. While the MSU process has been particularly cumbersome for this industry, the theory behind the work has great merit. Each industry has different work arrangements and essential elements of the 20-factor common law test should differ as the industry differs. Yet at the same time, we acknowledge that the government has a legitimate interest in limiting independent contractor status to those situations that objectively operate in such a manner. Legislation that permits such status to be claimed indiscriminately would not serve well.

From our experience we conclude that whatever solutions are found should apply even-handedly industry-wide. We also believe that appropriate factors for determining worker classification will vary by industry and sometimes by segments within an industry. Thus, while we support efforts at legislative improvement, we have reservations about the ability of any legislative solution to apply equally well and fairly in all industries and appropriate segments thereof. AMC applauds the Commissioner for the work on the training manual as a means to address these issues.

If Congress undertakes a broader-based legislative revision than changes to Section 530, AMC encourages the retention of safe harbor protections. We believe this step will be needed in order to provide an adequate level of comfort to taxpayers that any new legislation will be fairly applied and not lead to overly aggressive assertions by the IRS that will threaten the economic viability of existing businesses. A return to the conditions that led to the enactment of Section 530 cannot be viewed as progress.

#### **Withholding Should Not Be Seen As A Solution**

AMC opposes the imposition of withholding on independent contractors as a solution to the worker classification issue. Withholding will not solve the issue of appropriate classification of workers but will serve to penalize workers, such as in the moving industry. Van operators incur substantial operating expenses and withholding will only subject their revenue to another reduction.

Van operators are responsible for truck payment, fuel purchases, insurance and various other expenses and record keeping responsibilities. It is inappropriate to add withholding to their administrative burden. Withholding should be reserved for employees and should not be an added burden for small business independent contractors.

**Conclusion**

AMC encourages the Committee and the IRS to continue to grapple with the difficult problems of worker classification. AMC supports some modifications to Section 530 that will benefit small businesses and the IRS. However, AMC can not support legislation which will permit independent contractor classification without substantial justification.

Furthermore, AMC supports many of the initiatives suggested by the Treasury Department including expansion of the jurisdiction of Tax Courts to hear worker classification cases. However, AMC's experience with the MSU process would not lead us to support allowing the IRS to continue with further guidance beyond the audit guidelines now under consideration. Finally, AMC would be pleased to continue to work with both the IRS and this Committee in an attempt to refine solutions to this complicated issue.

STATEMENT OF  
THE AMERICAN PAYROLL ASSOCIATION

Concerning the June 4 and June 20, 1996  
Hearings on Worker Classification Issues

Before the  
OVERSIGHT SUBCOMMITTEE OF  
THE WAYS AND MEANS COMMITTEE  
UNITED STATES HOUSE OF REPRESENTATIVES

INTRODUCTION

The American Payroll Association (APA) is a nonprofit professional association representing more than 13,000 companies and individuals on issues relating to wage and employment tax withholding, reporting, and depositing. We estimate that over 70 percent of the gross federal revenues of the United States are reported, collected, and deposited through company payroll withholding. APA's members are the nation's information reporters and tax collectors.<sup>1</sup> Because our members are interested in the information reporting consequences of worker classification, not the corporate or individual tax consequences, they are caught in the middle of the worker classification debate. Often the worker prefers to be classified one way, management supports a different classification, and APA's members are forced to decide how to report information and/or withhold and deposit taxes for that worker, based upon unclear rules, and faced with the constant prospect of IRS audits and penalty exposure. However, most of APA's members are not tax lawyers, nor do they have the time, expertise, or resources to research complicated tax questions. Thus, APA strongly encourages the Committee to support legislation that would simplify the legal standard for classifying workers.

STATEMENT

The purpose of our statement is to register APA's support for legislative efforts to clarify and simplify the federal tax rules governing the classification of workers as employees or independent contractors. The current standard, the common law "control test," is unwieldy and highly subjective, resulting in payroll professionals making very difficult decisions about how to report compensation and whether to withhold and pay employment taxes. The problem does not end there, however. An individual's classification also determines how certain fringe benefits, such as health and life insurance, should be reported (if at all) and whether certain individuals should be allowed to participate in a company's pension plan. Not only can the penalties for failing to report these items properly be staggering, but the financial burden that a company must bear to defend itself during a

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<sup>1</sup> The Court of Federal Claims has characterized payroll professionals as the "deputy tax collector." General Elevator v. United States, 90-1 U.S.T.C. ¶ 50,248.

protracted audit, and even litigation, of worker classification issues can jeopardize a company's existence.

Payroll professionals are often charged with the task of deciding how to classify individuals for payroll withholding and reporting purposes. Hinging this important decision on such a subjective test places the payroll professional in a very difficult situation. We commend Representatives Christensen and Kim for having taken the initiative to introduce legislation that could make great strides in reducing the subjectivity and complexity of the legal test for worker classification.

We also commend Senator Nickles for his proposal to clarify section 530 of the Revenue Act of 1978, which has been included in H.R. 3448, at section 1122. In recent years, section 530 has been as much a source of confusion as the common law test itself, not to mention a significant source of contention between taxpayers and the IRS.

Briefly, section 1122 would modify section 530 in several important ways. First, to qualify for the industry practice safe haven, it would not be necessary to show that any more than 25 percent of an industry treated its workers as other than employees. The provision would also clarify that, to be long-standing, an industry practice need not have been continued for more than 10 years and that employers in industries created after 1978 can qualify for relief. APA strongly supports both of these changes.

Second, section 1122 would require Internal Revenue agents to provide taxpayers with written notice of the availability of relief under section 530 before or at the commencement of an audit of an employer's worker classification practices. Many small employers do not have the resources to hire tax counsel and thus may be unaware of all of the legal avenues available to them. As an "off-Code" provision, section 530 can be quite difficult to locate. Accordingly, APA believes mandatory written notice of the availability of 530 relief is an excellent improvement to the statute.

Despite APA's generally strong support for the Nickles proposal, we are concerned that this provision should not be treated as a permanent solution to the problems caused by the vague and confusing "20-factor test." However, much of the current pressure from taxpayers to simplify the worker classification tests will be eliminated if Congress enacts the proposed version of section 530(e)(3), "Availability of Safe Harbors." That section states: "Nothing in this section shall be construed to provide that subsection (a) only applies where the individual involved is otherwise an employee of the taxpayer." This section is designed to end a long-standing controversy between the IRS and employers about when section 530 applies. The IRS maintains that section 530 applies where workers who are employees have been misclassified by their employer. Taxpayers have maintained that section 530 relief should be available as a short-cut alternative to determining whether a worker is an employee or an independent contractor. Section 530(e)(3) supports that "short-cut" approach. Stated

differently, the use of section 530 would not provide any indication of whether or not a worker is an employee. Companies could simply elect section 530 if they meet the criteria set forth there, and their payroll tax audit over worker classification issues would end.

APA urges Congress to realize, however, that section 530 alone does not end the confusion for workers (or payroll professionals) over how the workers should be classified. The company's audit may have been stopped more quickly, but the workers themselves are still confused over whether they should be classified as independent contractors or as employees. As independent contractors, they are subject to SECA taxes, required to establish their own benefit plans, ineligible for unemployment benefits, but permitted to take business expense deductions without the limitations applied to employees. As employees, they are required to pay only the employee share of FICA taxes, can participate in the company's benefits plans, and qualify for unemployment benefits. Workers still need an objective, administrable definition of "employee" versus "independent contractor" to help them resolve this confusion permanently.

The Senate leadership has proposed an additional amendment to H.R. 3448, which would further reduce confusion and add simplicity for payroll professionals. Briefly, the Amendment would codify section 530, extend section 530 relief to workers, and, apparently, extend relief to all tax consequences of worker classification. That is, if an employer had a reasonable basis for treating its workers as other than employees, such workers would be considered as other than employees throughout Title 26 of the United States Code. This eminently sensible approach would be welcome relief to payroll professionals and is strongly supported by APA.

#### RECOMMENDATIONS

In summary, APA recommends the following:

- replace the common law "right to control" test with a simple, objective statutory test for classifying workers as employees or independent contractors to ease the burdens on both information reporters and the IRS;
- clarify section 530 of the Revenue Act of 1978 in accord with section 1122 of H.R. 3448; and
- extend section 530 relief beyond employment taxes to the entire Internal Revenue Code in accord with the Senate leadership amendment.

\* \* \*

APA would like to thank the Subcommittee for holding hearings on this important issue and for affording organizations like ours the opportunity to be heard. We would also like to thank Representatives Christensen and Kim and Senator Nickles for their foresight and initiative in attempting to solve the worker classification problem. APA is committed to assisting in any way it can in the effort to simplify the law in this area and will be happy to answer any questions that may arise.

Respectfully,



Carolyn Kelley  
Director of Government Affairs  
American Payroll Association

**Statement of**  
**American Pulpwood Association Inc.**  
**Independent Contractor Association of America, Inc.**  
**Independent Insurance Agents of America**  
**National Association of Independent Insurers**  
 on  
**Employment Classification Issues**  
 submitted to  
**House Ways and Means Oversight Subcommittee**  
**July 8, 1996**

The American Pulpwood Association, Inc., the Independent Contractor Association of America, Inc., the Independent Insurance Agents of America, and the National Association of Independent Insurers represent members directly affected by employment classification issues. On behalf of our members companies, we respectfully submit the following comments on worker classification issues and request that they be included in the hearing record. Our associations are strongly supportive of the current-law protections concerning the classification of workers as independent contractors. Over five million Americans work as independent contractors and nearly one-third of all companies use independent contractors to some degree. Literally tens of thousands of businesses and individuals rely on the current statutory protections in structuring their independent contractor relationships. Our industries are no exception.

We urge the committee to proceed with caution when considering changes to independent contractor status. Specifically, we urge the committee to ensure that

- the current Section 530 protections are not displaced;
- other statutory independent contractor provisions are preserved;
- the 20-factor common law test is retained as a fall-back test for workers who do not qualify for safe harbor protection; and
- mandatory or optional withholding is not imposed on payments to independent contractors.

Numerous disputes arise each year between taxpayers and the Internal Revenue Service (IRS) over the classification of workers. However, as is evidenced by a close examination of the testimony of the witnesses before the committee, the problems experienced by taxpayers over worker classification issues in general stem from difficulties arising from enforcement activities and not from the law itself. Many of the cases arise not from uncertain applications of the current law, but rather from overzealous efforts on the part of the IRS to reclassify workers. These actions are clearly demonstrated by the inclusion as part of the IRS's Employment Tax Examination Program a component which targets businesses with assets of less than \$3 million for worker classification challenges. Admittedly problems exist with the enforcement of the independent contractor law, however, it stands as a testament to the success of the current law that millions of Americans are independent contractors and many of our nation's businesses use their services.

#### **Section 530**

Section 530 was enacted in 1978 in response to over zealous efforts by the IRS to reclassify workers as employees. Our associations were active participants in the coalition of business interests which was instrumental in securing passage of this important legislation. It provides businesses and independent contractors with a sense of security and safe harbor protections. Each of the safe harbors — administrative or judicial precedent; prior audit; industry practice; and other reasonable basis — are important for specific reasons.

#### **Judicial or Administrative Precedent**

Reasonable reliance on administrative or judicial precedent protects businesses that have relied on good faith interpretations of applicable precedents when classifying their workers. Taxpayers may base their reliance on judicial precedents, published rulings, or technical advice or letter rulings with respect to the taxpayer. This safe harbor provision enables businesses that comply with the

requirements of Section 530, including issuing 1099's and consistently treating similarly-situated workers, to engage independent contractors without fear that the IRS will later interpret the precedent differently and call their classifications into question.

#### Prior Audit

Businesses are protected from repeated IRS investigations by the prior IRS audit safe harbor. The provision, enacted to protect businesses from repetitive IRS audits involving the same workers, allows taxpayers to continue to classify workers as independent contractors with a sense of certitude if the IRS failed to raise an employment tax issue on audit, even if the audit was not for employment tax matters. Eliminating or limiting this valuable safe harbor would subject businesses, once again, to repeated harassment by the IRS. The Senate Finance Committee included a modification to the prior audit safe harbor during its consideration of H.R. 3348, the Small Business Job Protection Act of 1996. Under the proposal, taxpayers would not be permitted to rely on audits commenced after December 31, 1996, unless the audit specifically included an examination of the treatment of workers for employment tax purposes.

Our associations oppose such a modification in the prior audit safe harbor. Restricting the prior audit safe harbor to employment tax audits involving the classification of workers would leave taxpayers open to IRS challenges to their worker classification, even though the IRS had conducted prior audits and was aware of the taxpayer's practice. As a result, taxpayers could be made liable for reclassification and retroactive employment tax liability in cases where the IRS was aware for years that the business was classifying the workers in question as independent contractors and had not raised an issue. While the modification was proposed in response to criticisms that the businesses would assert prior audit protection even for audits of totally unrelated issues, we believe these concerns are simply unfounded. The requirement that the reliance be "reasonable" effectively prohibits taxpayers from asserting protection for completely unrelated audits. If the committee chooses to clarify the prior audit safe harbor so that the above-noted potential abuses are explicitly proscribed, we would suggest the language of the provision be altered to read that Section 530 protection is available if reasonable reliance was based on "any prior audit except one where the IRS would not be reasonably expected to have considered an employment tax issue."

#### Long-standing Industry Practice

Taxpayers are accorded Section 530 protection if they relied on a long-standing recognized practice of a significant segment of the industry as a basis for classifying workers as independent contractors. This industry practice safe harbor provides critical protection for taxpayers in industries where workers have always been classified as independent contractors, but no administrative or judicial precedent has been established. Over the years, questions have arisen in applying this safe harbor regarding the interpretation and application of the terms "long standing practice" and "significant segment of the industry." Section 530 does not stipulate a specific time period in order to qualify as long-standing, neither does it provide a clear standard for what constitutes a significant segment of a taxpayer's industry. The Finance Committee also included modifications to the industry practice safe harbor in its changes to H.R. 3348. The Senate provision would clarify that 10 years constitutes a long-standing practice and that industries begun after 1978 can meet the long-standing standard. In addition, the provision would provide that taxpayers would be required to show that no more than 25 percent of their industry follow a specific practice in order to satisfy the significant segment of the industry requirements. In both instances, the numeric standards are intended to provide a safe harbor and, based on a taxpayer's particular facts and circumstances, lesser percentages of the industry or shorter periods of time could qualify for the Section 530 protection. Acting Treasury Assistant Secretary for Tax Policy Donald Lubick has informed the committee that the IRS is working to develop administrative guidance to be released later this year to stipulate that industry practices in place for 10 years would be presumed to be long-standing and the long-standing practices could exist in industries established after 1978. We support these modifications and believe that the thresholds are appropriate and will reduce the number of taxpayer disputes with the IRS in which the Service has applied unreasonable standards.<sup>1</sup>

<sup>1</sup> The IRS has argued that significant segment of the industry means more than 50 percent. *In re Bentley*, 73 AFTR2d No. 94-667 (Bkrcty. E.D. Tenn. 1994).

### Other Reasonable Basis

Finally, the other reasonable basis safe harbor is invaluable to those businesses that have sound and justifiable grounds for classifying workers as independent contractors but do not qualify for one of the statutorily prescribed safe harbors. The courts have provided a constrained interpretation of this safe harbor and current law in this area should not be disturbed.

Section 530 has and continues to serve a useful purpose in stopping repeated taxpayer audits and ensuring fairness. We strongly urge the committee not to disturb the protections currently afforded under Section 530, except as noted above.

### The Common Law Test

The determination of worker status for Federal tax purposes is generally made under a common-law test. The common-law test developed by the IRS from court cases and rulings include 20 factors which may be examined in establishing whether an employer-employee relationship exists with the relative importance of each factor determined based on the facts and circumstances of each particular case.

The common-law test is essential for taxpayers that may not qualify for one of the safe harbor provisions. In today's ever changing economic environment, it would be virtually impossible to construct safe harbor provisions that would cover all of the types of services that are now or may be offered in the future. Services provided today would have been unimaginable a few short years ago. For this reason, it is imperative that, regardless of modifications or expansion of the current harbors, the common-law test stand as the test of last resort. We exhort the committee to preserve the sanctity of the 20-factor test.

### Withholding

Many of the proposed modifications affecting independent contractors will result in significant revenue losses to the U.S. Treasury. Proposals have been made by the General Accounting Office and others to impose withholding requirements on payments made to independent contractors. Withholding would be devastating to the viability of independent contractor status and we were pleased that during the committee's hearings Rep. Christensen rejected the idea of either mandatory or optional withholding as a revenue offset.

Withholding requirements would impose costly and time-consuming recordkeeping burdens on service recipients and would place independent contractors at a competitive disadvantage vis a vis their competitors operating in other forms. Under current law, employers are required to withhold income and employment taxes from payments of wages and employees are required to file withholding allowance certificates with their employers. In accordance with proscribed tables and computational procedures, employers compute the correct amount of withholding based on the withholding allowance claimed, the taxpayer's wages and the frequency of payroll payments.<sup>2</sup> Withholding on payments to independent contractors are not subject to withholding, however, service recipients are required to file information returns for each payee receiving payments totaling \$600 or more during the calendar year.

Withholding would require independent contractors to file withholding allowance certificates with each service recipient and service recipients would be forced to compute and remit withholdings on payments made outside the business' normal payroll system and deposit cycle. Significant problems would arise if withholding were imposed on payments received from service recipients, even if a uniform rate were imposed. Service recipients would still face the problems associated with withholdings which occur outside their normal deposit cycle and independent contractors would be burdened with uneven and widely varying effective withholding rates.

While withholding amounts may be computed with a relatively high level of certainty for wage earners, the financial impact of withholding would vary greatly depending on the contractor's net profit as a percentage of gross revenues. In the case of wage earners, net income is generally equal to, or very near, 100 percent of wages paid; however, large variances of net income as a

<sup>2</sup> Internal Revenue Code Section 3402.

percentage of gross revenue exist both within and among industries. For example, two independent contractors operating in the same industry may experience vastly different profit margins for a variety of business reasons. If say a five-percent withholding rate were imposed on payments to both independent contractors the business with a net profit margin of 10 percent would be more severely impacted than the similar business with a 50 percent net profit margin. In the first case, withholding five percent from the business' fees would result in 50 percent of the contractor's net income being retained, while his competitor would face an effective withholding of only 10 percent. As a result, the first business would face cash flow constraints and be placed at a significant competitive disadvantage.

Additionally, singling out independent contractors for withholding would place individuals operating in this form of business at a disadvantage relative to their competitors operating in other forms, such as corporations, partnerships, sole proprietorships and limited liability companies. Service recipients contracting with these businesses would have no withholding responsibility pursuant to payments for services received. However, relationships with independent contractors would expose the service recipient to burdensome administrative withholding duties, making them more reluctant to engage in these transactions. To single out independent contractors for withholding would impede their ability to attract and retain clients and erode their competitive position in the marketplace.

For the foregoing reasons, our associations remain steadfast in our opposition to any effort to impose withholding in any form on payments made to independent contractors.

#### **Finance Committee Modifications**

In addition to the above-referenced modifications, the Finance Committee made a number of additional changes to provisions affecting independent contractors. The provisions include language clarifying that a worker does not have to otherwise be an employee of the taxpayer in order for Section 530 protections to apply. Although nothing in the language or legislative history of Section 530 requires that a worker be determined to be an employee under the common-law test before Section 530 relief is made available, the IRS adopted the position that such a determination be made first. While most court decisions have not explicitly addressed this issue, those which have considered the question directly have ruled that Section 530 relief is available irrespective of the worker's status under the common law test.<sup>3</sup> Despite these holdings, the draft of the new IRS worker classification training guide released earlier this year indicated that there must first be a determination of employee status before agents could apply Section 530 relief. The Finance Committee action would reverse this position and codify the decisions of the courts. Our groups applaud the Senate's action and urge the committee to follow the Finance Committee language.

The Senate panel also included provisions requiring workers and service recipients to sign agreements acknowledging that the worker will not be treated as an employee for employment tax purposes in order to receive Section 530 protection. We do not oppose this requirement. In addition, under the modified provisions, the IRS would be required to provide taxpayers with written notice of the provisions of Section 530 at the commencement of any audit involving worker classification. IRS Commissioner Margaret Richardson has advised the committee the final version of the IRS training manual due out this fall will also include this requirement. We support this requirement and urge the committee to codify the mandate.

Finally, the Finance Committee included changes to shift the burden of proof to the IRS with respect to all aspects of Section 530 except for determining whether the taxpayer had any other reasonable basis for treating a worker as an independent contractor, if the taxpayer can establish a prima facie case that it was reasonable not to treat a worker as an employee for purposes of Section 530. The burden of proof will shift only in the case of taxpayers who fully cooperate with "reasonable" requests by the IRS for information relevant to their classification of workers. Although we believe that the IRS should bear the burden of proof, we are concerned that the

<sup>3</sup> Lambert's Nursery and Landscaping Inc. v U.S., 894 F.2d 154 (5th Cir. 1990); I&J Cab Service Inc. v. U.S., 75 AFTR2d No. 95-618 (W.D. N.C. 1995); Queensgate Dental Family Practice Inc. v U.S., 91-2 USTC No. 50,536 (M.D. Pa. 1991).

provision as worded could result in taxpayers being forced to incur significant costs in producing inordinate amounts of information — perhaps of dubious relevance — in order to be deemed cooperative. The requirement could also result in a more protracted administrative consideration of the issue. If the committee includes language to shift the burden of proof, we urge the members to include report language limiting the scope of compliance necessary for a taxpayer to be deemed cooperative.

### Treasury Department Recommendations

At the committee's June 20th hearing on employment classification issues, Donald Lubick, on behalf of the Department of Treasury, requested four specific legislative changes related to independent contractor status. Mr. Lubick called on the committee to enact legislation permitting the IRS to forgive prior year employment tax liabilities in certain circumstances, to provide access to tax court, to permit Treasury to issue guidance under Section 530 and to increase certain information return penalties.

#### Forgiveness of Prior Year Employment Tax Liability

Treasury requested that the committee permit the IRS to forgive prior year employment tax liabilities in certain circumstances for taxpayers who prospectively reclassify their workers. Treasury proposes that, in the case of taxpayers who are determined to have misclassified their workers, but who meet the Section 530 reporting requirements and have a reasonable argument that they meet the consistency and reasonable basis requirements, the IRS be empowered to forgive prior year's employment tax liabilities. Treasury believes that taxpayer's fear of retroactive employment tax liability, rather than the prospect of future responsibilities, presents the greatest roadblock to IRS efforts to settle disputes involving worker classification. Our associations do not oppose this proposition, however, we believe it will be important for Congress to exercise effective oversight to ensure that the IRS does not abuse the authority and coerce taxpayers into reclassifying workers who are legitimately classified as independent contractors.

#### Access to Tax Court

Earlier this year, the IRS established procedures for taxpayers to request early referral to Appeals of any developed, unagreed issues arising from an examination under the jurisdiction of the district director.<sup>4</sup> Issues which, if resolved, could reasonably be expected to result in speedier resolution of the entire case and which the taxpayer and district director agree should be referred to Appeals would be eligible for the new program. Employment tax issues, including disputes over whether a worker is a common-law employee or independent contractor, or whether Section 530 applies, will be eligible for the early referral program on a one year test basis.

Additionally, Mr. Lubick has requested that the committee enlarge the jurisdiction of the U.S. Tax Court to cover cases involving worker classifications for employment tax purposes on a prospective basis. Treasury believes providing taxpayers access to Tax Court will result in quicker and lower cost resolutions. Tax Court judges have substantial experience resolving tax cases involving similar issues and, in many instances, are able to resolve suits without requiring the business to retain counsel. Our groups applaud the IRS efforts to promote referral of cases to early Appeal and support expanding access to the Tax Court. Taxpayers incur significant expense in independent contractor disputes in large part due to the protracted settlement process. Even in cases where the taxpayer prevails, they have often spent tens of thousands of dollars and countless man hours defending their position through audit, appeal and litigation. Providing speedier resolution at the IRS level and greater access to independent judicial review will relieve taxpayers of some of the effects, financial and otherwise, of these lengthy and costly disputes.

#### Section 530 Guidance

Current law precludes the IRS from issuing revenue rulings or regulations to provide clarification under Section 530. Treasury believes that it would be possible to improve understanding of and compliance with the common law classification standards if IRS were permitted to issue revenue ruling or other guidance. The revised IRS training manual draft attempts to clarify for agents that

<sup>4</sup> Rev. Proc. 96-9, 1996-2 I.R.B. 15.

the common law test refers to the ability of a service recipient to “direct or control” a service provider and that the 20 factors are merely criteria used to evidence whether or not the test is satisfied. Lubick advised the committee that the Administration would like to communicate their positions to not only agents, but taxpayers as well, through more formal guidance. We strongly urge the committee to reject the IRS’s request for authority to issue guidance under Section 530. The IRS has demonstrated through its words and actions that it should not be entrusted with this authority. Despite court decisions to the contrary, the IRS continues to assert positions in litigation and in training manuals which are clearly contrary to congressional intent. We believe extending authority to issue guidance in this area would lead to more, not less, disputes between taxpayers and the Service.

#### Information Return Penalties

The Treasury has also requested that the committee provide increased penalties for service-recipient failures to file timely and correct information returns. Specifically, Lubick encouraged the enactment of the penalty provisions included in the President’s Fiscal Year 1997 budget proposal. Businesses are required by law to file an informational report with the Internal Revenue Service for each service provider to whom it makes payments which in aggregate total \$600 or more per year.<sup>5</sup> These reports must include the name, address and taxpayer identification number of the service provider, as well as the amount of the payments.

Under current law taxpayers who fail to timely file correct information returns, such as a Form 1099, are subject to a penalty of up to \$50 per return, up to \$250,000 during any calendar year. President Clinton proposes to increase the penalty for failure to file these information returns to the greater of \$50 per return or five percent of the amount required to be reported. Our groups oppose this proposal.

The proposed penalty modifications would be particularly burdensome and costly for property-casualty insurers. Property-casualty companies make tens of millions of payments each year on behalf of policyholders to third-party service providers, such as auto repair shops, towing services, construction companies, doctors, and hospitals. Typically, the insurer has no role in selecting the service provider or control over the information provided by the third-party. Insurance personnel generally do not contract with the service provider. Such arrangements clearly are not the target of efforts to reform independent contractor status and the nature of the arrangements make it extremely difficult for insurers to obtain timely and accurate taxpayer information. Nevertheless, the President’s proposal would punish an insurer for an inaccurate report that occurs through no fault of its own. This proposal would have significant and detrimental consequences which extend well beyond the scope of worker classification issues. We strongly urge the committee to reject this proposal both in the context of independent contractor reform and in the broader context of budget reconciliation.

#### Recommendations for Reform

As the committee considers modifications to provisions relating to independent contractor status, our groups urge members to consider the following recommendations.

##### Fee Recovery Provisions

One of the most onerous aspects of independent contractor disputes is the financial toll it takes on taxpayers who defend their position. Many businesses are not in a financial position to engage the IRS in lengthy and costly legal battles to defend their position. These taxpayers are often forced into agreeing to reclassifications even though they know their position is sound. Under current rules, in order to qualify for attorney fee reimbursement taxpayers must show that the IRS’s position is not substantially justified. In addition, recoverable fees are limited to those incurred in connection with actual litigation and the law imposes an hourly cap on these fees. As a result, for taxpayers who are unable to front the associated legal costs, appealing or litigating to prove their position is often not a realistic possibility.

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Although the pending Taxpayer Bill of Rights 2 legislation contains a fee recovery provision, the current language which would shift the burden of proof to require the IRS to demonstrate that its position in a case in which the taxpayer prevailed was substantially justified does not apply to Section 530 cases. We encourage the committee to expand this fee recovery provision to independent contractor issues. We also urge the committee to modify the language to provide that a taxpayer who responds to an IRS challenge concerning its classification of workers by claiming eligibility for protection under Section 530 and is subsequently held by the courts to qualify for Section 530 protection be entitled per se to recover all of his or her costs incurred in defending against the IRS challenge, including costs incurred during the IRS's administrative consideration of the issue.

#### Section 530 Consistency Requirements

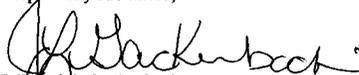
One of the most onerous and unforgiving requirements of Section 530 is the requirement that the taxpayer must not have treated any worker holding a substantially similar position as an employee for purposes of employment taxes for any period since 1978. In order to receive Section 530 protection, therefore, a taxpayer must have and continue to classify all substantially similar workers as independent contractors. Thus, a company that has treated even one of a type of worker as an employee is forever precluded from obtaining Section 530 protection with respect to that type of worker.

Despite the very valid objective of the consistency requirement, its application in many cases has produced harsh and unjustified results. As an example consider the case of two businesses competing in the same industry and utilizing similar workers performing comparable functions. One business began in 1980, a pioneer in the industry, initially classified workers as employees, but almost immediately converted the "employees" to independent contractor status. Under the consistency rules, this business would be forever precluded from obtaining Section 530 protection with respect to those workers. The second business entered the market in 1990 and classified its work force as independent contractors, as was the practice of the industry. Unlike its competitor, the new business would be eligible for Section 530 protection. However meritorious the objective of the consistency requirements, we find the result of its application in this and like situations unjustified and inequitable.

To remedy this situation, we urge the committee to modify the consistency requirements so that it would not operate as an absolute perennial bar. We urge the members to modify the consistency requirement so that for purposes of determining whether a taxpayer satisfies the requirement 1) a taxpayer's classification of a *de minimis* number of workers as employees during a taxable year would not be taken into account, and 2) a taxpayer's classification of workers as employees made more than five years prior to the taxable year at issue would not be taken into account. These minor modifications would preserve the general objectives of the consistency requirements without placing taxpayers at a permanent competitive disadvantage.

We appreciate the opportunity to present our views on proposed legislative changes affecting employee classification and to make specific recommendations for reform. As we have previously stated, the underlying problems inherent in employee classifications stem from enforcement and not from the law itself. We urge the committee to proceed with caution and to safeguard the Section 530 protections and to retain the common-law test. We believe the modifications we have endorsed and proposed will go a long way to solving the issues the committee has raised without disrupting a system on which thousands of workers and service recipients rely.

Respectfully submitted,



Julie Leigh Gackenbach  
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### **The American Pulpwood Association, Inc.**

The American Pulpwood Association Inc. is a nationwide nonprofit trade association responsible for issues that surround the safe and efficient harvest and transportation of forest products from the woods to the mill. APA members include the nation's pulp and paper mills, wood dealers, and independent logging contractors who harvest and transport pulpwood and timber, and equipment companies that manufacture pulpwood and timber harvesting and processing equipment.

### **The Independent Contractor Association of America, Inc.**

The Independent Contractor Association of America, Inc. (ICAA) is a national association dedicated to the preservation of independent contractor status. ICAA members consist of individuals working as independent contractors and businesses that purchase services from independent contractors. ICAA currently represents over 3,000 independent contractors and business that engage independent contractors.

### **The Independent Insurance Agents of America**

Founded in 1896, the Independent Insurance Agents of America (IIAA) is the nation's oldest and largest national association of independent insurance agents, representing a network of 300,000 agents and agency employees. Independent agents offer customers a choice of policies from a variety of insurance companies. Independent agents offer all lines of insurance - property, casualty, life and health.

### **The National Association of Independent Insurers**

The National Association of Independent Insurers (NAII) is a trade association representing 555 property and casualty insurance companies. The NAII was founded 50 years ago on the principles of open competition and pricing flexibility in the insurance industry. Our members range in size from the very largest national writers to the smallest one state writers. Among our members are mutual and stock companies and reciprocal exchanges. Their marketing strategies range from providing the widest range of insurance products to those specializing in relatively few product lines. NAII members account for one-third of all property-casualty insurance premiums written in the United States.

**STATEMENT OF KATHY FORD MONTGOMERY,  
KATHY FORD INTERIORS  
ON BEHALF OF THE  
AMERICAN SOCIETY OF INTERIOR DESIGNERS (ASID)**

On behalf of the 30,000 members of the American Society of Interior Designers (ASID), I am pleased to have the opportunity to submit a written statement for the record to the Subcommittee on Oversight, Committee on Ways and Means, in support of H.R. 1972, a bill introduced by Rep. Jon Christensen (R-Neb.).

ASID would like to thank Chairman Nancy L. Johnson (R-CT) for holding this hearing to provide a forum for discussion on this important issue.

As National President-Elect of the American Society of Interior Designers (ASID) and owner/principal of Kathy H. Ford Interiors, Lubbock, Texas, I am keenly aware of the effect of the status of independent contractors on the entire design-build industry, including interior design businesses.

ASID's membership includes interior design practitioners, as well as manufacturers and suppliers of products which interior designers specify. As the largest interior design organization, ASID represents a broad cross section of the design industry, including contract and residential designers, self-employed individuals, and large and small businesses.

As the subcommittee is aware, the independent contractor issue drew considerable attention at the third White House Conference on Small Business in June 1995. Interior designers were among the participants at that conference.

ASID supports the Christensen bill along with the other organizations that belong to the Independent Contractor Coalition. Many of our partners in the coalition represent trades and industries which provide services as independent contractors on design projects. We welcome H.R. 1972, as it establishes an objective, three-part test for determining whether an individual is an independent contractor or employee.

I started my firm 18 years ago and specialize in design for health care facilities and corporate offices. Today's business environment demands that my business run "lean and mean" on overhead costs; yet, thanks to new technology, we are able to work with clients anywhere by using independent contractors in different cities, wherever the client is located.

The greatest operating cost in an interior design business is the cost of labor. To remain profitable, firms must outsource. Using independent contractors also enables us, as designers, to assemble the best and most suitable team possible for each project. Independent contractors may be specialists in aspects of design such as lighting, custom cabinetry, environmental design, life cycle analysis or ADA compliance review. Or independent contractors may offer support skills in Computer Aided Design (CAD) drawings or project supervision to ensure that the design firm's clients are well served.

I would not be able to maintain my firm's competitiveness if I had to add these resource contractors to my payroll. Different jobs require different resources. Part of my competitive advantage is having the flexibility to identify and use the best resource contractors for each client's needs. These independent contractors make it possible for me to take on large projects that I cannot handle with my small staff.

The independent contractors my firm uses are small businesses like myself. They are proud of their companies and struggle with many of the same issues my design firm handles. They do not want

to be on my payroll or work as my employee. They are accustomed to competing for jobs and working as subcontractors in the design/build industry. They like the independence of being a small business owner, and they market their specialty to stay in business.

Today's students and entry-level professionals are taught that in the business world they are entering they should consider becoming independent contractors, outsourcing work or becoming specialists who will then contract out to many different firms, such as mine. Interior designers are offered diverse training and experience and may choose a general or specialized business. In either case they are likely to be involved as, or with, independent contractors in their future.

It is very difficult for the small business owner to make a profit and grow his or her business. Using independent contractors to perform various services is a long standing practice among small businesses, yet the IRS has never fully accepted that reality. As a result, we live with the fear that the IRS will arbitrarily determine that these individual contractors, whom we have engaged, are not independent contractors, but employees for whom federal withholding tax, FICA, and FUTA payments are owed. The loss of ability to work as an independent contractor or use one would make it practically impossible for small businesses to maintain any sort of profitability.

We are not suggesting that guidelines are not needed. Small interior design firms who have faced an IRS audit with regard to independent contractors can attest to the need for more clarity.

ASID believes that legislation which clarifies the independent contractor classification, fairly written, would go a long way toward making certain that the independent contractor status is not abused. We believe H.R. 1972 is that kind of common sense approach to clarify who is an independent contractor.

Before the

**SUBCOMMITTEE ON OVERSIGHT  
COMMITTEE ON WAYS AND MEANS  
U.S. HOUSE OF REPRESENTATIVES**

June 20, 1996  
Washington, DC

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Statement for the record of

**AMERICAN TRUCKING ASSOCIATIONS, INC.**

on

**INDEPENDENT CONTRACTOR/EMPLOYEE TAX CLASSIFICATION ISSUES**

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- o The trucking industry has long been a source of opportunity for individuals wishing to go into business for themselves. Because an individual who does not wish to be an independent contractor nearly always has the opportunity to work elsewhere as an employee, it is rare to find trucking companies who have inappropriately classified workers. The industry has repeatedly been supported in its interpretation of the law: some of the most important case law defining who is an independent contractor involves the trucking industry, dating back to Supreme Court decisions in the 1940s.
- o Because the proper classification of a worker necessarily depends heavily on the particular facts of that worker's arrangements with a service recipient, statutory definitions or standards are unlikely to end controversies. Instead, the solution lies in giving agents and taxpayers a clear understanding of how to apply existing law.
- o Recently, the National Office of the IRS has taken some positive steps to improve fairness and consistency in worker classification. For instance, the draft training manual for field offices and agents handling classification requests shows a refreshing balance, clarity and awareness of what factors should or should not be relevant for classification in today's business environment. The "market segment understanding" initiative also shows promises of developing appropriate occupation-specific standards in cooperation with affected industries. We think these approaches will deliver more benefits than legislation that inevitably introduces terms and concepts subject to further litigation. If legislation is adopted, it should broaden consistency by applying to all income and unemployment tax purposes.
- o The IRS has unfortunately chosen to force service recipients to become tax collectors rather than improving compliance directly. A fairer way to improve compliance is for the IRS to use the information it already obtains, by requiring individuals with income subject to reporting on Form 1099-Misc to list these receipts separately; that would allow efficient matching of 1099s and tax returns, as the IRS has successfully done with dividends and interest.

**I. ATA Represents an Industry with Thousands of Independent Contractors**

The trucking industry includes more than 350,000 companies, of which 88% are small businesses. The American Trucking Associations (ATA), the national trade association of the trucking industry, has member companies in every state and business segment. ATA is a federation comprising 38,000 trucking companies and suppliers that belong directly to ATA or its 51 state affiliates and 14 specialized national affiliates. ATA includes motor carriers of all sizes and types, ranging from single owner-operators to major companies that

employ drivers, contract with owner-operators, or both. Classification of workers as employees or independent contractors is a major concern in trucking, and we appreciate the chance to offer our views on this issue.

Independent contractors play a vital role in several segments of trucking. Independent contractor drivers are small businesses that buy or lease and operate their own equipment and pay virtually all of the costs of such businesses, including fuel, maintenance, labor, bookkeeping and taxes. Such businesses are specifically recognized by Congress in the Interstate Commerce Act and regulations of the Federal Highway Administration and Surface Transportation Board. As independent business people, they make their own decisions as to what shipments to contract to handle, what routes to take, and what business and personal expenses to assume.

## **II. Current Law Protections Should Be Retained**

Despite complaints and "horror stories" regularly trotted before committees that have held hearings on employee classification, there are many industries in which the current, common law approach to classification works well. For instance, in trucking there is a long history of case law, including Supreme Court decisions, establishing conditions under which drivers are independent contractors. ATA has worked hard to educate our members regarding classification criteria. We have also worked with IRS and Treasury staff on a number of initiatives to improve certainty and compliance.

"Current law" does not imply an absence of guidance. The IRS issues hundreds of private letter rulings and technical advice memoranda per year, and courts continue to rule on employment classification cases. In fact, it is the very continuity of current law that makes it the best solution for an inherently complicated problem.

## **III. Improving IRS Guidance and Enforcement**

The quality of IRS guidance and enforcement can be improved without changing the underlying law. Recently, the IRS has taken steps that hold some promise of improving the classification process.

The most significant step is issuance of a training manual for agents. The draft of this manual, which was wisely made available for public comment (and has received over 60 comments), did a good job of presenting the issues and law in a clear, well-organized fashion. It also provided a realistic view of what factors should be disregarded or downplayed in classifying workers. For instance, use of a uniform or logo on a vehicle is not an indicator of employment status, as the manual acknowledges. Nevertheless, the manual can be strengthened. For example, ATA has recommended that the manual should allow examiners to make a section 530 determination before going through the common law factors, and that efforts by companies to assure compliance with requirements of other government agencies or to pass along feedback from customers should not jeopardize independent contractor status.

A second positive initiative has been the "market segment understanding" dialogue that the IRS has engaged in with several industries, including household goods movers, to come up with a shortened list of "critical" and "significant" factors that would demonstrate worker status. Unfortunately, the IRS has not had the internal unity or organization to conclude these discussions in timely fashion. Industry groups are showing understandable frustration with the lack of results after as much as four years of discussions. But we still believe an industry- and occupation-specific approach is a promising one. We hope the Committee will encourage the IRS to engage in more such dialogues and to conclude them promptly.

#### IV. How to Improve Compliance

A major reason that the IRS focuses so heavily on worker classification is that it believes that it is much easier to have payors withhold and remit tax than to get individuals to do so. Yet the Treasury Department noted in its 1991 report, "Taxation of Technical Services Personnel: Section 1706 of the Tax Reform Act of 1986", that compliance can be as high for some independent contractors as for employees.

The IRS has ignored its own success in boosting compliance from dividend and interest recipients. This success resulted from three measures: beefed-up reporting by payors, IRS matching of these reports against individuals' listing of each dividend and interest payor, and IRS letters to individuals asking them to pay tax on unreported income or to explain discrepancies.

ATA believes the same model would work with self-employment (independent contractor) income. In repeated meetings with Treasury and IRS officials we have urged two simple changes to Schedule C of IRS Form 1040 that would lead to a number of benefits for compliance:

- o Require individuals to list their total self-employment income separately from other receipts.
- o Require that they list the amount paid by each service recipient and the payor's name.

The IRS would then be able to match the total from Schedule C against the amounts the IRS had posted on the individual's master file. Where a discrepancy existed, the IRS could see which payors were omitted from Schedule C. The process would enable the IRS to target and resolve discrepancies much more efficiently and less intrusively than is presently possible. There would be no added burden for businesses or for individuals who are already reporting all self-employment income. These individuals are already creating a listing of payors (if they have more than one) for their own use and could readily include that list with their returns. No legislation would be required for the IRS to require and use this data.

#### V. Legislation

As noted, ATA believes that the combination of common law and section 530 provides a reasonable degree of certainty and protection for many taxpayers, both individual and business. Improved IRS training of its agents, application of section 530 first in audits, and agreements or "understandings" with industries regarding specific categories of workers would resolve many of the existing problems without new legislation.

Although ATA does not oppose legislative attempts to provide more objective standards for service recipients wishing to treat workers as independent contractors, we have some reservations. First, we fear that injecting undefined or imprecisely defined terms into the tax code will lead to the same sorts of controversies as now exist over whether a particular taxpayer qualifies for relief. Second, standards that must be applied worker by worker may require the business to obtain and keep more documentation than is currently necessary and to risk losing independent contractor treatment for those workers for whom paperwork is incomplete or missing. In contrast, under current law, a company can generally show that it treats workers "consistently" without having to provide documentation on each one. Third, we are worried about how the revenue loss from a bill would be offset. Companies that have not had a problem under current law are naturally apprehensive about legislation that would give them no further relief but might be paid for by cutting back the very protection they now rely on or by imposing new recordkeeping, reporting or withholding burdens.

If the Committee decides legislation is necessary, we recommend that it emphasize consistency among all federal taxes in applying a worker's classification. Currently, section

530 provides relief only from employment tax obligations. But the IRS takes the view that when a business qualifies for section 530 relief, the worker is nevertheless an employee for the business's pension and benefits income tax obligations as well as for individual tax considerations. In addition, states are free to classify the same worker differently from the federal government for the same unemployment tax. These results are illogical and incomprehensible for both the business and the individual. The Committee has jurisdiction over these issues, though not for the broader questions of defining employment status for other state taxes or for nontax purposes. For instance, Internal Revenue Code section 3304(a) already imposes 19 requirements on states seeking to have their unemployment laws qualify under the Federal Unemployment Tax Act (FUTA). Requiring states to adhere to an IRS determination of worker status for FUTA purposes would be consistent with these other requirements and would remove a trap for unwary businesses and individuals. (H.R. 510, introduced by Reps. Christopher Shays and Tom Lantos, includes such a provision.)

Any new statutory standards, as well as determinations under section 530 if that is to be amended, should apply for all tax code purposes, not just for employment tax. (H.R. 582, introduced by Rep. Jay Kim, and S. 1610, introduced by Sens. Kit Bond and Don Nickles, would achieve that result by applying to "this title", meaning the entire tax code title of the U.S. Code. In contrast, H.R. 1972, introduced by Rep. Jon Christensen, would apply only to the employment tax subtitle, as does current section 530.)

The Senate Finance Committee has reported out (as part of its version of H.R. 3448) several proposed modifications to section 530. Several of these are clearly worthwhile, such as applying section 530 without first making an employment determination, specifying that 25% is a safe harbor for defining "significant segment" of an industry and that 10 years (or less for newer industries) is a safe harbor for defining "long-standing". We believe the IRS could and should adopt all of these even without legislation, however. The bill's most controversial proposal would limit the prior audit safe harbor after 1996 to examinations that specifically covered workers doing similar work to those whose status is being challenged; some ATA members have expressed concern that it would be hard to get documentation from the IRS that workers' employment tax status had been examined and judged satisfactory unless the bill is strengthened in this regard.

There also have been proposals to increase penalties for failure to issue information returns (Form 1099-Misc) to independent contractors. Many penalties in the tax code have been increased in the past decade, yet both IRS officials and outside researchers have expressed doubt about the value of increasing penalties in general. We urge the Committee to seek evidence that a proposed penalty increase would be useful in boosting compliance before adopting it.

## VI. Conclusions

Court cases have provided more than 50 years of interpretation of the common law regarding tax classification of workers. Section 530 of the Revenue Act of 1978 has been in place for nearly 18 years. Congress should be very cautious about undermining these approaches to classification. Instead, the IRS should be urged to keep working internally and with taxpayer representatives to improve clarity and consistency in applying current law. In addition, the IRS should focus on making use of existing information to bolster compliance instead of either turning legitimate independent contractors into employees for its own convenience or seeking new penalties. If legislation is adopted, it should apply for income tax and the state portion of FUTA as well as existing federal employment tax requirements.

## **STATEMENT OF ASSOCIATED BUILDERS AND CONTRACTORS**

Associated Builders and Contractors (ABC) is a national trade association representing over 18,500 contractors, subcontractors, material suppliers, and related firms from across the country and from all specialties in the construction industry. ABC represents 80 percent of the nation's construction workforce. The association's diverse membership is bound by a shared commitment to the free enterprise system and the merit shop philosophy of awarding construction contracts to the lowest responsible bidder through open and competitive bidding. ABC appreciates the opportunity to offer the following statement for the record of the Committee's June 4, 1996, oversight hearing on worker classification issues, the problems concerning independent contractor classification under the tax code, and the pending legislation to simplify this system.

ABC is pleased with the Ways and Means Committee's commitment toward examining the current problems with regard to the Internal Revenue Service's (IRS) handling of classification of independent contractors. This has been a contentious issue in the construction industry, which provides significant opportunities for independent contractors but has to operate under a confusing framework of rules that inadequately address the classification of workers as employees or independent contractors. Much of the problems stem from a confusing tax code which provides no clear definition of an independent contractor. ABC strongly believes there needs to be a reasonable and workable law that can be enforced in an evenhanded manner by the IRS. ABC supports the legislation (H.R. 1972) introduced by Rep. Jon Christensen (R-NE), which will set fair and objective rules for determining who is an employee and who is an independent contractor.

### **The Value of Independent Contractors in Construction**

Independent contractors often provide the perfect answer to a pressing need for special skills and know-how required for short term projects. The flexibility an independent contractor provides to a small, fledgling operation creates numerous advantages for all parties involved. This arrangement allows the independent contractor to have the freedom to choose his or her work schedule, a small business owner the flexibility to adjust staff demands with business activity, and the consumer the opportunity to benefit from a reasonably priced, quality product. ABC believes that employers should continue to be able to make sound economic decisions about the classification of individuals as employees or independent contractors. Lawful utilization of independent contractors provides a good source of labor for projects where the contractor does not need to exercise the type of control that would necessitate the hiring of an employee.

Small businesses, the backbone of the American economy, particularly benefit from this practice. In fact, many ABC members started running their own businesses by working as independent contractors. It is not unusual for these individuals to work as employees during regular hours and as independent contractors during off-hours and weekends. There is no better way to become established as a small business than to begin as an independent contractor.

For example, in the drywall business, independent contractors are used for very specific tasks such as framing and drywall hanging and finishing. They are small, insured contractors who move from job to job and company to company. They own their own trucks and their own tools. These contractors greatly value their ability to work independently. The mark of an independent contractor is that he can control how, when, and where he provides services – qualities greatly valued by many in the small business world.

The construction industry as a whole faces a unique problem due to its high number of transient and seasonal workers. Because of the cyclical nature of the industry, many businesses cannot afford to keep certain specialized trade craftspeople as employees. Sometimes, skilled craftspeople are needed several times throughout the year, but not enough to warrant full-time or even part-time employment. Having to place two or three extra employees on the payroll just to finish a short-term project places a significant and unnecessary burden on companies.

### **The 20-Factor Test**

Under current law, taxpayers must use a 20-factor common law test to determine whether a worker is an employee or an independent contractor. The 20-factor test is controversial and cumbersome, as well as subjective, and often leads to disputes between the IRS and businesses.

Imagine the difficulty of a small contractor, not trained in the field of law, but merely wishing to engage the services of a worker for some project, in confronting those 20 factors.

The same common law, 20-factor test is used by the IRS to determine compliance. The IRS generally examines the classification of workers some time after the taxpayer has made its determination of the workers' classification and after the taxpayer has filed its returns. Thus, reclassification by the IRS can result in severe penalties in the form of back taxes and interest. ABC believes that Congress, and not the IRS, should define independent contractor status. By clearly setting out rules that encompass how an independent contractor is defined, Congress can protect those in the construction and other industries who find it mutually beneficial to utilize independent contractors.

HR 1972 would establish a three-part objective test for determining whether someone is not an employee. In order to qualify as an employee, the individual must meet all three parts which address the level of investment, independence, and existence of a written contract. The independent contractor and business being served must continue to comply with all the income reporting rules. The legislation does not eliminate the 20-factor test, but provides an alternative test for those who comply with income reporting requirements.

ABC believes this process will provide distinct, clear and objective criteria to establish who qualifies as an independent contractor. In the construction industry, the worker's own investment in training, tools, and equipment, the worker's ability to perform services for several different people, and the contract under which the worker operates are critical to the determination of whether the worker is an employee or independent contractor. The control by the hiring party is one component, but similarly important is the independence of the worker, which has to be integrated with the appropriate level of instruction and control to properly sequence the work on a project. All subcontractors have to work in harmony, and therefore must work under a clear plan or schedule. A delicate balance must be struck to avoid misclassification of these individuals when they are simply carrying out their duty to build the project. The appropriate focus on investment, independence, and contracts will help clarify the decision and free individuals to enter into business arrangements of their own choosing, without fear of the IRS making subjective decisions to push them into a different category.

#### **Misclassification of Independent Contractors**

When considering the independent contractor issue, it is critical to distinguish between wrongful classification and misclassification. In construction, wrongful classification can result in a competitive edge. Those companies not paying employee taxes or workers' compensation can undercut the competition by offering lower bids. ABC in no way condones intentional misclassification by businesses who shirk their duties to society and their workers.

On the other hand, simple misclassification or failure to file a 1099 form can easily occur through administrative error. A penalty should not apply in de minimis circumstances where the taxpayer correctly issues information returns to most of its workers. Why should those who genuinely believe they are within the bounds of an admittedly vague law be treated in the same manner as those who purposefully violate that law to gain a benefit? Innocent businesses who have mistakenly misclassified a worker as an independent contractor can be subjected to back taxes that can literally bankrupt them.

The "safe harbor" provisions in Section 530 protect taxpayers from reclassification if there is a reasonable basis for treating workers other than as employees. This reasonable basis may come from published rulings, a prior audit, or industry practice. Section 530 recognizes that taxpayers must be able to rely on reasonable methods of classification without risking bankruptcy. The protections found in Section 530 are invaluable, especially to the construction industry with its long history of industry practice.

#### **Conclusion**

In addition to protecting past classifications, ABC believes it is time to clear up the confusion surrounding the 20-factor test for future classifications once and for all. A clean and simple test that recognizes the valuable role of independent contractors in the small business world would ease the

way of the contractor struggling with a classification and make it easier to identify wrongfully classified workers. ABC supports H.R. 1972, which will preserve the current, mutually beneficial industry practice of properly utilizing independent contractors, and eliminate the need for the enigmatic 20-point common law test and replace it with a far more simple and objective formula.

The value to our nation of strong relationships between small businesses and independent contractors cannot be overstated. This is true local empowerment which creates thousands of new small businesses every year. It is also a critical part of the equation for improving the lives of disadvantaged and minority Americans who are working hard to seize opportunities to start their own businesses. ABC thanks the Committee for the opportunity to provide this statement for the record and urges Congress to continue its efforts to clarify and simplify the U.S. Tax code dealing with worker classification.

## STATEMENT OF ASSOCIATION OF ALTERNATE POSTAL SYSTEMS

The Association of Alternate Postal Systems is a trade association of door-to-door delivery companies. AAPS has approximately 120 member companies in 38 states who serve more than 35% of the total population of the United States with distribution services in competition with the U.S. Postal Service.

Our membership is comprised of approximately one third newspaper ownership, about one third free publication ownership and about one third independent ownership. Most AAPS members are small businesses. A few, certainly a small minority of members, are large newspapers located in major metropolitan markets, including the Columbus Dispatch, Sacramento Bee, Houston Chronicle and Orlando Sentinel.

Most of the advertising being distributed by AAPS members is saturation flyers. These are produced by grocery chains and major retailers such as Kmart, Wal-Mart and Sears. In addition, a number of member companies distribute monthly magazines such as Popular Science and Better Homes & Gardens. All member companies distribute occasional product samples for major food and cosmetic manufacturers. Most member companies also distribute phone books and community directories.

With few exceptions our member companies depend on independent contractors to perform the delivery of these materials. This has been the case for many decades. Throughout the years many AAPS member companies have experienced Internal Revenue Service audits of independent contractor applicability and procedures. Throughout the 1960s through the 1980s, most have been found by the IRS to be in compliance with applicable contractor laws and filing requirements.

However, it seems that in the past five years the IRS has been increasingly inclined to rule that businesses performing the same functions in the same ways are no longer able to so categorize their carriers. The infamous twenty question test tends to be unclear and it is subjectively and arbitrarily applied. A company no longer is able to ascertain what is necessary to comply, how many of the twenty questions they have to "get right," what their own personal IRS auditor will consider to be "enough" compliance.

No company going into a compliance audit has any idea whatsoever, based on the twenty question test, what may be considered by the auditor to be an independent contractor or what will be pronounced to be an employee. Furthermore, a number of companies have been assessed back taxes and penalties contrary to the safe harbor laws of section 530 of the Revenue Act of 1978.

One typical AAPS member company, a small Midwestern business which had been in existence for about 30 years, was recently audited by the IRS. The conclusion of that audit was that the independent contractors who have been performing the delivery activity all those years were really employees all along. The company was assessed more than \$250,000 in back taxes and penalties. I am personally familiar with this company and its ownership, and I can vouch for their integrity. These people play by the rules and are careful to comply with reporting regulations.

Even if this company was doing something in ignorance that would tend to support the IRS's conclusion that its carriers were employees (to my knowledge they were not), they clearly were eligible for safe harbor relief. The entire industry has a long history of utilizing independent contractors for its carrier force, and this long established practice has been repeatedly upheld in many past IRS audits of numerous companies. This particular company's record of reporting and the submission of 1099 forms was unquestionable. In every way this company was entitled to relief under the safe harbor laws. Yet the IRS concluded that in their case, somehow the safe harbor rules were not applicable.

However, the IRS has generously offered to waive the back taxes and penalties if they will only classify their carriers as employees in the future. When threatened with a quarter million dollar payment, they appear to have decided to do what most small businesses would do; they have told me that they will likely cave in to the blackmail in order to get the IRS off their backs. Throughout the process they have incurred substantial legal fees, and by reclassifying their contractors as employees they now face a new annual expense in the \$100,000 range.

These people were very agreeable to give me the details, but asked that their business name not be identified for fear that their settlement position with the IRS would be jeopardized. Like most American individuals and businesses, they fear getting on the wrong side of the IRS. If your committee would like verification of this incident, I would happily provide you with more specific information on your assurance that their identity be protected.

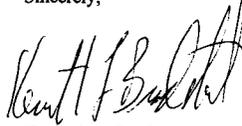
It is our opinion that the IRS is out of control. It appears that their objective is to convert every contractor situation that they possibly can into an employer/employee relationship. It is my observation that they chafe under the safe harbor "limitations" and that they routinely ignore them. By refusing to extend safe harbor relief, they use the threat of back taxes, interest and penalties to coerce compliance and to force settlements that are favorable to them.

Our member companies contract with tens of thousands of individuals all over the United States for delivery of their products. Moreover, our industry extends far beyond our own association's membership, consisting of a substantial number of small businesses in every state, virtually every community, and comprising a significant segment of the labor market. As small businesses trying to comply with government regulations, we need a more clear, concrete guideline than the obscure twenty question test. Further, we need better oversight of the IRS to assure that they properly apply safe harbor laws and any corrective legislation as Congress intends them to.

We enthusiastically support the proposed legislation, HR 1972, as a significant improvement. While we have some concerns that some of the wording might be mis-construed by the IRS, certainly the proposed legislation is a significant step in the direction of clarity. We urge the Committee on Ways and Means to recommend this legislation to the full House of Representatives.

Beyond this pending legislation, however, we urge the Congress to take whatever action is necessary to force the IRS to comply with both the letter and the spirit of this proposed legislation as well as existing law. The improvements contained in HR 1972 will have little positive effect if the IRS is allowed to simply ignore them as they have the safe harbor laws. While it is important that small businesses comply with the law, it is every bit as important that government (specifically the IRS) is in compliance with the law also. The IRS in numerous cases has chosen to ignore the safe harbor protection laws, and we urge Congress to take whatever corrective action is necessary to force compliance.

Sincerely,



Kenneth L. Bradstreet  
Executive Director,  
Association of Alternate  
Postal Systems

Statement of Tom Brewster  
before the  
Oversight Committee of the House Ways and Means Committee

June 20, 1996

Chairman Johnson and Ladies and Gentlemen of the Subcommittee:

I appreciate the opportunity to address this Subcommittee. My name is Tom Brewster. I am a Marine Corps veteran, and a retired Montgomery County Maryland government worker. I am here today to ask on behalf of caddies that you consider why they should be treated as employees by country clubs. I am here to tell you that because caddies are generally treated as employees for every other purpose, they should not be regarded by clubs as independent contractors--because clubs generally control the employment of their caddies, no basis should exist to provide them relief or shelter from employer tax obligations.

I am a recipient of the Francis Quimet caddie scholarship which paid for my college education. I have caddied at country clubs, and I have caddied on the LPGA, PGA, and Senior PGA tours. I am also the author of the most comprehensive caddie training manual used today. As a caddie for almost forty years, I have witnessed the lives of caddies in a number of different and often disturbing settings. I have seen caddies working in deplorable conditions, many relegated to waiting in boxes no bigger than an outhouse, not getting paid for this waiting time, but only when they're carrying a bag. I have seen the system work as it has for many years, essentially under the table, and without recognition by clubs or caddies that wages are being earned.

I have observed that in the various country clubs I have worked for over the years, country clubs and their members almost never issue 1099 forms to caddies. They claim nevertheless that caddies should be treated by the government as independent contractors without the benefits or privileges of the employment relationship. At the same time:

- . they set the caddies hours and provide the place to work
- . they require caddies to wear uniforms
- . they provide training for the caddies
- . they post caddies fees and in many cases publish them in club materials
- . they appraise the caddies performance and control their assignment to club members
- . most caddies work solely for one club and many work for years at a time
- . the club provides the office or "caddie shack" where the caddies report and wait for bags to carry

clubs funnel the caddie fees through the monthly membership billing

Because caddies have almost always been regarded as independent contractors by country clubs, they do not receive any employment benefits, much less recognition that the legal benefits of employment apply to them, such as workers' compensation and unemployment benefits. Caddies are expected to be responsible for reporting their income, and paying their own Social Security and Medicare contributions. In practice, of course, this income is rarely ever reported, these contributions are never made, and everybody loses in the long run except for those employing caddies.

Caddies are integrated into a club's business operations by delivering to its members a service to members who play golf. Caddies spend more time one on one with a club's members who play golf, than anyone else at the club. Because caddies play such a very important role in club operations and are in fact controlled by the club in a multitude of ways, they should be considered employees of the club.

The IRS has recognized this issue in their recent audit of one of the most prominent private country clubs in the nation. Exhibit I. In their audit, they recognized the true relationship between a club and its caddies, and reclassified the club's caddies from independent contractors to employees of the club. Additionally, the IRS levied a substantial fine against the club for worker misclassification. This is causing the country clubs to stand up and take notice for the first time in history that their current treatment of caddies is, as they have always suspected, incorrect. It is also the reason that country clubs are supporting through association an interpretation of H. R. 1972, H.R. 582, and of Section 530 of the Revenue Act of 1978, that will sanction their treatment of caddies as independent contractors.

I must say that I am hoping to communicate to this Committee not only on my own behalf, but on behalf of a majority of caddies who are less fortunate than me. I am not the norm among caddies. The group I also hope to represent are referred to as "career caddies." These individuals generally have minimal education, and come from lower income backgrounds. More importantly, most of these individuals are unaware of their rights as employees and the benefits of an employment relationship. They are also unaware of the obligations that flow from self employment.

It is a mistake to think of the caddie as a young teenager taking on a casual temporary job. While it is true that most caddies start out carrying a bag as youths, many of them stay for the rest of their lives. They are promoted to carrying two bags at a time as young adults and men, and continue caddying into their 50s and 60s, when the profession begins to wear down their bodies until they are demoted to single bags, and ultimately can carry only putters for people who are riding in their carts. These caddies cannot afford to retire. They have no retirement benefits. They have not even made Social Security contributions.

These caddies also almost never report their income, and maybe that is their

own fault. I ask, however, whether society can really blame them when they are paid so minimally, while being given a false assurance that their clubs are taking care of them. These clubs may warn their caddies to report their income or pay their self-employment taxes, but such cautionary warnings may also come with a wink. While clubs would have this pending legislation give caddies more than a wink by officially classifying them as independent contractors, I implore this Committee to recognize the caddie-club relationship for what it really is in practice, and that is an employment relationship.

I believe that under any test of the employment relationship, whether it is the twenty factor test of the IRS Code or the broader test contemplated by H.R. 1972 and H.R. 582, caddies will be considered employees. Exhibit 2. I understand, however, that many country clubs feel that because caddies have not been treated as employees for tax purposes for so many years, that clubs should be able to seek shelter from employer tax obligations under the section 530 Safe Harbor provisions. Even though most clubs do not file 1099 forms on behalf of their caddies, they argue that they should benefit from a tradition of relegating caddies to a worker classification that denies them an employment relationship.

The country club is always one of the last institutions in America to fall in line with common perceptions of equal treatment and social conscience. The clubs will not embrace such ideals because they believe such an embrace can come only at the expense of compromising tradition. While it may be tradition to deny caddies the benefit of an employment relationship, that does not make it right. The task with any legislation, is to test its boundaries. It extends section 530, H.R. 1972, and H.R. 582 beyond the boundaries of reason to permit employees such as caddies to be treated as independent contractors. If pending legislation can be interpreted to designate caddies as independent contractors, then it reaches too far and should either be tailored more narrowly, or not made law.

Thank you again for the opportunity to testify before you, and for trying to understand our position.

[Attachments are being held in the Committee Files.]

Statement of  
Robert A. Georgine  
President  
Building and Construction Trades Department, AFL-CIO

Before the Ways and Means Oversight Subcommittee  
The Honorable Nancy Johnson, Chair  
United States House of Representatives

June 4, 1996

To the Honorable Nancy Johnson and Members of the  
Subcommittee:

I appreciate the opportunity to convey to the Committee the grave concerns of the Building and Construction Trades Department, AFL-CIO regarding H.R. 1972, as well as the Internal Revenue Service's inability to effectively combat rampant misclassification of workers occurring nationally in the construction industry.

The Department, which is a federation of 15 national and international building trades unions representing more than four million construction workers across the country, believes that H.R. 1972 and H.R. 582, as now written, would seriously and adversely affect the interests of the millions of men and women, and their families, who depend on the construction industry for their livelihoods. Moreover, the Department believes that recent IRS initiatives which limit potential tax liability for employers who misclassify their workers will only encourage continued abuse of the federal tax laws in the construction industry.

I.

The Department's Concerns Are not  
With Legitimate Independent Contractors.

Let me make clear at the outset that the Department is not in any way challenging the right of workers to be their own bosses and build their own businesses. In the construction industry, it is a common occurrence for individual workers to make the transition from being employees to being contractors, and the Department does not want to do anything to harm their ability to do so.

What we are opposed to is the unscrupulous contractor who deliberately misclassifies workers and treats them as independent contractors even though the workers unquestionably are employees under any definition of that term.

This deliberate abuse of the tax laws costs the state and federal governments tens of billions of dollars of needed tax revenues, deprives workers and their families of pension and health benefits and other protections to which they are entitled, and creates an

unequal playing field on which honest contractors who play by the rules are unable to compete.<sup>1</sup>

II.  
Flagrant Abuses are Occurring Every Day  
in the Construction Industry.

This is not some abstract tax issue. It is very real, and it is hurting real people. Every day, we see construction sites where there are scores, or even hundreds of workers, and yet every single worker is being treated as an independent contractor. The truth is, of course, that most if not all of these workers are employees. The reason they are being misclassified is not because the rules are too complex. The contractors know full well that the workers are employees, but they misclassify them anyway because they believe, with a lot of justification, that they will never be caught - and, even if they are caught, the penalties will be minimal.

Let me share with you just one recent example that has been called to my attention that demonstrates what is going on out there in the real world. This is a case that occurred in the last six weeks. We obtained affidavits from the workers involved, and those affidavits have been provided to the regional office of IRS.

In New York, a drywall contractor was awarded the contract on a public construction project. He hired seven drywall workers - who unbeknownst to him were union members - to do the drywall work under his supervision. The terms of their engagement made it clear that they were employees.

Even though the workers clearly were employees, the contractor told them they would be issued 1099s rather than W-2s. The job they were hired to do was subject to the state's prevailing wage law, which required the drywall contractor to pay certain wages to all employees, but the workers were not being paid the required amounts.

The New York State Department of Labor performed a surprise inspection of the job site. When the state inspector revealed his identity, the contractor told the workers to "disappear" until the inspector left the site. The following evening, the contractor telephoned one of the workers and offered him \$5,000 if he would falsely claim that the other workers were his employees and not the employees of the company. In this way, the drywall contractor hoped to buy his way out of trouble.

Substantial uncollected taxes and penalties are due from this contractor. It is clear that the contractor knew the workers were employees, since he

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<sup>1</sup> By misclassifying their workers, construction contractors can save 30% to 40% of their labor costs, by virtue of the fact that they illegally avoid paying social security, medicare and unemployment taxes, as well as worker compensation premiums. The contractors also thereby avoid providing pension and health coverage to the workers and their families. Such illegal cost savings give the unscrupulous contractors enormous bidding advantages over legitimate contractors.

told them to "disappear" from the job site as soon as the labor inspector showed up and then offered one of the workers \$5,000 to falsely claim the other workers as his employees.

And yet, when the workers went to the local IRS office and presented these facts and supporting affidavits, they were told that nothing would be done because these types of cases are considered a low priority. I should point out in defense of the IRS that these cases are considered low priority because this Congress last year removed all enforcement funding for the agency. There is no one available to follow up on situations like these. These incidents I have just described are, when compared to other concerns faced by IRS, of lesser priority. Yet, the failure to be able to act against violators of public law simple encourage employers to continue to violate the law.

Here we have substantial revenues that are owing and could be collected, the IRS is presented with a strong, ready-made factual case supported with affidavits - and the IRS does nothing. I would hope that Congress would immediately take steps to remedy this situation and ensure that the laws are being enforced.

### III.

#### H.R. 1972 and H.R. 582 Would Protect Construction Contractors Who are Abusing the Tax System.

Instead of providing for greater enforcement, however, Congress is considering legislation like H.R. 1972 (the "Christensen bill") and H.R. 582 (the "Kim bill"), which, if enacted, would protect employers like the drywall contractor described above as long as they had the foresight to compel their workers to sign written contracts containing certain representations.

The Christensen bill and Kim bill set out a number of factors to be applied in order to determine whether a worker is an employee. However, these factors are contained in a series of alternative criteria so that a worker's satisfaction of only a minimum number of factors would result in classification as an independent contractor.

Under the Christensen bill, an employer may treat a worker as an independent contractor by making the following three showings:

- 1) in the year of the services or in the immediately preceding or subsequent year, the worker has performed a significant amount of services for other persons;
- 2) the services are performed by the worker pursuant to a written contract which provides that the worker will not be treated as an employee with respect to such services; and
- 3) the worker is treated as having a significant investment in assets and/or training.

The first requirement under H.R. 1972, regarding work for others, typically will be met in the case of construction workers who are employees, since they

often work for a number of contractors over a three-year period. Thus, this requirement provides no meaningful basis for distinguishing employees from true independent contractors in the construction industry. Moreover, the written contract requirement easily could be satisfied by a contractor that wants to treat its workers as independent contractors, even though those workers are in every real sense employees. Finally, a construction worker who owns more than the most minimal hand tools could be considered to satisfy the third requirement, and thus would be treated as an independent contractor under the Christensen bill.

The Kim bill also protects contractors and allows employers to treat workers as independent contractors even though they clearly are employees. It provides that an individual is not treated as an employee if:

- 1) the worker has a separate principal place of business and has a significant investment in tools; and
- 2) there is an agreement between the service-recipient and the worker which contains certain representations about the engagement.

These requirements could be satisfied in the case of construction workers who are in every real sense employees, since such workers often have "home offices" where they keep records and take calls, and they typically own their own tools. The written agreement requirement obviously would not pose a problem for construction contractors who wish to misclassify their workers.

The fundamental problem with H.R. 1972 and H.R. 582 is that both bills presuppose that employers are acting in good faith and that the only reason for noncompliance is the complexity of the rules. While that may be a reasonable assumption in some industries, it very definitely is not the case in the construction industry, where the patterns of deliberate abuse are well-established. Construction workers are particularly vulnerable to veiled threats by contractors that unless they agree to sign on as independent contractors, they will not be hired.

The Department's concern is that H.R. 1972 and H.R. 582, as now drafted, would permit a worker to be treated as an independent contractor based on the satisfaction of only a minimal number of factors. Such an approach is simply not appropriate in the construction industry, given the economic incentives for misclassification and the history of abuses by many contractors. H.R. 1972 and H.R. 582, in my view, would serve only to encourage contractors to manipulate classification rules to the detriment of the worker.

If it is determined that the approach now embodied in H.R. 1972 or H.R. 582 meets the needs of other industries, the Department urges that at a minimum the bills be amended expressly to recognize the special circumstances of the construction industry by either (a) specifically excluding the construction industry from their coverage, or (b) including special rules that would govern the classification of workers in the construction industry.

IV.  
 The IRS's Recently Announced  
 Classification Settlement Program  
 Exacerbates Serious Abuses  
in the Construction Industry.

On March 5, 1996, the IRS announced its Classification Settlement Program ("CSP") which drastically reduces the deterrent value of audits by allowing employers who misclassify workers to pay only a small fraction of the taxes they owe.

Under the CSP, a construction contractor that misclassifies its workers will be required to pay only the amount it owes for one year. This is opposed to the amount it could owe for the two or three years open under the statute of limitations. All companies may take advantage of this, as long as the contractor consistently filed Form 1099s for its workers. Moreover, a construction contractor will receive an even bigger break under the CSP if it consistently filed Form 1099s and has merely a "colorable" legal argument that it meets the other requirements for section 530 relief.<sup>2</sup>

These substantial tax breaks are available under the CSP even though the employer clearly has misclassified employees. The CSP is "tax forgiveness" on a massive scale, and it considerably reduces the tax risks for employers who misclassify their workers. The CSP will only encourage contractors -- like the drywall contractor in New York described above -- to continue ignoring the worker classification rules.

We urge the Committee to review the CSP to confirm that it is undermining compliance with the tax laws and to take steps to cause IRS to reconsider this recent, ill-conceived program.

The Department will be pleased to provide you with any further information or to meet with you or your staff at your convenience. Again, let me express the Department's appreciation for the opportunity to convey these concerns regarding this very serious issue.

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<sup>2</sup> Section 530 provides that a worker found to be an employee under the common law test will be deemed to be an independent contractor for employment tax purposes if certain conditions are met. These conditions are: 1) that the employer did not treat the worker as an employee during any prior period, 2) since 1979 the employer has filed applicable information returns, i.e., Form 1099, on a basis consistent with independent contractor status, 3) the employer has classified the worker in the same way it classified all other workers holding substantially similar positions since 1978, and 4) the employer had a "reasonable basis" for classifying the worker as an independent contractor. Pub. L. No. 95-600, § 530, as amended by Pub. L. Nos. 96-157, 97-248 and 99-514.

**Committee On Ways and Means  
Hearing of June 4, 1996  
on  
Employment Classification Issues**

**Statement for the Committee Record  
by the  
Computer Software Industry Association**

June 17, 1996

This testimony is submitted for consideration by the committee and for inclusion in the printed record of the June 4<sup>th</sup> hearing of the Oversight Subcommittee of the House Ways and Means Committee.

The Computer Software Industry Association (CSIA) membership consists of over 3,000 companies in the computer software industry both within California and across the United States. Our members have been extremely negatively affected by worker classification problems.

**Computer Software Industry Is Singled Out For Harsh Treatment**

Many of our members are small businesses which provide software and electronic product development services to larger companies. CSIA is sure that you are aware of the problems caused for all businesses by worker classification problems. In our industry these problems are even worse due to the extremely discriminatory Section 1706 provision of the 1986 Tax Reform Act which enacted Section 530(d). That provision, for no valid reason, singles out the high tech industries for especially harsh treatment in worker classification audits. Prior to 1986 there existed a very efficient network of computer consultants and brokers who were able to offer services to a variety of clients. This network has now broken down, forcing many consultants, who wish to remain self-employed, to turn down work formerly available on a contract basis which is now offered only on an employee basis. Further market inefficiencies exist in the inability of companies to obtain the skilled technical expertise needed since company policy now frequently prohibits use of independent contractors at all, due to the fear of unreasonable IRS audits. The most skilled technical experts typically refuse to accept work requiring them to become short-term employees. This is due to their existing investment in equipment and other business assets, as well as their ability to provide consistency in their own self-provided retirement and health care benefits.

**Board Members**

*President: Kaye Caldwell*  
President, Caldwell Software Solutions  
Software Forum Representative

*Vice President: Lewia Shireman*  
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*Treasurer: Alan Miller*  
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*Secretary: Terry Ramus*  
Principal, Analytical Chemist  
Enable Analytical, Inc.  
PATCA Representative

**CSIA**  
**101 First St., Suite 324**  
**Los Altos, CA 94022**  
**(415) 948-9192**

There are further negative effects on the computer software industry which result from worker classification problems.

CSIA believes that one effect of worker classification problems is that they serve as a major driving force behind the industry's heavy use of foreign labor for product development and other short term (1-3 year) projects. It is indeed unfortunate that our own government prevents U.S. companies from doing business with U.S. experts while at the same time providing immigration programs such as the H1-B which encourage companies to import expertise from overseas. The IRS' policy of restricting access to U.S. experts works hand in hand with the immigration policy of encouraging short term importation of foreign experts resulting in the efficient transfer of U.S. know-how to foreign countries. This lessens our own country's long term global competitiveness.

Another effect is to deprive our technical experts of their intellectual property rights and to hinder the spread of useful technologies to the public. An independent contractor retains ownership of the copyright in his work. Portions of the copyrighted work can be assigned to a client, as appropriate, for a particular project. Other portions can be retained by the contractor for re-use in other projects for other clients. However, when the expert is forced to work as an employee all copyrightable work becomes the property of the employer - thus preventing the contractor from reusing it. This again negatively impacts the global competitiveness of the U.S. software industry.

Coupled with other discriminatory treatment of the software industry in additional tax areas it certainly seems as though our government is extremely interested in seeing that the software industry moves overseas as quickly as possible.

#### **Revenue Impacts of H.R. 1972**

We are aware that it is claimed that there will be a revenue loss due to the passage of H.R. 1972. We fail to see the justification for this claim. Government reports have concluded that misclassification of employees as independent contractors increases tax revenues due to the tax-favored status of many employee fringe benefits. Independent contractors pay more taxes due to the fact that certain benefits granted to employees are not available to independent contractors. The current partial deductibility of health insurance is but one example. The claim that independent contractors can deduct certain business expenses, typically office expenses, which cannot be deducted by an employee is highly misleading. In the case of an employee those expenses are typically paid by the employer and are deductible by the employer. As for the claim that some taxpayers will fail to pay taxes at all or will underreport their taxes, please note that the benefits of the "safe harbor" definitions of H.R. 1972 do not apply if 1099 reports are not filed. Also note that government studies have shown that, with 1099 reporting, tax compliance is very high. The current system of harsh and overbroadly applied employment audits punishes all businesses for the sake of preventing tax non-compliance by a few. This is highly inappropriate.

#### **It Is Time To Resolve These Problems By Passage Of H.R. 1972**

Worker classification problems have consistently been a serious problem for businesses. Severe penalties can be imposed even when both the service recipient and the service provider have filed all required forms and paid all required taxes. This situation should not be allowed to continue. H.R. 1972 offers a solution to this problem by defining when a worker is not an employee. We urge Congress to pass this legislation.

*Kaye K. Caldwell*

Kaye K. Caldwell  
President



CONSTRUCTION  
FINANCIAL  
MANAGEMENT  
ASSOCIATION

THE VOICE OF CONSTRUCTION FINANCIAL MANAGEMENT

TESTIMONY OF  
THE CONSTRUCTION FINANCIAL MANAGEMENT ASSOCIATION  
REGARDING WORKER CLASSIFICATION ISSUES  
BEFORE  
THE HOUSE WAYS AND MEANS SUBCOMMITTEE ON OVERSIGHT

JULY 8, 1996

[written testimony submitted for the record]

Ms. Chairwoman and Members of the Subcommittee:

The Construction Financial Management Association (CFMA) is pleased to comment on the various proposals designed to address worker classification issues that have been proposed by Congress and the Administration. Classification of workers as either employees or independent contractors has been a perennial problem for all parties involved in this issue and CFMA supports efforts to clarify and simplify the myriad of rules, factors and circumstances that dictate current law.

CFMA was established in 1981 and represents more than 5,800 financial managers in the construction business. Our members are employed by over 2,500 construction companies across the U.S. More than one-third of these members have gross annual revenues ranging from \$25-99 million.

We commend Chairwoman Johnson and the Subcommittee for its leadership in examining the worker classification dilemma, and we appreciate the opportunity to comment on behalf of CFMA and its members. Legislative activity in the worker classification area has recently gained momentum with the inclusion of several modifications to Section 530 in the Senate version of H.R. 3448, the *Small Business Job Protection Act of 1996*, and with new proposals by Treasury that were first announced at a recent Subcommittee hearing.

We know the Subcommittee will scrutinize every proposal very carefully and we encourage the Members to consider the economic contribution and unique requirements of the construction industry when deciding what approach is best for resolving this long-standing worker classification problem.

**SENATE MODIFICATIONS TO SECTION 530**

The Senate has proposed several clarifications and modifications to section 530 as part of its amendment to H.R. 3448, the *Small Business Job Protection Act of 1996*. CFMA supports the Senate's attempt to set clearer standards for taxpayers and the IRS to follow under section 530.

**Industry Practice Safe Harbor:** CFMA supports the Senate proposals to modify the industry practice safe harbor. The Senate amendment to H.R. 3448 would recognize that at least 25 percent industry participation in the same business segment is sufficient for the taxpayer to show a reasonable basis for treating a worker as an independent contractor. CFMA also favors the proposed modification to the IRS' interpretations so that an industry practice can be long-standing if it has been in place for at least 10 years. An industry practice in existence for a shorter period of time may be considered long-standing based on the facts and circumstances of the industry.

**Shift Burden of Proof:** CFMA also appreciates the Senate's proposal to shift some of the burden of proof in section 530 cases from the taxpayer to the IRS once a taxpayer establishes a prima facie case. The legislative history of section 530 clearly states that the safe harbor should be construed liberally in the taxpayer's favor. Shifting the burden of proof to the IRS in cases where a taxpayer has a reasonable basis for treating workers as independent contractors and has complied with IRS requests for information should help prevent needless and costly litigation.

**Prior Audit Safe Harbor:** We are concerned, however, that the provision to eliminate the prior audit safe harbor for non-employment tax audits commencing after December 31, 1996, would have an adverse effect on new entrants to the construction industry.

#### **CFMA OPPOSED TO GIVING TREASURY AUTHORITY TO ISSUE GUIDANCE**

One of the new worker classification proposals by Treasury at the recent Subcommittee hearing would provide Treasury with the authority to issue "a revenue ruling or other guidance," in order to "improve understanding of the common-law classification standard and its application in different industries."<sup>1</sup>

CFMA supports the goal of simplifying this complex area and we agree that some factors are more important in a particular industry than others. However, we believe it would be a serious error to give Treasury sweeping authority to influence the IRS examination policy and position on who is and who is not an employee on an industry-wide basis, thereby reversing the prohibition on regulatory action originally and intentionally imposed by Congress on Treasury and the IRS. The goal of section 530 and the freeze on regulatory action was to require determinations to be made on a case-by-case basis, not on a wholesale basis.

Congress has had sole authority to govern the classification of workers since 1978 because of the controversies that developed between the business community and the IRS over the independent contractor issue. If Treasury is given authority to propose new guidance through regulations or rule-making authority, it would constitute a major shift in power from Congress to Treasury and the IRS and would represent a dramatic change in congressional policy on the worker classification issue.

CFMA believes that other proposals by Treasury do merit consideration by the Subcommittee, although additional details on the provisions would have to be reviewed by CFMA before we could support them. Proposals to allow employers to eliminate all prior employment tax liability in certain instances where workers were misclassified and expanded Tax Court jurisdiction to resolve disputes more quickly and less costly than in Federal district court could prove to be valuable tools to the construction industry.

#### **BACKGROUND ON SECTION 530**

Congress adopted section 530 of the Revenue Act of 1978 in recognition that the rules on the classification of workers as "employees" or "independent contractors" were imprecise. For years before section 530 was enacted, the IRS increased its employment tax audits -- leading to increased controversies between the IRS and businesses. Section 530 was a stopgap measure to provide Congress time to produce a permanent solution to the complexity of the

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<sup>1</sup> Statement of Treasury Acting Assistant Secretary Donald Lubick, before the House Ways and Means Oversight Subcommittee, page 10, June 20, 1996.

independent contractor issue that would eliminate this source of controversy. While Congress has made some progress on the issue, it has also learned the lesson learned earlier by business and the IRS: this issue eludes simple solutions.

Congress addressed this issue in 1982. Statutory standards were adopted for two types of workers (direct sellers and real estate agents); if the standards are met, the workers will be treated as independent contractors. Congress also decided, as part of the same 1982 legislation, to extend section 530 relief to all other types of workers. Clearly, the Congressional intent was to simplify and clarify the law where possible, in this case for direct sellers and real estate agents, and to leave everyone else as is. Consequently, section 530 was indefinitely extended to give Congress time to produce legislation on the classification of workers as independent contractors or employees without reigniting controversy with the IRS over the classification issue. Congressional actions in 1978 and 1982 clearly indicate that section 530 was intended to help taxpayers.

### **IMPORTANCE OF SECTION 530 TO THE CONSTRUCTION INDUSTRY**

Each construction project involves an amalgamation of independent economic entities that come together under unique and complex legal arrangements for a specific job and then disperse. These entities are a combination of corporations, partnerships and sole proprietors who associate as general contractors, subcontractors, first-tier subcontractors and second tier subcontractors, and suppliers and vendors.

Within the construction industry, the general-subcontractor and subcontractor-subcontractor relationships have always been the norm for doing business. Additionally, specialty trade contractors are hired on a project-by-project basis for short durations under varying contractual arrangements to complete certain assignments. Some of these contracts can include lump-sum, fixed-fee, cost-plus, time and material, or labor-only agreements. Contractors can be selected on a competitive bid or negotiated basis depending upon the assignment.

The construction industry has always relied upon the existence of a contractor-subcontractor relationship to carry out construction jobs. The industry must continue to rely on these relationships because:

- the requirements of each particular project differ so dramatically as to the scope of work to be performed, the degree of skills needed, the number of disciplines to be engaged, and the human resources to be allocated;
- general contractors cannot afford to hire the number and variety of trade specialists they need as full-time or even part-time employees; and
- construction work, by its very nature, is cyclical, unpredictable, intermittent and non-repetitive.

To remove the section 530 "safe harbor" would threaten the long-standing industry practice of subcontracting and would threaten the ordinary way of doing business for smaller contractors and, especially, sole proprietors.

If section 530 is not available for the construction industry, the IRS could attempt to recharacterize legitimate independent contractors as employees, producing uncertainty and confusion for the industry. To avoid such a result, industry practice would have to be changed. And, before those practices can be changed, many general contractors will find that -- in the eyes of the IRS -- they are not general contractors but employers.

For example, in construction management, it is long-standing industry practice for an owner to contract directly with a general contractor who will manage a project and enter into contracts with trade specialists and other independent contractors. However, it is also common industry practice for an owner to contract directly with a general contractor and with trade specialists and other independent contractors. In both cases, under industry practice, the general contractors and the subcontractors are independent contractors.

If section 530 protection were removed, however, it is all but certain that some IRS agents will decide that owners who contract directly with subcontractors are employers under the common law 20 factor test. Consequently, owners, general contractors, and subcontractors will be left in a situation where they can no longer feel confident when they have issued a contract or work order that the IRS will view the arrangement similarly.

In addition, it is important to note that most construction contracts are acquired on a competitive bid basis. By removing section 530 protection, contractors would have to either increase the price for this contingency or else assume that any changes would impact their bid profit. This situation simply adds risk to an already very risk-laden business. (For additional information on the importance of section 530, see Appendix).

Several examples of subcontractor situations that could be misconstrued by IRS agents as employer-employee relationships are:

- punch list clean-up where many miscellaneous corrections are required in the work;
- contracts which only involve installation with materials supplied separately, e.g. HVAC subcontractor to install a central air conditioning system; and
- remodeling work where hidden site conditions are unknown and, therefore, the extent of the work is not determined in advance.

Given the competitiveness of this industry, it is important to retain section 530 in order to have a consistent approach to worker classification issues and not agent-by-agent determinations.

## CONCLUSION

CFMA contends that the majority of construction contractors use legitimate independent contractors for legitimate economic reasons. CFMA also recognizes that there are abuses in the system, but does not believe that these abuses are so widespread that the entire working structure of the industry needs to be dismantled.

CFMA supports the Senate proposals to modify the industry practice safe harbor and to shift some of the burden of proof in section 530 cases from the taxpayer to the IRS once a taxpayer establishes a prima facie case. We believe, however, that the Senate's proposal to eliminate the prior audit safe harbor for non-employment tax audits commencing after December 31, 1996, would have an adverse affect on new entrants to the construction industry.

CFMA believes that certain proposals by Treasury merit consideration, particularly those proposals that would allow employers to eliminate all prior employment tax liability in certain instances where workers were misclassified and would provide expanded Tax Court jurisdiction to resolve disputes more quickly. CFMA remains concerned, however, with the proposal to provide Treasury with the authority to issue a revenue ruling or other guidance. While providing guidance in this area may sound appealing, Treasury's goal of increasing tax revenue undermines this approach and could result in more controversy. To allow Treasury to have such sweeping authority to influence the IRS examination policy, thereby reversing the prohibition on regulatory action originally imposed by Congress on Treasury and the IRS could have detrimental effects on the construction industry.

## APPENDIX

## LIFE WITHOUT SECTION 530

We thought it might be helpful for the Subcommittee to see how these 20 factors -- in the absence of the Section 530 safe harbor -- might be used to recharacterize a traditional contractor relationship as an employer-employee relationship. Not all of the 20 factors have to be met to find the employer-employee relationship, so contractors will be faced with the possibility of having to continually defend how they do business with subcontractors.

Examples of how the 20 factors could be interpreted by IRS to question the existence of subcontractor relationships and to find an employer-employee relationship are as follows:

1. *Instructions:* The general contractor has the overall responsibility for safety and management of the job site and will direct subcontractors when they can work and the safety rules to be followed on the project.
2. *Training:* Certain work may be very technical or complicated, which could result in the general contractor providing training for subcontractor workers regarding materials handling, installation, safety, etc. For example, in the construction of "clean rooms" for manufacturing wafers and computer chips, it is common industry practice for the general contractor to provide "cleanliness training" for all workers -- including the subcontractors' workers -- to insure that the "clean rooms" meet contract requirements.
3. *Integration:* The general contractor will provide the schedule of access and completion times and coordinate work of other specialty contractors to minimize interference and increase productivity.
4. *Service Performed Personally:* A subcontractor's principal may also perform a portion of the work, especially if it is a sole proprietor or a small contractor.
5. *Hiring, Supervising, and Paying Assistants:* It would not be unusual to closely supervise and direct workers of a subcontractor who are in the process of correcting punch list items.
6. *Continuing Relationship:* A pattern of repeat business with the same general contractor could be read as a continuing employer-employee relationship.
7. *Set Hours of Work:* The general contractor controls access to the project and, therefore, sets hours of work.
8. *Full Time Required:* The general contractor monitors the progress of work and can force staffing changes to keep the work on schedule.
9. *Doing Work on Employer's Premises:* By necessity, the work location is established and controlled by the general contractor since it must be done at the job.
10. *Order or Sequence Set:* The general contractor is responsible for scheduling and coordinating subcontractors and, therefore, sets the order of work to enable the project to be completed on time.
11. *Oral or Written Reports:* The general contractor requires regular reports from the subcontractors on the progress of the work in order to continually update the completion schedule and coordinate other trades.
12. *Payment by Hour, Week, Month:* Usually a contract is done on a lump-sum basis, but can be on a per unit, hourly or cost-plus basis. Anything other than lump sum could be suspected of representing an employee situation.

13. *Payment of Business and Traveling Expenses:* This is usually not a factor, but if it should be, it is possible that reimbursement of these expenses would be provided for in the agreement.
14. *Furnished Tools and Materials:* Most subcontractors supply their own tools, but it would not be unusual for the general contractor to supply materials purchased separately from the subcontract agreement.
15. *Significant Investment:* Many subcontractors can maintain a business with little investment by working out of their homes or minimal rented space and using rented tools and machinery.
16. *Realization of Profit or Loss:* Contractors will most likely have the exposure, but may have a cost-plus contract which could isolate them from most exposure to loss.
17. *Working for More than One Firm at a Time:* Small contractors may not have the capacity to do this, but will have multiple contracts to be done on a rotating basis.
18. *Making Service Available to the General Public:* Subcontractors may be available to do work for general contractors, but not necessarily for the general public.
19. *Right to Discharge:* Owner contracts typically contain language that gives them the right to discharge any workers they find objectionable. The same right is given to the general contractor.
20. *Right to Terminate:* A subcontractor under certain contracts can terminate a relationship, providing proper notice is given.

These examples show that there could be many situations which could be falsely read as employer-employee relationships, resulting in the assessment of inappropriate penalties, interest and taxes. The construction industry today does business as it always has -- by subcontracting work. This is the reason that long-standing industry practice is relied on by law and the courts, not only for the construction industry but for all industries.

WRITTEN TESTIMONY  
OF  
BARRY H. FRANK, ESQUIRE  
AND  
JEFFREY COOPER, ESQUIRE  
MESIROV GELMAN JAFFE CRAMER & JAMIESON  
SUBMITTED TO  
SUBCOMMITTEE ON OVERSIGHT  
COMMITTEE ON WAYS AND MEANS  
UNITED STATES HOUSE OF REPRESENTATIVES  
ON  
INDEPENDENT CONTRACTORS

June 17, 1996

Madam Chairman and Members of the Subcommittee:

Barry H. Frank and Jeffrey Cooper are partners in the Philadelphia based law firm of Mesirov Gelman Jaffe Cramer & Jamieson. We have represented approximately one hundred businesses throughout the United States against the IRS attack on their use of independent contractors. We successfully represented Critical Care Registered Nursing, Inc., which was decided in favor of the taxpayer and have also settled favorably several cases in U. S. District Court prior to trial.

Most of the clients which we have represented are small businesses, that have been forced to defend themselves against the IRS challenge, at not only a heavy financial cost but also a heavy cost in terms of time. Sometimes I think it is the time needed by the business owner, which is taken away from their business in order to work with the attorneys to defend the IRS challenge, which can be as critical, if not more critical, than the financial cost.

Any legislation enacted by Congress must both include and clarify Section 530 of The Revenue Act of 1978. In addition, it is imperative that the legislative history, that Section 530 is to be liberally construed in favor of the taxpayer, be reinforced. Our experience is that the Internal Revenue Service ignores the directive that Section 530 be liberally construed in a majority of audits which it conducts.

Many of the businesses which we have represented, in more than thirty different industries, have sought protection under the third safe haven - (i) a long standing, (ii) recognized practice (iii) of a significant segment of the industry. The definition of "significant" must be clarified. Further, the application and applicability of industry surveys, whether local, regional or national, to establish industry practice, must be addressed.

Our attempt to define "significant" has, I am sure, met with the same obstacles as others. The Internal Revenue Service claims that significant should be eighty percent (80%) of an industry, yet, at the same time, acknowledging that the eighty percent may be too stringent; but has refused to lower that standard. On the

other hand, when the term significant is used in other sections of the Internal Revenue Code, whether it be related to the assessment of penalties, etc., its meaning has been found to be "less than fifty percent". Some objective range should be adopted and incorporated in any new legislation.

With regard to industry surveys, the Internal Revenue Service has repeatedly stated that an industry survey can only be used to satisfy the third safe haven, if it is a survey that was conducted or considered by the taxpayer at the time it started in business. We do not know of, nor have we ever heard of, any entrepreneur or business person that conducts a survey at or prior to the time they went into business. It is hard enough for someone to start a business without going out and paying for a survey.

In fact, many of the clients that we have represented in defending the IRS attack on their use of independent contractors had previously worked as an independent contractor themselves in that industry or a similar or related industry. The individual workers that they knew and came in contact with who worked in that industry also held themselves out as independent contractors. In other cases, we have represented businesses that, when first starting out, contacted workers and the workers themselves told the business owners that they only work as independent contractors. Also, if someone acquires an existing business that has always treated its workers as independent contractors, that should also have some impact.

We have represented businesses where professional surveys were conducted by the industry after the taxpayer began the business and at times contemporaneous with or close in time to the period under examination. When such surveys indicate that 70% or 80% or greater of an industry utilizes independent contractors, in all regions of the country, that survey is a definite verification that, in fact, the industry practice was and still is predominately staffed by independent contractors. If nothing else, such surveys should satisfy the fourth safe haven - any other reasonable basis.

The argument over whether Section 530 can and should be considered prior to considering the common law factors must also be addressed and, if Section 530 is found to apply, it must apply for all tax purposes, including pension plans, qualified plans, etc. For those taxpayers who are finally granted relief under Section 530, it is a total injustice that they still might be subject to attack because the Internal Revenue Service can claim that the workers are employees for other tax purposes.

The Independent Contractor Tax Fairness Act of 1985 (H.R. 582) is a step in the right direction but needs to be clarified and expanded in order to provide a fair treatment for all businesses and industries that traditionally use independent contractors. The Bill repeatedly uses the term "significant" in establishing the various tests to be used in meeting the three sets of requirements. Some dollar parameters along with some percentage of revenue generated by the independent contractor need to be established or nothing will be accomplished under the Bill, if adopted. The proposed legislation is well intended but as long as there are ambiguities and as long as the Internal Revenue Service is going to continue to aggressively attack businesses that properly and legitimately utilize independent contractors, the problem will not be solved. Something must be done to get the Internal Revenue Service to fairly treat companies that make a bona fide effort to use independent contractors.

There may be tens of thousands of businesses that pay their workers in cash and hundreds of thousands of workers who, being paid in cash, do not file tax returns or pay taxes; nor do we suggest that the workers and businesses be free from IRS enforcement. In fact, we encourage it. The cash economy should not taint those businesses and workers that legitimately engage in business by contracting with independent contractors. Despite the fact that the Internal Revenue Service, at the National Level, has taken steps which appear to be addressing the issue, the Classification Settlement Program makes it easy for the Internal Revenue Service to get companies to reclassify workers to employee status but, what about all of those businesses that want to, intend to, and need to continue to classify the workers as independent contractors. Their fight will have to continue because the Classification Settlement Program leaves an enormous gap between those companies will to convert their workers and those businesses that want to continue using independent contractors, unless they can clearly satisfy the IRS.

We appreciate the opportunity to submit this written testimony and to testify at any future hearings on the topic of independent contractors.

**STATEMENT OF JOY J. TURNER  
OF JEFFERS BUSINESS SERVICES  
ON BEHALF OF  
THE DELEGATES TO THE WHITE HOUSE CONFERENCE ON SMALL BUSINESS**

The Honorable Nancy L. Johnson, Chair  
Subcommittee on Oversight  
Committee on Ways and Means  
104th Congress of the United States  
House of Representatives  
1136 Longworth House Office Building  
Washington, D. C. 20515

Madam Chair Johnson and Subcommittee Members,

The opportunity to provide my statement on the INDEPENDENT CONTRACTOR issue is indeed an honor and is sincerely appreciated. It is encouraging that this issue, so vital to the small business community, is receiving well-deserved attention and I am hopeful that it will receive positive action from your committee.

I have been empowered to speak on behalf of The National Association of Women Business Owners, The National Society of Public Accountants, The National Society of Tax Professionals, The National Minority Delegates Caucus, and my diverse clientele. My testimony comes from experience of several vantage points.

First, I am the owner of a small business, an accounting, tax and small business consulting company. I have operated this business on a part-time basis for more than fifteen years. I recently began a full time operation after having been an employee of a fortune top-ten company for twenty-six years. I hold two degrees in Accounting, have specialized certificates in tax and accounting subjects, earn 16-24 CPE credits each year, and have combined twenty years experience in Corporate Accounting, Federal Taxes (domestic and foreign) and Corporate Finance. I have no employees.

At some point in the future, I plan to have employees but for now, if and when I secure jobs that I cannot personally complete, I must use the services of an independent contractor. I market my accounting and business consulting services as an independent contractor. I have been adversely impacted by the twenty factors test as it now stands and is administered by the Internal Revenue Service. (Revenue Ruling 87-41 defines a twenty-factors control test based on common law principles.)

Just recently, I was put in the position of having to sever a contract before term. A non-profit organization's board of directors, acting out of fear that I may later be reclassified as an employee, insisted that I sign a legal document that went considerably beyond what was reasonable, practical or necessary for the scope of the job. It seems that several board members who happen to be attorneys became vaguely aware of the twenty-factors test. They reacted rather strongly and to my detriment. Since I did not want to become their employee nor did I want to sign my rights away in order to complete the contract, I requested mutual consent to end the relationship. A written document (contract) had already been executed which was quite competent to establish my position as an independent contractor. In accordance with current law, a reasonable basis existed for not treating me as an employee. We chose to end the relationship two months early. They suffered and so did I. I could not dispute that reclassifications would lead to costly tax bills and I could not assure them that, upon audit, a reclassification would not occur, as the random determination would be up the discretion of an Internal Revenue Service agent.

Due to the nature of the work that I am educated, trained and skilled to perform, I am best able to provide my services to small business clients as an independent contractor. As an accountant or business consultant, I must maintain principles of independence of thought and action. The small business clients whom I service are small or micro businesses, start-ups or sometimes just people with flourishing ideas. They cannot afford to hire me as an employee nor do I want to give up the control and independence required to competently complete certain types of jobs.

For instance, in providing financial statements that accurately reflect the financial health of the client, I am not burdened by the compromises and conflicts that might beset an employee. In areas where conflict may arise, for example, are concepts such as asset valuations, inventory pricing or calculations of depreciation and expense or in the area forensic analysis where key employees may exercise extreme control over the results. The small business clients who need my services the most cannot afford the expense of administrative fees attached to payroll withholding requirements or the additional cost of payroll administration.

My second point of perspective comes from having served for the past ten years as a member of the IRS cadre of instructors who provide workshops and teach outreach sessions. I taught the SMALL BUSINESS TAX WORKSHOPS. A major segment of those workshops questions how to make the determination of who is an employee versus an independent contractor. The current law addresses the question "who is an employee?" rather than "who is an independent contractor?". This is a north-south focus on the issue, when what is required is a reverse point of view. In other words, let's first clearly determine who is an independent contractor, then anyone else must be an employee.

At the present time, IRS audits seem to favor reclassification to employee rather than to independent contractor. This is usually a false economical decision. The fines and penalties are (false) revenue producers but have not led to increased compliance.

My third point of view comes from the many months of hard work involved with the White House Conference on Small Business. I served as Co-Chair of the New Jersey Tax Committee. Many small business people were interviewed and the independent contractor issue was discussed at length. Evidential cases were submitted. Small business people shared many horror stories of what had happened to them or other owners during audits and reclassifications. Some were nearly put out of business as a result of the assessment of fines and penalties due to incorrect classifications even though fraudulent intent was not present.

At the National White House Conference on Small Business, the one conference issue to receive the most votes of all sixty was the issue of redefining an independent contractor (over 1400 votes). Although I had personally promoted this issue on behalf of the National Association of Women Business Owners, the votes projected the voice of small business.

My fourth point of view, comes from the recognition that this issue, not only received the most votes of the White House Conference on Small Business, but was also the top tax issue of over four hundred delegates who comprised the Minority Delegates Caucus (MDC). I served as the Tax Issues Director of the Minority Delegates Caucus. Of all small business owners who are independent contractors or who use independent contractors most, a high percentage is minority and women owned businesses. A large number of displaced and downsized corporate employees became independent contractors, a disproportionate number are women and minorities. This, one might say, was also due to economical reasons.

Another and fifth perspective has been brought about by my involvement in such organizations as the National Society of Public Accountants (NSPA) where I serve on the National Affairs Committee and the National Association of Tax Professionals (NSTP) where I serve on the state planning committee. These organizations include many small business owners who are entrepreneurs, sole proprietors, S-corporations and Limited Liability Corporations. They cannot always afford to put an expert on the payroll. For complex business problems, a solution may be sought from an independent contractor; whereas, a large corporation can afford a resident specialist on payroll. Due to the cyclical nature of the strictly tax oriented business, employees may not be needed long enough to justify the cost of setting up payroll withholding procedures.

During the past year, there has been infinite discussion of the issue of clarifying who are independent contractors and determining who are employees. Congressman Jon Christensen and others co-sponsored H. R. 1972, called The Independent Contractor Tax Simplification Act of 1995, which adequately sets forth a new criterion to be used in place of the twenty-factors test, but does not exclude it. Senator Kit Bond and Senator Don Nickles co-sponsored S.1610, Independent Contractor Tax Simplification Act of 1996, a mirror bill. Some of the major labor unions have had an adverse reaction to these bills for what they have perceived as attempts to make it easier for businesses to use the service of an independent contractor rather than employ the traditional employee. There seems to be fear of the wholesale conversion of many employees to independent contractor status, with or without their concurrence. This is a valid argument. One which has caused several congress people to become timid on the issue, but backing up and out does not make the need for action disappear.

Having been a labor union delegate in the early stages of my career, I helped to make such arguments. My very first experience with independent contractors occurred while employed by a major corporation where independent contractors shared space with employees. They worked alongside the employees, did the same jobs and received higher pay but no benefits. This was unsettling for the union and the employees. Having had this experience firmly convinces me, that it would be beneficial to the labor union's work force as well as to small business if there were a clearer definition of what determines who is an independent contractor and better ways to distinguish them from the employees. There has to be a better way and we have to work together to get to it. Right now, corporations so easily get through the loopholes using the current common law structure. This demands tightening up with better criteria. A clearer definition should be in place so that when a worker enters the door, all parties would know immediately whether this is an independent contractor arrangement or if this is an employee/employer relationship. A genuine non-partisan effort is required by ALL of congress to help strengthen and close the existing loopholes by developing a more definitive law.

Commissioner Margaret Richardson, Deputy Commissioner Mike Dolan, Director Barbara Jenkins and others at the Internal Revenue Service have done a heroic job at the administrative level to help resolve this issue. I will not reiterate all that they have done for it is in the public record. It was quite commendable that the draft of the new training manual was made available to the WHCSB Tax Chairs for input and suggestions. Although it is more than one hundred pages, I am pleased to have had the opportunity to contribute to the document for future training. It is now time for congress to sincerely "come to the table with good intentions" to resolve this issue.

Independent contractors are essential to the successful operation of a variety of business and industry types. While it is a fact that this issue is of great importance to the small business world, it is also important to large business and corporations. Independent contractors offer specialized skills for short term projects yet it should not be as easy as it currently is to replace traditional employees with independent contractors. Also, it should not be difficult or impossible for independent contractors to secure contracts without the fear of future reclassification.

All of the small business community is concerned with unreported income resulting from failure to file Forms 1099. These omissions translate into a tax increase to the rest of us who attempt to comply with the law. Voluntary compliance can best be promoted by clear unencumbered laws, education, reduced complexity of reporting and a more friendly environment from the local IRS personnel. It should be noted that the IRS has in recent years made commendable efforts to improve its client service atmosphere.

Statistics indicate that this country is being run by small and micro businesses. Small businesses employ about 54 percent of the private work force and contribute 52 percent of all sales in the country. What is required is to make it easier for them to comply with the income tax laws rather than to make it more difficult. During the 1976-1990 period, small firms with fewer than 500 employees provided 65 percent of net new jobs. This percentage does not appear to be in danger of slipping and is not being threatened by the use of independent contractors. Recently, small business dominated industries increased employment by 1.3 million workers, a 3.2 percent increase.

In conclusion, it is common consensus that a better definition of the independent contractor is urgently needed. In the process of getting there, we do not want to make it more difficult for the small business person to run a profitable, viable business. The proposed solutions as addressed by H. R. 1972 and S. 1610, should be considered as a first step, a beginning point.

If our system is to remain one of voluntary compliance, withholding should not be considered. The additional burdens of requiring withholding taxes from independent contractors would only encourage the development of creative ways to avoid the problem. It would serve to punish those small businesses who jump through the hoops of compliance.

Safe Harbor provisions are absolutely necessary. If a small business owner has made a good faith attempt to classify a worker under current common law..., and the independent contractor had filed appropriate information returns, reported income and paid tax, then as a result of audit, penalties should not be assessed.

Control and supervision should be primary factors of any criteria. Safeguards that prohibit abuse of the system and provide protection of the workers are critical requirements. Workers should not be classified as independent contractors when there are no elements in the relationship to warrant it, and an independent contractor classification should never be allowed as a unilateral option. Those workers who want to be independent contractors, should be allowed to legitimately be classified as such without the insecurity of future reclassifications. There must be measures at the beginning of the relationship to determine who owns the tax liability.

I look forward to working with your committee to find an agreeable solution to the pressing issue of Independent Contractor Classification. I thank you and your committee for your consideration of this matter.

Respectfully submitted,



Joy J. Turner,  
Tax Chair-WHCSB Region II  
New York, New Jersey, Puerto Rico

**Statement of the  
 Direct Selling Association  
 Concerning Independent Contractor Status  
 Before the  
 Subcommittee on Oversight  
 of the Committee on Ways and Means  
 U.S. House of Representatives**

The Direct Selling Association (DSA) appreciates the opportunity to submit this statement in connection with the committee's hearings on independent contractors on June 20, 1996. DSA is the national trade association of the direct selling industry. We represent over seven million independent contractor direct salespeople and the 180 direct selling companies for whom they market goods and services. We have, during the course of a year, on average over 16,500 direct salespeople per Congressional District and are presently recruiting over 62,000 distributors and salespersons per week. Our members firms account for over 95% of industry sales, and while many are large and familiar household names, a majority of them are small businesses.

**Background: The Independent Contractor Status of Direct Sellers  
 Is Well-Established for Federal Tax Purposes**

The independent contractor status of direct sellers has long been recognized for federal tax purposes. Almost 20 years ago, in a test case, direct sellers were found to be independent contractors for tax purposes under the common law rules (Aparacor, Inc. v. United States, 556 F. 2d 1004 (Ct. Cl. 1977)). In 1982, Congress adopted I.R.C. § 3508 to "provide a statutory scheme for assuring the status of ... direct sellers and real estate salespersons as independent contractors." (Staff of the Joint Committee on Taxation, General Explanation of the Revenue Provisions of the Tax Equity and Fiscal Responsibility Act of 1982 (1982), 382).

Internal Revenue Code Section 3508 establishes three conditions in order for a person to qualify as a "direct seller" treated as an independent contractor by statute. First, the person must be engaged in the business of selling consumer products to any buyer on a buy-sell, deposit-commission, or similar basis, in the home or otherwise than a permanent retail establishment. Second, substantially all of the remuneration paid must be directly related to sales or output, rather than to the number of hours worked. Third, the direct selling must be performed pursuant to a written contract between the direct salesperson and the direct selling company, and the contract must provide that the direct salesperson will not be treated as an employee of the company for federal tax purposes.

As part of this statutory classification of direct sellers as independent contractors for tax purposes, Congress also adopted a special tax information reporting requirement for direct salespersons. See I.R.C. § 604 1A(b). Under this special direct seller information reporting system, each direct selling company that sells \$5,000 or more of consumer products to a direct salesperson must indicate so on a special direct seller box on the IRS Form 1099-MISC, which is then filed with the Internal Revenue Service and sent to the direct salesperson. This information filing requirement also applies to a distributor in a multi-level direct selling arrangement who is wholesaling to direct salespeople in his or her sales organization. In addition, the Form 1099-MISC is used to report the payment of commissions, bonuses, and awards to direct salespeople in excess of \$600. The direct salesperson is required to provide his or her proper taxpayer identification number to the direct selling company as part of this process.

This statutory treatment of direct sellers as independent contractors and the special direct seller tax information reporting procedure constitute a clear and well-established system that has worked effectively for federal tax purposes for more than a decade and has achieved an extremely high rate of voluntary tax compliance for the direct selling industry. In discussions regarding independent contractor issues raised by recent health care reform efforts, senior representatives of the Treasury Department and the Internal Revenue

Service ("IRS" or "the Service") confirmed that the current statutory arrangement for direct sellers under Internal Revenue Section 3508 is working well and has produced a good compliance record. Our latest compliance estimates run in the 97% range.

#### **Independent Contractor Status Generally**

DSA believes it important to the nation that legitimate use of independent contractors, by all industries, not be threatened. The IRS has exhibited in the past and reportedly continues today to exhibit antipathy towards independent contractors and self-employed individuals. This antipathy is, in all probability, based on the belief that tax compliance levels for these groups are too low relative to compliance by employee groups. From an enforcement point of view, Section 530 of the Revenue Act of 1978 was originally enacted by Congress (and then indefinitely extended in 1982) as a direct result of IRS harassment of independent contractors and misclassifications by the Service of independent contractors into employee status. This harassment was done through abuse or misinterpretation by the Service of the twenty factor common law test of independent contractor status.

Finally, based on our own studies, people want to be independent contractors because they like being their own bosses, working their own hours, building their own businesses and directly relating effort to reward. Tax considerations generally do not enter the picture for them. From the viewpoint of the users of independent contractors, while there are some tax benefits created by this status, there are also productivity, recruiting, retention and tax *disincentives* as well. Businesses and individuals should be able to choose within structures they wish to operate.

#### **Direct Sellers Would be Unnecessarily Harmed by Withholding**

Over the years and recently, the General Accounting Office and the IRS have advocated withholding on independent contractors. Withholding would be counterproductive and an unnecessary burden to the direct selling industry. As this statement will show, it would do significant harm to the companies relying on the independent contractors and the independent contractors themselves. Withholding would ultimately result in the loss of approximately 10% of these independent contractors to our industry.

Over 80% of direct sellers (approximately 5.7 million individuals) earn less than \$2,500 per year. Our turnover rate is approximately 100% per year. Four percent of the adult population presently sell for our companies. An additional 13% have done so in the past. The difficulty of withholding on such a large number of people, who earn such small amounts of money, would hardly be worth the administrative costs and burden to both the private sector and the government. Studies conducted by our outside economic consultants indicate that the deductible costs of such a withholding system would largely offset the *de minimis* amounts of revenue collected. Indeed, a study we conducted based on IRS data indicated a very low average uncollected tax liability (under \$9.00 per annum in 1982) per independent contractor direct salesperson.

Many direct sellers will have business expenses which will not be taken into account by withholding. Because most direct sellers' average gross earnings are so low, any withholding is likely to result in significant over-withholding. Thus, withholding will result in a burden on individual direct sellers that will likely remove some of the financial incentive for their involvement in the business--or at least make their entrepreneurial activities more difficult. Even should the over-withholding be returned subsequently, the direct seller's cash flow would be unnecessarily and unfairly limited by withholding as to make the enterprise less attractive. Also, an initially low collection rate could be the proverbial nose of the camel under the tent. This year's 5% rate could be next year's 25%.

Additionally, many direct sellers are compensated through a multilevel system of compensation. Bonuses, commissions and other payments are often "passed through" to other salespeople in the multilevel sales structure, i.e., a check to one top distributor is divided between that distributor and the other salespeople in his or her organization,

known as the "downline," perhaps numbering in the hundreds. These other salespeople then take their earnings and pass on a portion to people they have brought into the business who generated sales bonuses for this "upline" distributor. The complexity of computing, then imposing, a withholding requirement on these multiple levels of payments is obvious and potentially overwhelming.

Our studies also indicate that imposition of withholding could result in a substantial reduction in the direct salesforce. A change of status could eliminate up to two-thirds of direct selling income opportunities. Withholding is inimical to the micro-entrepreneurial nature of our salesforces. As stated previously, we estimate a loss of 10% of our salesforces, or 720,000 income opportunities, should withholding be instituted. Withholding is a step in the wrong direction, and it is not in our industry's or the national interest.

### Conclusion

Industries seeking to protect the independent contractor status have traditionally received bipartisan support in Congress. Members of Congress have long understood the complexity of this "classification" issue and the need to protect this micro-entrepreneurial form of doing business. We are concerned, however, that any attempts to deal with the issues raised by this hearing might do inadvertent harm. Until now, Section 530 has proven to be the most inclusive, pro-independent contractor safe harbor test that Congress could enact. Any changes to this section of the law, whether they be designed to curb IRS abuses or to deal with the problem of misclassifications of employees in some industries resulting in competitive disadvantages for some firms, should be carefully handled. Inadvertent, unforeseen consequences harmful to industries legitimately using independent contractors must be carefully avoided. It is a very complex, economically significant area to both corporations and individual entrepreneurs. Experience has shown that there are many landmines in this area, and we urge that extreme caution be used in making any changes.

DSA appreciates the attention the subcommittee has devoted to this important and challenging issue. We trust that, as your deliberations continue, the legitimate use of independent contractors will be protected and preserved. We also respectfully urge that, in any changes in the law that might take place, nothing be done to endanger the statutory independent contractor status of direct sellers. By way of background, attached is a profile of the types of direct sellers in our industry.

Thank you for your consideration of our views. We are at your service to expand on this statement, to answer any questions you might have or to provide additional information.

Respectfully submitted,



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lrm  
Attachment

### Addendum

#### **Profile of the Typical Individual Direct Seller Small Business**

Direct selling is a well established method for marketing products directly to consumers, primarily in their home, tracing its roots to colonial times. Companies within the industry market a broad range of consumer products and services, including household cleaning products, cosmetics and other personal care products, jewelry, cookware and other housewares, educational materials, household decorative products such as baskets, home improvement products, food, and vitamins.

Most direct selling companies within our industry are themselves small businesses. Over 99% of the individual direct salespeople that market these companies' products are independent contractors. Each of these independent contractors is, in effect a small business, most of them micro-entreprises.

Direct selling offers a broad opportunity for these individual entrepreneurs. There are virtually no barriers to entry into direct selling - precisely because of their status as independent contractors. It is a field open to anyone. There are no demands that direct salespeople make significant investments, put in a given number of hours per day or week, or adhere to any sort of set work schedule. Direct selling is an ideal way for people with an entrepreneurial spirit to earn extra money without experience, without capital, and without having to make a full-time commitment to an employer. It is also a wonderful career opportunity where the sky is truly the limit.

As the result of this ease of access and flexibility in work arrangements, direct selling has wide appeal among women who have significant family responsibilities, as well as substantial numbers of minorities, the elderly, and handicapped persons. Of our over 7 million independent contractor salespeople across the United States, 70.4% are women. Some 12.5% of direct salespeople are African-Americans, 4.7% are Hispanics, 1% are Asians, and .5% are Native Americans or Alaskan Natives. Approximately 4.5% are over age 65, and 8% have disabilities (three out of four of them with permanent disabilities).

The overwhelming majority of direct salespeople conduct their direct selling activities on a part-time basis. Eighty-nine percent of direct salespeople spend less than 30 hours per week at direct selling, and many do it only for a few weeks or months per year. Some 60% engage in direct selling for less than 10 hours per week. Based on our latest data, only 6% sell for 40 hours per week or more.

In the great bulk of cases, direct selling serves as a supplement to the family income, with the main household income source coming from outside the industry through the full-time employment of the direct seller, his or her spouse, or both. (Fifty-six percent of all direct sellers have traditional employment in addition to their self-employment as independent contractor direct salespeople. Eighty-six percent of direct sellers who are married have any employed spouse.) For 60% of salespeople, direct selling activities provide less than 10% of household income and for 72% of direct salespeople, direct selling produces less than 20% of family income.

## Statement for the record in support of H.R. 1972

Ref: 6/4/96 Hearing of Subcommittee on Oversight of the House Committee on Ways and Means  
Hon. Nancy L. Johnson, Chair

Submitted by: Angelo C. Congello, Sr., C.E.O.  
in behalf of his company, ENCORE ENTERPRISES, INC.  
57 Leaning Street, South Hackensack, New Jersey 07606

This statement is intended to a) express general support for efforts to provide legislative assistance to small businesses in industries with a longstanding uniform practice of using independent contractors b) urge the oversight subcommittee to use a bill like H.R. 1972 as the basis of an effort to give long overdue relief to such industries and c) provide the Subcommittee with comments on questions it has raised.

The views expressed are based on extensive experience and expertise in an industry with a uniform practice of retaining independent contractors: the third party advertising sales industry. I have 30 years of experience both as independent contractor and as C.E.O. of my own business in the industry. From 1985-1975, I worked as an independent contractor throughout the nation selling advertising for published materials disseminated free of charge including bookcovers for Catholic and public schools and colleges, on maps distributed by chambers of commerce, on bowling sheets used at bowling alleys, on placemats provided without charge to restaurants, for anti-drug books given free to schools and law officers, for in-room hotel directories provided free to hotels and other similar services.

All the companies with which I have been associated used independent contractors like myself. To this date, persons similarly engaged continue to be retained as independent contractors.

In 1975, I started my own business selling educational materials to be provided to schools and law enforcement officials without charge and retained independent contractors who sell the publication advertising. My company now has four offices, services eighteen states and continue to use independent contractors for advertising revenue.

I have also served as an expert witness in the U.S. District Court for the Northern District of Texas in behalf of plaintiff, Advertiser's Dynamic Services Co., Inc., in a case against the IRS. Of note, the court found for plaintiff, a company in the same industry as my company.

The treatment of small business owners in my industry and similar ones which use independent contractors by IRS has resulted in a litany of horror stories of excessive penalties and claims, of inconsistencies in classification, in disregard of the existing statutory intent (e.g., the "Grandfather" clause of Section 530, the Safe Harbor rules), and of onerous bureaucratic tests which often leave small business owners vulnerable to burdens and punishments out of proportion to what is involved and often in disregard of existing rules. How many small businesses have the resources and expertise to resist an IRS judgment whether just or not.

To rely on self-policing by IRS (as with the new classification Settlement Program) is to perpetuate the existing problems. The IRS must be overseen and given direct guidance by the Congress to rein in overzealousness and to prevent injustice.

To this end, I support efforts to reduce the 20 factor test to 3 (as in H.R. 1972) so long as the 3 factor test is defined so as to assure that IRS will not indulge in eccentric interpretation of what constitutes compliance. For example, the criterion of "clear, written agreement" between company and contractor is a subjective criterion unless a model is provided. Moreover "independence" is differently defined in different industries. For example, payment of rent may be appropriate in office-based sales activity (as in travel) but not in my industry which is field-based. Criteria must be sufficiently flexible to include all appropriate industries. Perhaps the existing Congressional latitude afforded the Real Estate industry should be extended to our industry.

We appreciate the desire of IRS to collect taxes to which the government is entitled and their concern that such enforcement is made more difficult by some independent contractors who take liberties. But, it is unfair to make companies which have met their statutory obligations pay for a failure in the collection system for which the company has no responsibility. To relieve this problem, I suggest that, in addition to the regular filing of 1099 information, the law be modified to permit companies to withhold and submit 20% of an independent contractor's compensation to assure subsequent filing and compliance by Independent Contractors. We would be glad to assist IRS in such a fashion which, ultimately, benefits everyone.

## II.

The committee has raised several questions and the ff. comments supplement what has been stated above:

- . Are the promised IRS worker classification initiatives adequate to the problem?
- The history of IRS compliance activities without clear legislative direction and oversight suggests not (see above). Moreover, the classification procedures still leave too wide a latitude for IRS to engage in idiosyncratic interpretation and still penalize small businesses in a disproportionate fashion. Citation of appropriate case law (as in the above mentioned Texas Court) would help.
- . Should Section 530 be modified to apply for income tax purposes?

Any Section 530 modification is acceptable so long as it strengthens the rights and protections to which small businesses, in industries which have an historical uniform practice of using independent contractors are entitled. My experience and that of colleagues in my industry indicate that IRS is frequently insufficiently informed as to an industry's scope and, in ignorance, applies a narrow construal to worker classification.

We would strongly support the elimination of retroactive penalties particularly where ambiguity of interpretation exists. In particular, to assess retroactive penalties in situations where the independent contractors have met their tax compliance responsibilities is bizarre and unfair.

. Should Safe Harbor rules be classified to address the legislation's liberal intent as guidance to IRS?

IRS must be given explicit guidance particularly where longstanding industry practice is involved. "Reasonable basis" should be accorded a reasonable interpretation. IRS is, historically, on the margin in determining reasonableness. Without direction, IRS will continue to interpret narrowly and unreasonably.

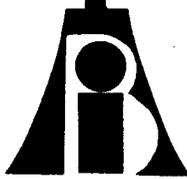
. Should "significant segment" of an industry be defined?

Such definition should be industry-specific and might be based on input from experts in that industry (such as myself). IRS tends not to have a clear conception of the industries involved and has often judged small business arbitrarily.

. I have already addressed Independent Contractor Tax Compliance above. Withholding, as described, would improve compliance without penalizing small business classification rights. This will also address an IRS priority by identifying Independent Contractor by correct S.S. # and easing subsequent collection of S.S. taxes as well.

. One last item which may interest the committee deals with benefits. I believe Congress should extend to Independent Agents the right to participate in company wide group health and other benefit plans. I believe that this would meet a national priority (making affordable health care available to all) and a compliance priority (encouraging Independent Contractors to meet their statutory obligations so as to participate). It would also add stability to industries with longstanding independent contractor arrangements.

The above views reflect the experience of one who has for thirty years participated in such a large industry using contractors and reflects a desire for strengthening the compliance system in the 3rd party advertising sales industry (estimated to be a five billion dollar industry) while assuring lawful and fair treatment for small businesses in the industry.



## INDEPENDENT BAKERS ASSOCIATION

P.O. Box 3731 • Washington, DC 20007 • (202) 333-8190 • Fax (202) 337-3809

### STATEMENT OF THE INDEPENDENT BAKERS ASSOCIATION IN SUPPORT OF H.R. 1972 TO CLARIFY THE EMPLOYMENT TAX STATUS OF INDEPENDENT CONTRACTORS

Hearings on H.R. 1972  
United States House of Representatives  
Ways and Means Committee  
Oversight Subcommittee  
June 4 and 20, 1996

The Independent Bakers Association (IBA) fully supports the efforts of Congressman Jon Christensen (R-NR) and the other cosponsors of H.R. 1972 to clarify the employment tax status of independent contractors. IBA is a Washington, D.C.-based national trade association of 360 small- to medium-sized, mostly family-owned, wholesale bakeries and allied industry trades.

The independent contractor issue has long been an issue of uncertainty and significant unnecessary expense for the baking industry. This is particularly true of small- to medium-sized baking companies who do not have the resources or the time to fight a government agency, such as the IRS, with its unlimited resources and little understanding.

Many bakeries are selling delivery routes and territories to independent distributors. These distributors then purchase product from the bakeries and sell it to retail establishments. They are then able to grow the business through active promotion of the product. This arrangement benefits both the route distributor and the bakery. These independent contractors are particularly affected by the current laws because "bakery drivers" are classified by statute as employees for employment tax purposes, even if they are treated as independent contractors for income tax purposes. Section 3121(d)(3)(A) of the tax code specifically classifies bakery drivers as employees for this purpose. The current law was written in the 1950s when bakeries typically distributed their products door-to-door. This is no longer the case. Instead, these products are often distributed by individuals owning their own territories, who purchase their products directly from the bakeries and who distribute the products to commercial customers for resale.

Application of the statutory employee rules to bakery product distributors creates numerous technical difficulties. First the distributor is required to compute his or her income in two separate ways - once as an employee and once as a self-employed individual - since certain expenses are deductible for self-employed individuals and not for employees. Second, the distributor system, as it has evolved through the years, has no resemblance to a wage-based system. If a bakery is required to treat the distributor as an employee, what amount does the bakery report to the distributor and to the IRS as wages paid? The distributor resells the product to retailers or other wholesalers, the bakery has no information about how much profit the distributor has made. The distributor's income is the profit from the turnover. If the bakery were to report the price paid by the distributor for the product, this would grossly overstate the

amount of income actually earned by the distributor since it would fail to take into account the purchase price of the products and any of the distributor's other expenses. Third, classification of distributors as statutory employees is particularly confusing in light of the fact that many distributors have their own employees. In particular, distributors with large, heavily populated territories may have several employees and operate in corporate form. It is simply unclear how a corporation can be an employee. Finally, the independent contractor form of distribution arose due to its efficient manner of operation for the bakery and potential opportunities for the distributors. By moving incentive away from this form of distribution, current law lowers bakeries' profitability and stifles individual entrepreneurship.

Congressman Jon Christensen's legislation would supersede Section 3121 and allow bakery distributors to be treated as all other independent contractors in our economy. IBA understands the Committee's concern that this legislation should not be a vehicle for individuals and companies to avoid paying taxes. However, we feel that in the case of bakeries, something must be done to change the inconsistencies in the current law. H.R. 1972 would allow bakeries the simple right of being treated like other independent members of the economy.

Robert Fanelli, Chairman  
Sam Philippine, Vice-Chairman  
Independent Contractor Committee  
Independent Bakers Association

**STATEMENT OF MICHAEL F. WEISBARD  
OF CHANDLER SYSTEMS, INC  
ON BEHALF OF  
INDIANA SOFTWARE ASSOCIATION**

Submission to U.S. House of Representatives  
Ways & Means Committee / July 5, 1996

**STANDING TO SUBMIT** \_\_\_\_\_

Submitted by: Michael F. Weisbard, Chair, Legislative Committee, the Indiana Software Association ("ISA"). The ISA is an Indiana Not-For-Profit trade association. Mr. Weisbard's office address is c/o Chandler Systems, Inc., 1844 W. Century Way, Indianapolis, Indiana, 46260. Telephone: 317-872-9925.

THIS SUBMISSION IS IN RESPONSE TO HEARINGS HELD BY THE COMMITTEE ON June 4th and 20th, 1996. In Press Releases # OV-13 and OV-14, Chairperson Nancy L. Johnson (R-CT), asked concerned citizens to comment upon the impact of Section 530 of the Revenue Act of 1978 (P.L. 95-600) and upon changes to the law as proposed in H.R. 1972 and H.R. 582.

I believe that these comments reflect the feelings and analysis of a majority of the Software Association member firms located in the State of Indiana. This represents something over 65 firms. Opinion and analysis from various member firms was gathered by discussions, phone calls, Internet messages, and review of this submission by interested members of the Association.

**TAXPAYERS' BACKGROUNDS** \_\_\_\_\_

The Indiana Software Association ("ISA") is made up of over 65 member firms. The majority of these firms employ programmers and other technology workers in the research, development, and on-going support of their products and services.

One member firm is publically held and its stock is traded on the NASDAQ. Most of the software development firms within the ISA have employed independent contractors in order to obtain specialized skills and/or to meet project schedules.

The software field is characterized by rapid and frequent change and increasing complexity. This creates constantly-changing needs in our member firms for skills, often just for specific projects or short-term work periods (eg, less than 12 months).

Other allied firms that are ISA members include several law firms with Intellectual Property practices; and several CPA and accounting firms that audit and/or advise software firms that are located in Indiana.

**LEGISLATIVE BACKGROUND AND PROBLEMS WITH PRESENT IRS PRACTICES** \_\_\_\_\_

The classification of workers as either employees or independent contractors for Federal tax purposes has traditionally been determined under common law (i.e., nonstatutory) rules. Employment classification issues have long been the subject of considerable controversy between taxpayers and the IRS. In the late 1960s, the IRS significantly increased its employment tax audit activities.

In cases when the IRS prevailed in reclassifying workers from independent contractors to employees under the common-law test, the employing business were assessed significant amounts for Social Security and Medicare taxes (FICA) and Federal Unemployment Tax Act (FUTA) taxes on behalf of the reclassified employees. This occurred even though the formerly-independent contractors had fully paid their liabilities for self-employment and income taxes. Further, in many reported cases the back-tax liabilities assessed against businesses were so large that the companies were forced into bankruptcy.

In response to this problem, Congress enacted section 530 of the Revenue Act of 1978 (P.L. 95-600). This provision generally allows a taxpayer to treat a worker as an independent contractor for employment tax purposes, regardless of the actual status under the common-law test, unless the taxpayer has no reasonable basis for such treatment.

This section 530 safe harbor was intended to alleviate what Congress perceived as overly zealous pursuit and assessment of taxes and penalties by the IRS against employers who had, in good faith, misclassified their employees as independent contractors. The legislative history of this provision indicates that the Congress intended for the section 530 safe harbor relief to be liberally construed and applied by the IRS.

In recent years the IRS has again stepped up its enforcement efforts with regard to employment tax issues, particularly with regard to small businesses with assets of \$3 million or less. However, many small businesses undergoing employment tax audits do not have the financial resources necessary to litigate adverse determinations by the IRS even where the IRS's determination is erroneous. Moreover, those who do appeal IRS efforts to reclassify their workers and successfully prevail in litigation often incur hundreds of thousands of dollars in management costs, as well as accountant and attorney fees, during the examination and administrative appeals phases.

The Internal Revenue Code section 7430 provides for the payment of attorney fees and certain costs by the Federal Government when taxpayers substantially prevail on the merits of their tax disputes with the IRS and the IRS's position was not substantially justified. However, this provision only applies to litigation costs incurred in connection with a court proceeding. The management costs are rarely, if ever, recovered.

At the 1995 White House Conference on Small Business, a legislative solution to the problem of the IRS's aggressiveness in recharacterizing independent contractors as employees was ranked the number one priority among small businesses.

Several bills have been introduced in this session of Congress to clarify the rules for classifying workers for Federal tax purposes, including H.R. 1972, the "Independent Contractor Tax Simplification Act of 1996," introduced by Representative Jon Christensen, and H.R. 582, the "Independent Contractor Tax Fairness Act of 1995," introduced by Representative Jay Kim.

The Subcommittee hearings in June examined current problems with regard to classification of workers for tax purposes, including the IRS's handling of employment tax audit issues and reasons for its failure to liberally construe and administer the safe harbor rules created by section 530 of the Revenue Act of 1978. In addition, the Subcommittee received testimony on proposed legislation to clarify the tax laws relating to worker classification (e.g., H.R. 1972 and H.R. 582).

The sponsor of H.R. 1972, Rep. Jon Christensen (R-Neb), has written a concise description of his bill in the June 6th edition of the Wall Street Journal, which we quote:

"Unlike past attempts to resolve the issue, this legislation does not define who is an employee, but rather who is an independent contractor. To qualify under this alternate test, an individual must fulfill not 20 factors, but three: investment, independence and contract.

First, a worker must invest in his own training or assets. Second, the worker has to show some independence from the agency, for example by paying a fair market rent for use of the service recipient's place of business. Finally, the parties must describe their relationship in a clear written agreement."

#### EXPECTED IMPACT OF PROPOSED CHANGES ON TAXPAYERS' BUSINESS PRACTICES

We foresee several benefits from creating greater certainty as to "Independent Contractor" versus "Employee" status for workers in the field of software technology:

- (1) More mobility, enabling people having critical skills to move to projects and companies where they're most needed, to the benefit (efficiency) of the American economy.
- (2) Reduced costs to software development firms, resulting in more cost-efficient operation. Again, this provides a net benefit to our economy and our nation's competitive position.
- (3) The proposed legislation (H.R. 1972) would provide a clearer and statutory definition as to who is an independent contractor. Providing an alternative test to the present complex IRS "20-Factors" questionnaire will reduce audit and appeals costs for both the Internal Revenue Service and for businesses.

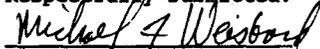
The question may be raised, as to whether the "contract" requirement would be a new burden to software firms and independent contractors in this field. It is our belief that no new burden would be created. Under section 530, a taxpayer is relieved from Federal employment tax liability when it can demonstrate that, in classifying its workers as independent contractors, it reasonably relied upon: "a long-standing recognized practice of a significant segment of the taxpayer's industry".

Many firms that engage independent contractors already require contractual documents that specify Intellectual Property Rights and establish Non-Disclosure obligations. Thus, the relevant existing practice in the software field include significant aspects of the "written contract" as required in H.R. 1972.

RECOMMENDATIONS & REQUESTED ACTION

1. This legislation (H.R. 1972) should be passed so as to bring long-needed certainty and simplification to this area.
2. The rules should be revised to encourage labor (skills) mobility within the software industry. It is in the national interest to encourage greater mobility of educated, skilled technology workers between companies. It is also clearly in the interest of individuals to be able to undertake work among a variety of firms as industry needs change.
3. The Congress should protect, by law, a long-standing, bona-fide and recognized practice of a significant segment of the software (e.g., taxpayers') industry.
4. The section 530 safe harbor rules should be modified to apply to income tax purposes as well as employment tax purposes. The basis for taxation arises out of a singular transaction and therefore should be treated uniformly and consistently.
5. The Indiana Software Association prefers H.R. 1972 over H.R. 582, the "Independent Contractor Tax Fairness Act of 1995" introduced by Representative Jay Kim, for two reasons:
  - (1) H.R. 1972 appears clearer in its text, intent, and expected implementation; and
  - (2) H.R. 1972 appears to be a simpler solution to the issues investigated by the committee. Simplicity is a virtue here, leading to better compliance and reduced IRS costs to audit and secure enforcement of the law.

Respectfully Submitted:



Michael F. Weisbard  
for the Indiana Software Association

cc: Indiana Congressional Delegation (listed by district)

Rep. Peter J. Visclosky	(Indiana 1)
Rep. David McIntosh	(Indiana 2)
Rep. Tim Roemer	(Indiana 3)
Rep. Mark Souder	(Indiana 4)
Rep. Steve Buyer	(Indiana 5)
Rep. Dan L. Burton	(Indiana 6)
Rep. John T. Meyers	(Indiana 7)
Rep. John Hostettler	(Indiana 8)
Rep. Lee H. Hamilton	(Indiana 9)
Rep. Andrew Jacobs, Jr.	(Indiana 10)

INTERNATIONAL ASSOCIATION FOR FINANCIAL PLANNING  
5775 Glenridge Drive, NE, Suite B-300, ATLANTA GA 30328

WRITTEN TESTIMONY ON WORKER CLASSIFICATION FOR TAX PURPOSES

HOUSE WAYS AND MEANS SUBCOMMITTEE ON OVERSIGHT  
JUNE 20, 1996 HEARING

This statement is submitted in connection with the hearings of the Subcommittee on Oversight, held on June 4 and June 20, 1996, on current issues relating to the classification of workers as employees or independent contractors for Federal tax purposes.

The International Association for Financial Planning (IAFP) is the oldest and largest membership association serving financial planning. Our over 14,000 members are guided by the principle that everyone needs objective advice to make good financial decisions. The financial planning process is client-centered, rather than product-centered and includes an analysis of the client's current situation; determination of the client's needs, goals and objectives; formulation of a written plan of action, and implementation and ongoing review of that plan. The membership includes over 100 broker/dealer firms. There are over 75,000 individuals associated with these firms as registered representatives, most of whom are actively engaged in providing financial planning services to the public. These services include asset management, retirement and estate planning, budgeting, accounting, tax return preparation, processing of transactions involving investment assets (including stocks, bonds, mutual funds, variable annuities, limited partnership interests and real estate), and insurance brokerage.

This statement addresses the application by the IRS of the 20-factor common law test --- and in particular those factors that indicate whether a service recipient "controls" the manner and means by which the worker performs the work --- to the securities industry. In the securities industry, as in many regulated industries, government and self-regulatory agencies, such as the National Association of Securities Dealers (NASD) issue detailed rules and regulations on how the work must be done. In the securities industry, these rules are designed primarily to prevent fraud, undue influence and misrepresentation in the sale of securities. The securities agencies also impose upon the broker/dealer the duty to "supervise" the sales activities of the registered representatives associated with it to ensure compliance with these rules and regulations. The IRS has generally attempted to treat activities undertaken by a broker/dealer reasonably to comply with this quasi-governmental duty to supervise as evidence of control within the intentment of the common law test.

We respectfully urge Congress to clarify the law to state explicitly that activities undertaken by a service recipient reasonably to satisfy the duty imposed on it to supervise the worker's activities to ensure compliance with regulatory rules and regulations should be a neutral factor and should not be treated as evidence of employee or independent contractor classification.

A. The Clarification Is Necessary To Prevent the IRS From Misapplying the Common Law Test to Reclassify As Employees Workers In Regulated Industries Who Have Historically Been Treated As Independent Contractors.

The securities industry provides a prime example of how the IRS has misapplied the common law control test to reclassify workers as employees in a regulated industry.

In the securities industry, both the registered representative and the broker/dealer with which he or she is associated are subject to the rules and regulations of the Securities Act of 1933, the Securities and Exchange Act of 1934, and the rules of self regulatory organizations such as the NASD.

Under these rules, a broker/dealer has the duty to supervise the registered representative with respect to his or her adherence to the regulations of the Securities and Exchange Commission and the NASD.

Under the regulatory regime established by the SEC and self-regulatory organizations, the broker/dealer, in effect, acts as a surrogate for the regulators --- by monitoring and policing sales activities to assure that the registered representatives do not engage, or come close to engaging, in fraudulent, misleading, or overreaching practices. However, this is a far cry from exercising control to ensure that the manner and means employed by the registered representative in performing his or her work are best suited to serve the interests of the broker/dealer. In this context, the do's and don'ts of the broker/dealer are nothing more than an implementation of the do's and don'ts of the regulator. They are not controls which are designed to maximize the profits of the broker/dealer's business. To the contrary, they represent additional costs to the broker/dealer, which it is required to bear to maintain its registration.

This may be illustrated by the relationship between broker/dealers and registered representatives in the financial planning industry. Many financial planners are licensed as registered representatives so that they can initiate securities transactions on behalf of their clients. In order to provide this service, a financial planner is required by law to be associated with a broker/dealer who processes the transactions, shares in the sales commissions, and is charged with the responsibility of supervising the transactions to assure compliance with securities rules and regulations. As described above, however, financial planners perform a wide range of financial services for their clients, of which the handling of securities transactions may comprise a small part. The broker/dealer generally has no involvement in these other activities --- it does not exert any control over them, and does not receive any remuneration from them.

Financial planners generally have substantial investments in facilities (either owned or leased) and equipment; they decide their own work hours, the portion of those hours that is devoted to the sale of securities, and the content and order or sequence of their work (except to the extent they follow procedures established by the broker/dealer with regard to securities transactions); they hire their own assistants; they do not perform the work on the broker/dealer's premises but rather on premises owned or leased by them or by another financial planner; they furnish their own tools and materials; and they have the opportunity for profit and risk of loss.

However, even though many of the common law factors point strongly towards independent contractor status, the IRS has continued to focus on the broker/dealer's "duty to supervise" registered representatives to assure their compliance with the securities laws and has sought to base reclassification on this factor. In doing so, the IRS has failed to distinguish between controls that are imposed on a worker by the recipient of his or her services to enhance or maximize the benefits to the recipient and controls that are imposed on the worker to comply with government or other regulatory requirements. In the latter case, it is the government or regulatory organization, not the service recipient, that is concerned with the "manner and means" by which the worker performs the job.

We therefore propose clarifying the common law test to make it clear that supervisory activities imposed upon, and reasonably undertaken by, a service recipient to assure that the worker complies with government or self-regulatory agency rules and regulations should not be treated as evidence of independent contractor or employee status.

B. There Are Sound Policy Reasons for Adopting the Proposed Clarification.

The IRS's misapplication of the common law control test to situations, such as described herein, arising in regulated industries has created a tension in these industries between tax and regulatory policies. While the service recipients are encouraged (indeed required) by the industry regulators to implement and strengthen existing supervisory procedures to assure compliance with agency rules and regulations, they are discouraged from doing so because of the IRS's reliance on such procedures to reclassify the workers as employees. These conflicting policy objectives would be brought into harmony under the proposed clarifying legislation.

C. The Proposed Clarification Is Consistent With the Case Law.

Although we are not aware of any case law that addresses this issue in the tax area, case law in other relevant areas holds that actions taken to comply with government regulation are not considered "controls" imposed by the service recipient under the common law test.

For example, North American Van Lines, Inc. v. N.L.R.B., 869 F.2d 596 (D.C. Cir. 1989), involved the employee/independent contractor classification of truck drivers for purposes of the National Labor Relations Act. There the court held that the trucking company's "efforts to ensure the worker's compliance with government regulations even when these efforts restrict the manner and means of performance, do not weigh in favor of employee status." The court reasoned that the trucking company "cannot evade the law . . . and in requiring compliance with the law [it] is not controlling the driver; [i]t is the law that controls the driver." Id. at 599.

Similarly, in Local 777, Democratic U. Organizing Com. v. N.L.R.B., 603 F.2d 862, 875 (D.C. Cir. 1978), in responding to the Board's argument that the "extensive regulation of taxi drivers by municipal ordinance gives the companies control over the drivers' conduct on the job," the Court stated that "Government regulations constitute supervision not by the employer but by the state."

The proposed clarification is designed to ensure that, in the tax area as well, the IRS adheres to this established legal doctrine.

D. Conclusion

We appreciate the opportunity to present this issue of great significance to the securities industry and urge Congress to clarify current law to prevent the IRS from misapplying the common law test to find employee status on the basis of a broker/dealer's duty to supervise to ensure compliance with the securities laws and regulations.

**STATEMENT OF THE INTERNATIONAL BROTHERHOOD OF TEAMSTERS  
ON EMPLOYMENT CLASSIFICATION ISSUES**

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This statement is submitted by the International Brotherhood of Teamsters ("IBT"). While the IBT did not present oral testimony at the June 4, 1996 Subcommittee hearing, its absence from the hearing should in no way be interpreted as a lack of interest in the subject of employment classification issues in general, and H.R. 1972, in particular. As a labor organization which represents approximately 1.4 million members, the IBT has a very strong interest in any legislation which affects worker classifications. The IBT submits this statement in opposition to H.R. 1972.

**BACKGROUND**

The Internal Revenue Code does not currently set forth criteria for classifying a person as an employee or an independent contractor. Rather, workers are classified as either employees or independent contractors by statute, under a "safe harbor" provision contained in section 530 of the Revenue Act of 1978, or by applying a subjective test using a list of twenty questions developed by the Internal Revenue Service ("IRS") in the context of litigated cases.

**SUMMARY OF POSITION**

The stated purpose of H.R. 1972 is to clarify the definitions of employee and independent contractor for purposes of federal tax laws. However, the proposed language fails to accomplish this purpose. Indeed, its real purpose is to make it easier for employers to seek to classify their workers as independent contractors rather than employees, thereby leaving many legitimate employees without benefits to which they are legally entitled. H.R. 1972 also has the potential to deprive the federal government of billions of dollars in employment tax revenues. H.R. 1972 is a poorly crafted and unnecessary bill which, if enacted into law, would be harmful to thousands of hard-working Americans and potentially destructive of efforts to balance the federal budget. It should not be approved by the Subcommittee.

**DISCUSSION**

**I. H.R. 1972 Creates More Ambiguity, Not Less**

H.R. 1972 would substitute a three-part statutory test for the IRS' twenty question test to determine whether workers are employees or independent contractors. More specifically, H.R. 1972 provides that in order to be considered an independent contractor the worker or employer must demonstrate that:

1. One of the following five requirements are met:
  - (i) the worker has made significant investments in assets and/or training;
  - (ii) incurs significant unreimbursed expenses;
  - (iii) agrees to perform the services for a particular amount of time or to complete a specific result and is liable for damages for early termination without cause;
  - (iv) is paid on commission, or (v) purchases products for resale;
  
2. One of the following two requirements are met:
  - (i) the worker has a principal place of business, does not primarily perform services in the service recipient's place of business, or pays a fair market rent for use of the service recipient's place of business, or (ii) the worker is not required to work exclusively for the employer and the worker's services are performed for others, the worker's services are marketed to others, or the services are performed under a trade name; and

3. The services are provided pursuant to a written contract clarifying the independent contractor status of the service provider.

This new three-part test is no less ambiguous than the old test in that it fails to define several key terms contained in the above-quoted language. For example, it is not at all clear what would constitute "significant investments," "significant unreimbursed expenses," or "a particular amount of time." As a result, confusion and litigation between taxpayers and the federal government is certain to continue or even increase. Taxpayers and the IRS are certain to interpret these vague terms in a way most favorable to their respective positions. Resolution of which interpretation is correct will inevitably require further litigation. Accordingly, H.R. 1972 does not serve its stated purpose of clarifying the law and reducing litigation between taxpayers and the government.

The effect of this ambiguity will be to encourage employers to interpret the new law broadly to allow them to classify or re-classify their workers as independent contractors rather than employees. Until such employment classification issues are resolved through litigation, many workers will lose their status as employees, with the significant resulting consequences discussed below.

#### II. The Real Purpose of H.R. 1972 Is to Make It Easier to Classify Employees as Independent Contractors

Instead of clarifying existing law, H.R. 1972's real purpose is to make it easier for employers to seek to classify or re-classify their workers as independent contractors rather than employees. H.R. 1972's standards for independent contractor status arguably are relatively easy to meet. For example, if a worker has some college education or vocational training (arguably a significant investment in assets and/or training), performs services for at least two people (the worker does not work exclusively for the employer), and has a written contract with each such person, the worker could be considered an independent contractor. This lower threshold, coupled with the safe harbor provision of section 530, gives employers a great deal of discretion in classifying or re-classifying their workers as independent contractors rather than employees.

#### III. Consequences of Employment Classification

Classification of a worker as an independent contractor rather than an employee has significant consequences for both the employer and the employee. By classifying a worker as an independent contractor, the employer escapes its liability for payment of federal taxes and social security with respect to that worker. It also permits the employer to exclude the worker from insurance, retirements plans and other benefits available only to employees. While in the short run this may save employers some money, in the long run, it would be a drain on our economy.

Independent contractors have to provide for their own insurance, which is generally more expensive when not done as part of a large group plan. Many independent contractors may be uninsured or underinsured because they are unable to afford the proper amount of insurance. We as a society end up paying for that deficiency through emergency, rather than preventative, medical care and higher insurance premiums.

In addition, independent contractors may not be able to set up their own retirement plans because of the significant expense and burden involved. By contrast, participation in an employer's 401k or other group retirement plan is simple and convenient and the administrative costs are generally borne by the employer. The burden and expense of setting up an individual plan may discourage independent contractors from saving for their retirement. In addition, even if independent contractors make the required investment to set up an independent retirement plan, certain investment options may be closed to them or more expensive because they do not have sufficient buying power. Accordingly, independent contractors will have a more difficult time saving and investing for their retirement than they would if they were able to participate in an employer's 401k or other retirement plan. As our population ages and stretches the limits of social security, it will become increasingly important that our elderly have an adequate retirement plan of their own.

Independent contractors also may not be eligible for other benefits, such as life and disability insurance, paid vacation and sick leave, unemployment compensation, worker's compensation, etc. Their wages may be lower and they will be unable to organize a union to protect their rights and better their employment situation. Hence, the potential financial and emotional consequences of being classified as an independent contractor rather than an employer are tremendous.

In addition, if unscrupulous employers are able to secure lower costs by stretching the statutory language to classify their workers as independent contractors, such employers will have an unfair competitive advantage over employers who retain their traditional employees and pay them for the benefits to which they are entitled.

Classifying workers as independent contractors also means that employers avoid paying federal taxes and social security for those workers. It is well established that the compliance rate for reporting and payment of taxes is much higher in cases where the wages are paid to an employee rather than an independent contractor. Joint Committee on Taxation, Present Law and Issues Relating to Classification of Workers as Employees or Independent Contractors (JCX-23-96), June 3, 1996, at p. 25. Furthermore, an independent contractor classification may reduce the amount of taxes owed. Id. at pp. 34-35. Hence, under H.R. 1972, the federal government stands to lose billions of dollars in potential tax revenue.

#### CONCLUSION

The IBT recognizes the plight of employers and legitimate independent contractors who suffer from ambiguous laws and zealous Internal Revenue Service agents. Accordingly, the IBT supports proper reform of the tax code to address these issues. However, H.R. 1972 is not the solution.

UNITED STATES HOUSE OF REPRESENTATIVES  
 COMMITTEE ON WAYS AND MEANS  
 SUBCOMMITTEE ON OVERSIGHT  
 HEARING ON EMPLOYMENT CLASSIFICATION ISSUES

JUNE, 1996

STATEMENT OF MITCHELL ROUSE  
 PRESIDENT  
 INTERNATIONAL TAXICAB AND LIVERY ASSOCIATION

The International Taxicab and Livery Association ("ITLA") represents more than 800 small businesses that provide taxicab, livery ("executive sedan"), and limousine service in communities across America.

As an association of small businesses, most of whom lease vehicles to drivers who are classified by the IRS as independent contractors under the common law "right to control" test, ITLA strongly supports both the purpose and the provisions of HR 1972. We applaud Congressman Christensen and his more than 210 co-sponsors for their willingness to tackle a topic that has vexed both tax collector and taxpayer for 25 years.

With minor changes to clarify its application to the passenger transportation industry, HR 1972 should be enacted because it would clarify the law, leading to higher rates of tax compliance, more evenhanded enforcement by the IRS, and, in our industry, improved taxicab and livery service. (We have provided our recommended changes to Congressman Christensen.)

Company-driver contracts

The majority of taxicab and livery businesses in the United States lease their vehicles (using written leases) to drivers who are classified as independent contractors, pursuant to Rev. Rul. 71-572 (Situation 2), 1971-2 C.B. 347 (copy attached). Under Situation 2, if the lease is for a fixed rate, the company has no interest in the fares and tips received by the driver, and the company is not otherwise entitled to control the driver and the conduct of his work, the driver is deemed to be an independent contractor.

Changes in the law are required

With a few notable exceptions, ITLA members have been able to avoid classification controversies with the IRS because of the existence of Rev. Rul. 71-572. However, the IRS' interpretation of the common law "the right to control" test has been so stringent that it has resulted in deterioration of service in the taxicab industry. This is because companies are uncertain whether, for example, they can require the driver to adhere to a dress code, or to satisfy particular standards of cleanliness and courtesy towards passengers. These facts are not addressed in Rev. Rul. 71-572, and one court has ruled that, for purposes of the National Labor Relations Act, drivers who were subject to a dress code were employees. This is important both to taxicab passengers and drivers. A driver's poor conduct and/or slovenly appearance has

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\* City Cab of Orlando, Inc., v. N.L.R.B., 628 F.2d 261, 265 (D.C. Cir. 1980). But see Local 777, etc. v. N.L.R.B., 603 F.2d 862, opinion on rehearing, 603 F.2d 891, 902 (D.C. Cir. 1978) (dress restriction limited to a "no sandal" rule is a "very minimal" control). That the same court has drawn fine lines over the extent of a dress code is itself evidence that the law needs to be clarified.

a negative impact on passengers who will seek to meet their transportation needs in an alternate manner (e.g., rental cars, executive sedan services, airport shuttle vans). Less obvious is the adverse consequence suffered by the professional taxicab drivers who provide quality service. Drivers in the same company may lose the opportunity to serve that passenger in the future due to the strong probability that the passenger will select a different taxicab company, and all taxicab drivers are harmed as dissatisfied passengers simply use taxicabs less often.

While the IRS' recent initiatives, to improve agent training and to resolve classification issues more quickly, are helpful, they do not address the underlying problems: lack of clarity in the law and the IRS' institutional bias against companies that engage independent contractors.

Clarify the law. The Subcommittee has heard the litany of complaints by numerous witnesses about the difficulty of complying with the common law test, and how "errors" in judgment can lead to assessments by the IRS that are overturned, if at all, only after a long, arduous, and expensive battles with the IRS bureaucrats or in the court. This should not be! The "bright-line" test in HR 1972 will not only help both businesses and the IRS to properly classify workers, but will enable businesses that engage independent contractors who perform services for third parties, including taxi, livery, and limousine drivers, to require those independent contractors to satisfy standards of conduct that do not materially affect the independence of the driver.

Eliminate arbitrary enforcement. Enactment of HR 1972 would also help eliminate the litany of complaints about arbitrary and capricious enforcement by the IRS. For example, in 1975, one taxi company obtained a private letter ruling from the IRS National Office, concluding that the drivers to whom it leased taxicabs were not employees. Ten years later, the company was audited, and the collections officer, in violation of the IRS' own rules, reclassified the drivers and proposed to assess the company \$3 million in taxes and penalties. Although this action was subsequently overruled by the IRS National Office, the process took three years and over one hundred thousand dollars in legal fees. HR 1972, if properly followed by the IRS, would put a stop to this kind of nonsense.

Help new industries comply. Finally, HR 1972 would help many companies in industries that have grown up since 1978, and thus, do not have published revenue rulings to guide their classification of workers. In particular, HR 1972 would help ITLA members who lease limousines and executive sedans to drivers. Although the economic arrangements with these drivers are usually quite similar to those with taxi drivers, the lack of any published ruling with respect to these drivers has left these companies at the mercy of the IRS. Thus, the limousine industry has fought a series of battles with the IRS, wasting many thousands of dollars to fight battles that will never arise if HR 1972 is enacted.

### Conclusion

ITLA urges the Subcommittee to act favorably on HR 1972 and recommend its approval by both the full Ways and Means Committee, as well as the House of Representatives. Please seize this important opportunity to clarify the law, reduce the cost of tax administration and compliance, and improve service in the passenger transportation industry.

ITLA appreciates the opportunity to submit this statement, and will continue to constructively work with the Congress to reach an appropriate resolution of this issue.

## Congress of the United States

Washington, DC 20515

STATEMENT OF CONGRESSMAN TOM LANTOS  
ON HR 510, THE MISCLASSIFICATION OF EMPLOYEES ACT

June 20, 1996

Mr. Chairman and members of the Committee, thank you for giving me the opportunity to say a few words about the employee/independent contractor classification or the classification of workers.

As I look over the witness list for today's hearing, I see that you have before you an impressive panel who will no doubt describe to you some of the important reasons why Congress should take another look at how workers are classified for Federal income and employment tax purposes, as well as for many non-tax purposes. You might hear from witnesses who will tell you that confusion with employee classification rules can lead to costly disputes with the IRS with devastating effects for small businesses. These costs include, among others, assessments of back taxes, interest and penalties for businesses who misclassify workers as independent contractors, as well as the legal costs involved with coming into compliance with or for defending against an IRS audit.

As you probably know, Chris Shays and I became interested in the classification of workers several years ago when we served together on the Employment and Housing Subcommittee of the Government Operations Committee. We found that the misclassification of workers as independent contractors instead of employees is a pervasive and serious problem which impacts employers, workers, and Federal and State governments. We found that the current means for determining employment status has had several negative effects: one, it results in similarly situated employers being treated very differently under tax law; two, it allows -- and actually encourages -- businesses to undercut competitors through unfair practices; three, it leaves some workers exploited and unprotected; and four, it deprives the Federal government of significant revenue.

As you know, under current law, workers are classified as either employees or independent contractors in one of three ways. First, some workers are explicitly categorized as either employees or independent contractors by statute. Second, workers may be classified as independent contractors under statutory "safe harbors" enacted in Section 530 of the Revenue Act of 1978. Third, if a worker is not classified statutorily, and cannot be classified under the statutory "safe harbors", then the worker is classified by applying a very subjective common law test. Most workers fall under this third category.

I would like to make clear that I agree with and recognize the appropriate and valuable roles of those who work as independent contractors. This country has benefitted greatly from the spirit and independence of the self-employed individual and I do not think there is anyone who wants to stifle the creativity of these individuals. It is the misuse of the independent contractor status and its serious adverse effect on both employer and worker that concerns me. The misclassification of workers affects the unsuspecting worker, it affects the honest businessman trying to compete with a competitor who has misclassified his workers, and it affects the federal budget deficit. Our bi-partisan legislation, HR 510, the Misclassification of Employees Act, would remedy some of the unintended effects of the current law.

First, current law gives some companies an unfair competitive advantage over other companies in the same industry by permitting employers to misclassify workers if they have a "reasonable basis" for classifying employees as independent contractors. An employer may rely upon a prior IRS audit, including audits not made for employment tax purposes, in holding a reasonable basis for classifying workers. It makes no sense to permit the wrongful classification of workers based on a previous audit which may have had nothing to do with the issue of worker classification. Our legislation eliminates the "safe harbor" provisions which allows the misclassification of employees to continue. We thus restore a level playing field and eliminate the unfair competitive advantages which arise due to the misclassification of workers.

Second, because the common law test is extremely subjective, employers have trouble in properly determining worker classification, and revenue agents often classify workers differently even where the underlying circumstances of their employment are the same. Since a large part of the misclassification of workers is due to a lack of understanding of worker classification, clearer rulings and definitions will eliminate a tremendous amount of uncertainty in this area. Our legislation eliminates the restrictions of the IRS to draft regulations and rulings on the employment status of workers.

Third, employers who have unintentionally misclassified workers should be given the incentive to come into compliance. Our legislation offers a one-year amnesty to employers who have misclassified workers on the basis of a good faith interpretation of common law or of Section 503. This provision removes the devastating possibility of large assessments for back taxes, interest and penalties and ensures compliance in the future.

Fourth, misclassification can have a devastating effect on the unsuspecting worker. As an independent contractor, a worker may receive a higher take-home pay and may be allowed to deduct more business expenses from income taxes. But the loss of financial benefits and of the many protections which are provided to employees can be catastrophic in cases of illness, unemployment and retirement. For example, there is no unemployment compensation for the independent contractor to fall back on between jobs. Health insurance is an individual responsibility and is usually far more costly than an employer's group policy. In the case of work-related injury or illness, there is no worker's compensation available. HR 510 would require prime contractors to notify independent contractors of all their tax obligations and other statutory rights and protections.

Mr. Chairman, our investigation found that the economic incentives for businesses to misclassify workers as independent contractors are huge. An employer who misclassifies a worker as an independent contractor escapes many obligations, including paying social security taxes, unemployment taxes and workers compensation insurance, withholding income taxes and providing benefits such as vacation, sick and family leave, health and life insurance, pensions, etc. Most employers are honest, but the law abiding employer is put at a serious disadvantage since he or she cannot compete on a level playing field with those who illegally cut their labor costs. Law abiding employers will not be able to compete fairly until we provide more clear, objective standards by which businesses and the government can determine whether an individual is an employee or an independent contractor.

Lastly, and perhaps most importantly in these times of scarce federal dollars, billions of dollars in federal and state tax revenues are being lost as a result of the intentional misclassification of workers. This is one of the few remaining areas where we can help balance the federal budget deficit without further cutting government services or levying new taxes. A recent Coopers and Lybrand study found that at least 35 billion dollars in legitimate tax revenue over 9 years will be lost by the federal government due to the misclassification of employees. At a time

when critical services are on the chopping block, we can no longer allow this waste and abuse to continue. We must take steps to curb the continued misclassification of employees. We must enact HR 510, the Misclassification of Employees Act. I respectfully request that a summary of HR 510, the Misclassification of Employees Act, be entered into the record.

#### H.R. 510

**Section 1.** Section 1 provides that the short title of the bill is the "Misclassification of Employees Act."

**Section 2.** Section 2 would remove an impediment to many employers' correcting the misclassification of their workers. Section 2 would waive liability for prior employment taxes for past periods if the employer met five requirements:

- (A) The employer treated the worker as an independent contractor for purposes of employment taxes.
- (B) The employer's treatment of the worker as an independent contractor was based on a "reasonable good faith misapplication of the common law rules" using for determining employment relationships.
- (C) All the employer's federal tax returns consistently treated the worker as an independent contractor.
- (D) The employer and any predecessor employer treated all similarly situated workers as independent contractors for all periods after 1977.
- (E) The employer enters a closing agreement with the Internal Revenue Service agreeing to treat the worker and all similarly employed workers as employees, and to file all federal employment tax returns with respect to the workers as if they were employees.

The employer would have one year from the date of enactment of the bill to enter the closing agreement with the IRS. The waiver of past liability would expire one year after enactment of the bill. The five requirements would amend Internal Revenue Code [IRC] § 3509 by adding a new subsection (e).

**Section 2(a)(2)** of the bill would not amend the Internal Revenue Code, but it would require the Internal Revenue Service to monitor compliance of each closing agreement for at least five years after the agreement is entered into. The monitoring would include payments to the individual workers covered by the closing agreement as well as wages paid to other employees and independent contractors.

**Section 2(b)** of the bill would modify Section 530 of the Revenue Act of 1978, a tax statute which is not part of the Internal Revenue Code. The bill would tighten up the safe harbors slightly, and would eliminate one safe harbor which has proved to be a significant impediment to IRS reclassification of misclassified workers. It would reestablish safe harbors for technical service workers.

Paragraph (1) of section 2(b) would amend section 530 of the Revenue Act of 1978 to provide that a worker would be deemed to be an independent contractor if the employer has a reasonable basis for treating the worker as an independent contractor. Present law deems a worker an independent contractor unless the employer has no reasonable basis for treating the worker as an independent contractor.

Paragraph (2) would amend the statutory standards for treating workers as independent contractors. Under the bill, section 530(a)(2) would be amended to contain a list of reasonable bases for treating a worker as an independent contractor. Under the bill, an employer would have a reasonable basis for treating a worker as an independent contractor only if the employer reasonably relied on one of the following:

(a) judicial precedent, published rulings, technical advice or a letter ruling furnished to the employer [this is the same as present law];

(b) an IRS audit conducted solely for employment tax purposes within three years before the period in question, which audit included an examination for employment tax purposes of workers holding substantially similar positions to the worker in question, and following which audit the employer was notified in writing by the IRS that the employer had classified the workers correctly, and the IRS notification was not revoked before the period in question [this is substantially different from current section 530]; or

(c) long-standing, recognized practice of a significant segment of the industry in which the worker was engaged [this is the same as present law].

Subsection 2(c) would essentially repeal section 1706 of the Tax Reform Act of 1986. This would permit employers of technical service workers to take advantage of the safe harbors in section 530 of the Revenue Act of 1978, if they could meet the requirements.

Subsection 2(d) would repeal the prohibition against the IRS issuing regulations and rulings on employment status, originally enacted as part of section 530 of the Revenue Act of 1978.

Subsection 2(e)(1) would amend IRC § 6041 to require that additional information be provided on the Form 1099 furnished by businesses to providers of services worth more than \$600 per year. The 1099 would be required to include information that explains

1) the payor is treating the payee as not being an employee and the payee may be liable for self-employment taxes;

2) the procedure for obtaining IRS review of employment status, if the payee believes that he or she should be properly treated as an employee;

3) the payee is not eligible for employee fringe benefits and may lose protections or benefits under federal laws relating to fair labor standards, occupational health and safety, civil rights, unemployment insurance, and workers' compensation; and

4) tax benefits for the self-employed such as retirement plans and deduction for a portion of the cost of health insurance.

Similar information would be required to be furnished to service providers and direct sellers under IRC § 6041A by bill subsection 2(e)(2).

For the provisions in section 2 of the bill, subsection 2(f) would establish a general effective date beginning 120 days after the date of enactment. The modifications of the safe harbor provisions and the termination of the treatment of technical personnel would be effective for "periods ending on or after the date which is 120 days after the date of enactment" of the bill. It is not entirely clear whether the word "periods" refers to taxable years or to periods for which deposits of employment taxes are required to be made.

Section 3. Section 3 of the bill would amend IRC § 3304(a) to require that state unemployment compensation laws use the same definition of employee as is used under federal law as set out in IRC § 3306(i). This definition is nearly identical to the social security tax definition. This provision would take effect on the 180th day after the date of enactment of the bill, unless the state legislature had not been in session for at least 30 calendar days during the 180 days between enactment and the effective date. In such a case, the effective date would be 30 days after the first day on which the legislature is in session on or after the 180th day.

**THE U.S. HOUSE OF REPRESENTATIVES COMMITTEE ON WAYS AND MEANS  
SUBCOMMITTEE ON OVERSIGHT  
HEARING ON EMPLOYMENT CLASSIFICATION ISSUES**

Statement of the Mechanical Contractors Association of America  
June 4, 1996

The Mechanical Contractors Association of America (MCAA) represents businesses providing mechanical construction services in the residential, commercial, and heavy industrial construction markets nationwide. MCAA member firms compete in both public and private sector markets and perform services as both prime contractors and subcontractors.

The highly skilled craft labor employed by MCAA member firms is supplied under local collective bargaining agreements negotiated by 75 local MCAA affiliates and local unions of the United Association of Journeymen and Apprentices of the Plumbing and Pipe Fitting Industry of the United States and Canada (UA). MCAA member firms also provide equipment maintenance and services under the National Mechanical Equipment Service and Maintenance Agreement negotiated with the UA at the national level and MCAA's subsidiary, the Mechanical Service Contractors of America.

**Support stringent classification standards**

MCAA supports, without reservation, efforts to stem the workforce degradation that is directly the result of misclassification of employees as independent contractors. Similarly, MCAA supports efforts to narrow the excuses from liability for misclassification to remove incentives for abuse. Moreover, MCAA supports attempts to assure full payment of taxes by independent contractors.

Even with this unqualified support for the legislative objective, MCAA does not support the two legislative proposals under consideration today (H.R. 1972 and H.R. 582). In short, MCAA is concerned that the classification criteria set out in either proposal, when applied to the highly trained, highly mobile skilled construction workforce, would jeopardize the entire structure of training, health and welfare, pension, and other workforce development and retention benefits that are based on hours of covered employment.

**Protect industry workforce development structures**

We acknowledge the tremendous change in workforce patterns in this country in recent years, and agree that individual responsibility for career development can be beneficial for individuals in all types of careers - production and administrative and professional occupations as well. However, we also note that not all trends in work flexibility are necessarily beneficial. Much of the growth of the contingent workforce, and the concomitant growth of independent contractor status, leads to a tenuous attachment to

employment and the economy - with fewer benefits - which in turn accounts for a high level of underemployment in the economy overall.

In the union sector, trade union and multiemployer groups in local collective bargaining have built and maintain a system of apprenticeship training, health and welfare, pension benefits, and career advancement training that ensure an adequate supply of high-skilled trades persons with commitment to the industry engendered by substantial career opportunities. The viability of these structures - as well as individual careers - could be at jeopardy with even more permissive worker classification standards.

Misclassification of employees as independent contractors is in fact epidemic in the construction industry and is a severe threat to degrade the quality of the workforce and service even in the union sector, spreading beyond the low-skill, open-shop segments of the market where the abuses were formerly concentrated.

The construction industry as a whole surpassed even the finance, insurance, and real estate industry, with rates of worker misclassification at 19.8% and 19.3% respectively, according to be 1991 Treasury Department study cited in the Coopers and Lybrand study commissioned by the Coalition for Fair Worker Classification in 1994. (Coopers & Lybrand, *Projection of the Loss in Federal Tax Revenues Due to Misclassification of Workers*, Coalition for Fair Worker Classification, June 1994, page 8.)

Nevertheless, we acknowledge that there can be some legitimate classification of production and skilled craft workers in construction as well as clerical, administrative and professional workers as independent contractors. And we are proud to note, along with our colleagues in the building trades, that the opportunities for career progression from skilled production jobs into supervisory, management, and even business ownership and entrepreneurship are unrivaled in construction as compared with virtually all other manufacturing and goods-producing industries.

However, the epidemic rise of worker misclassification in construction has nothing to do with career enhancement, but rather everything to do with unfair low-wage competition. Our industry can ill afford declining skills and abilities at a time when our product and services are expanding in complexity and sophistication. In fact, the effect of unfair competition by firms that misclassify employees and avoid the payment of employment taxes and other requirements of employment law threatens the maintenance of workforce standards.

### **Allow flexible criteria by industry to stem abuses**

While perhaps well-intentioned, neither H.R. 1972 nor H.R. 482 will stem the tide of workforce degradation brought on by worker misclassification. Unfortunately, either may have the unintended effect of being even more permissive toward abusive practices. While we do not contend that the current IRS standards for judging employment control and direction - along with the flexible 20 common law factors - are either a model of clarity or blueprint for consistency; we nevertheless point out that they have the virtue of established use. The classification standards are at least known, and their impact on encouraging abuse may be far less than the broad leeway and excuse from liability permitted under Section 530.

Unfortunately, both proposals suffer from the same defect - that is, they attempt to legislate, with a complex list of conjunctive and disjunctive factors, a formulaic approach to a highly fact-specific inquiry. Moreover, a legislative approach is static.

We submit that a flexible regulatory approach would be more effective. The draft IRS Training Manual, *Employee or Independent Contractor?*, demonstrates a more flexible approach that would remain adaptable. The IRS manual addresses the fact-specific "control factors under the common-law standard that may indicate the existence of an independent contract or an employee relationship" and "emphasizes that factors may change over time because business relationships and the work environment change over time." (IRS Manual, page 1-1).

### **Encourage full compliance with employment standards**

Both H.R. 1972 and H.R. 582, as legislative standards, are too static to meet the changing workplace practices. Rather, we support IRS efforts to craft appropriate market segment understandings to reflect current industry practices in a more flexible way. Under either legislative proposal, whether the criteria are profit/loss, separate place of business, different clients, or commission payments, taken together they would be too permissive as applied to the construction trade workforce, the unique character of which is not reflected in the law.

Likewise, judgments that turn on investment in training or tools and equipment would encourage misclassification of highly trained, self-equipped construction workers. Similarly, any requirement of a qualifying agreement memorializing the classification could too easily become a unilaterally imposed contract in cases where individuals are without bargaining representation.

In summary, the criteria laid out so far, as applied to a highly trained construction workforce that meets fluctuating market demand from referrals to several projects over a year, could well force a radical transformation of the employment relationships in the construction industry to the detriment of the training and benefits structures that are based on contributions for hours worked under covered employment. Moreover, all the other important legal protections that flow from employment status, including prevailing wage, workers compensation, EEO, family and medical leave, and other labor and employment protections would be jeopardized as well.

In conclusion, MCAA would urge the committee to avoid codification of classification criteria, which perforce would be too broad to meet specific industry conditions, and encourage administrative efforts to continue market segment development of specific industry criteria. Instead, Congress should narrow the liability excuses permitted under Section 530, encourage remedial employment classifications, and increase reporting and filing requirements to achieve greater taxpayer compliance.

MCAA member firms appreciate the Subcommittee's invitation to participate in the hearings. Our association will continue to work with Congress on this most important workforce issue.

**STATEMENT OF  
THE NATIONAL ASSOCIATION OF HOME BUILDERS**

Madam Chairwoman and Members of the Subcommittee:

The National Association of Home Builders (NAHB) and its 185,000 members congratulate you for holding this hearing and appreciate the opportunity to present its views. This statement will address the current issues relating to classification of subcontractors as independent contractors in the home construction and remodeling industry.

At the outset, it has long been the position of NAHB that the current law pertaining to worker classification recognizes the unique characteristics of the home building business and allows the flexibility necessary for building industry workers to function in a changing economy. Moreover, the current rules under Section 530 of the Revenue Act of 1978 provide equitable relief for taxpayers who become involved in disputes with respect to worker reclassification.

It has been our concern that a rigid application of static rules regarding the classification of workers would result in the improper classification of legitimate independent subcontractors as employees, and thereby unfairly burden both small businesses and workers.

In this regard, there have been few legislative proposals which address this concern. H.R. 1972, introduced by Representative Jon Christensen would establish reasonable guidelines for the protection of independent contractor status for the home construction and remodeling industry. H.R. 1972 would replace the common law test of employment status with a more objective three-part test but would not repeal Section 530 of the Revenue Act of 1978. It would prohibit the Internal Revenue Service from classifying subcontractors as employees if certain requirements are met. Should a taxpayer fail to maintain active compliance with Internal Revenue Code filing requirements, the taxpayer would then lose the protection of the statute. For the reasons set out below, NAHB supports H.R. 1972.

By contrast, H.R. 582, introduced by Representative Jay Kim, would repeal the safe harbor rule of Section 530 and establish a "modified" rule, which NAHB opposes, as explained more fully below.

**INDUSTRY PROFILE**

The industry, building single family housing, is comprised mostly of small businessmen and women. Over 50 percent of NAHB members build less than 10 houses per year. Approximately 20 percent build more than 25 houses per year and less than 2 percent of the builders build over 500 houses per year. The single family home building business is clearly comprised of small businesses in virtually every community in the country.

Because the construction of a home entails the transportation to a job site of a wide variety of different materials which are assembled and/or fabricated by a host of different trades, and because job sites necessarily change as the homes are built, the relationship between the home builder and the person who performs the different trades varies widely. The construction of single family homes is basically the coordination of the work of as many as 18 different subcontractors. Another complicating factor, principally in the view of the Internal Revenue Service, is the fact that a home builder routinely does "sub-out"- that is, hire an independent contractor to perform services which may appear to the IRS to constitute performance of "common labor". In those instances, the IRS often alleges that the person is an employee rather than an independent contractor.

Since the volume of work in the home building industry is very unpredictable and seasonal, there is a strong necessity for the business owners to match labor to business needs and not to be encumbered by large permanent payrolls. In today's market, two out of three builder firms are organized as corporations and about one-fourth are sole proprietorships.

	<i>NAHB's Builder Membership</i>	<i>Census of Construction: 1992</i>
Corporations	64 % Subchapter S -- 35 % Regular C Corps -- 29 %	57 %
Partnerships	5 %	5 %
Sole Proprietorships	29 %	38 %
Other	1 %	1 %

During the last ten years, more builders have been organizing as Subchapter S corporations, so that they can combine limited liability with taxation on only individual earnings.

A builder's organizational structure tends to depend on the size of the business. About 25 percent of small-volume builders are sole proprietorships, whereas only 5 percent of the medium-volume builders and 2 percent of the large volume builders choose to operate under that structure. The average remodeling firm has one office employee on payroll and operates in one or two counties. Approximately half of the remodeling firms are corporations, while 42 percent are sole proprietorships.

#### LAND DEVELOPMENT

Home builders vary considerably in the degree to which they directly perform the operations it takes to develop land and build and market homes. According to NAHB's 1996 builder survey, less than half of all builders buy the raw land, install the infra-structure, construct the units, and then sell the product. Over half buy lots from other builders or developers, use subcontractors for all the construction work, and sell through real estate agents.

The difficulty builders have recently experienced obtaining financing for property acquisition and development may result in land development becoming more heavily concentrated among large firms. Moreover, more stringent requirements for loans from financial institutions could mean that builders will look more often to land developers to provide financing for purchases of developed lots. Increasing fees and regulation may also cause land development to become more concentrated among well-financed specialists.

#### ROLE OF SUBCONTRACTORS

During the past 30 years, the role of subcontractors and professional specialists in the home building industry has increased significantly. Most builders believe that the trend toward increased use of subcontractors will continue. Framing, roofing, bricklaying, foundations, and masonry are generally done by the subcontractors on a labor-only basis, with materials provided by the builder. Other jobs, such as flooring, insulation, and painting, involve subcontracts for both labor and material.

The home building industry (as well as the non-residential construction industry) is characterized by extensive subcontracting of the actual construction work. In 1959, 31 percent of NAHB survey respondents subcontracted three-quarters or more of their construction costs. This figure increased to 63 percent by 1993. Over the same period, the share of builders subcontracting one-quarter or less of their construction costs declined from 19 percent to 6 percent. Large-volume builders tend to subcontract a larger share of the construction cost.

*Share of construction cost subcontracted:*

Large Builders	86 %
Medium Builders	81 %
Small Builders	56 %

NAHB's 1994 Survey of Builders indicated that subcontractors were the most relied upon source from which to obtain materials and equipment. The survey showed that the majority of general contractors (those that build for a fee on someone else's land) and merchant builders (those that build on land they own and offer the house and land for sale together) subcontracted more than 75 percent of the total construction cost. Larger builders subcontracted an even larger share than small builders. The 1994 Census of Construction indicated that residential builders subcontracted \$36.6 billion, or 49 percent of the value of their hard cost. An earlier study by the Bureau of Labor Statistics found that construction of the typical home involves about 18 different subcontractor firms.

The 1989 NAHB remodelers survey showed that remodelers heavily rely on subcontractors. Ninety-three percent of the remodelers used subcontractors during 1988. Twenty-five percent attributed 50 to 99 percent of their dollar volume to work done by subcontractors and 5 percent subcontracted 100 percent of their dollar volume. The survey also suggested that the usage of subcontractors, rather than hiring of employees, was market, as opposed to tax, driven.

From the worker's point of view, a worker with a skill can generally earn more as a contractor working for a variety of customers than he could on straight salary working for a single employer. The worker may also take pride in being independent of a boss supervising the details of his work.

The primary reason for the extensive use of subcontractors is the episodic, uneven nature of construction and the fact that a particular type of specialist is only needed for a short period during the construction process. Moreover, the general contractor does not have either the expertise or the capacity to oversee and manage the activities of each specialist, monitoring the number of hours worked and purchasing all the materials. So the general contractor issues a subcontract based on negotiation or competitive bids and leaves it to the subcontractor to figure out how to accomplish the work, with the subcontractor often responsible for supplying the necessary building materials.

In 1992, there were 1.5 million establishments characterized by the Census of Construction as "special trade contractors" working as subcontractors to residential and non-residential builders, as well as serving consumers and non-construction firms directly. Establishments with payrolls, of which there were 367,000, had total receipts of \$220 billion, while the 1.10 million establishments with no payroll had receipts of \$25 billion. Out of total receipts, about 36 percent went toward the purchase of materials and supplies and another 8 percent was subcontracted to other subcontractor firms.

Although subcontract work may be subject to competitive bids, most builders develop long-term relationships with their subcontractors, just as consumers tend to patronize the same doctors, dentists, or lawn care firms. Even in long-term relationships and where the subcontractor has no employees, however, the relationship between general contractor and sub is different than that between employer and employee. The builder is not obligated to provide continuing employment for the sub and the sub remains liable to the builder for performance in ways an employee generally is not. There are a variety of other distinctions, many of which are reflected in the common-law tests currently used to distinguish independent contractors from employees.

Construction of a single family home involves about 1,000 hours of on-site labor, and since it takes an average of about six months to complete a house, that is equivalent to one full-time worker. Those 1,000 hours, however, may be performed by as many as 100 different workers, most of whom are proprietors or employees of subcontractor firms. Even if a general contractor knew who all the workers were and how much of the payment to subcontractors was for labor, it would be an overwhelming burden for a builder to account for tax withholding for the army of workers involved in building a home.

#### **CONSEQUENCES OF CLASSIFICATION**

Reclassification of subcontractors as employees would:

1. Add substantially to the cost of doing business of the small home builder;
2. Remove the flexibility of the owner to respond to a volatile market and seasonal conditions;
3. Shift the nature of the home building business from small business to a concentration of large firms; and
4. Add substantially to the cost of housing driving thousands of projected buyers out of the market.

#### **SECTION 530 OF THE REVENUE ACT OF 1978**

Congress enacted §530 of the Revenue Act of 1978 to provide relief to taxpayers involved in tax controversies. This Act provides generally that if a business: (1) did not treat an individual as an employee for any period; (2) filed all tax returns (including Forms 1099) on a basis consistent with its tax position; and (3) has a "reasonable basis" for treating the worker as an independent contractor, the government is not to raise the employment tax issue in an examination.

A reasonable basis that is acceptable under §530 includes having a case or ruling that supports the taxpayer's position, a previous IRS audit in which the independent contractor treatment resulted in no assessment, or a long-standing industry practice.

When a "safe haven" under §530 is found, a company is not a) subject to back taxes or penalties, b) obligated in the future to withhold income taxes from contractor payments nor c) obligated to pay employment taxes on independent contractors.

#### **THE INDEPENDENT CONTRACTOR SIMPLIFICATION ACT, H.R. 1972**

Under H.R. 1972, introduced by Representative Jon Christensen (R-NE), in order to be classified as an independent contractor, the subcontractor must satisfy three tests.

To pass the first test, the subcontractor must satisfy one of the following:

- (1) Have a significant investment in assets and/or training;
- (2) Incur significant unreimbursed expenses;
- (3) Agree to work for a specific time or complete a specific result, and be liable for damages for failure to perform;
- (4) Be paid on a commission basis; or
- (5) Purchase a product for resale.

The second test requires that the subcontractor satisfy any one of the following:

- (1) Have a principal place of business;
- (2) Show that he/she does not primarily provide the service in the service recipient's place of business;
- (3) Pay a fair market rent for use of the service recipient's place of business; or
- (4) Show that he/she is not required to perform service exclusively for the service recipient, and
  - a) has performed a significant amount of service for other persons;
  - b) has offered to perform the service for other persons through advertising, individual written or oral solicitations, listing with agencies, brokers and other referral services; or
  - c) provides service under a registered business name.

To satisfy the third test, there must be a written contract between the parties, specifying that the subcontractor is not an employee. In order to retain the protection of the statute, the service recipient must properly file all Forms 1099 or W-2. Should the subcontractor fail to file the required returns, the protection of the statute would be lost.

This legislation would protect construction industry subcontractors from misclassification as employees through the establishment of clear, easily understood, tests. Moreover, H.R. 1972 would not erode the protection of the safe harbor provisions of Section 530 of the Revenue Act of 1978.

#### **THE INDEPENDENT CONTRACTOR TAX FAIRNESS ACT, H.R. 582**

H.R. 582, introduced by Representative Jay Kim (R-CA) would repeal Section 530 of the Revenue Act of 1978 and incorporate a modified version of the safe harbor provision into the Internal Revenue Code. Under H.R. 582, in order to be classified as an independent contractor, a subcontractor must perform services pursuant to a written contract and must (a) be able to realize a profit or loss from the services, (b) maintain a separate place of business and have a significant investment in tools or facilities, (c) make his or her services available to the general public on a regular and consistent basis and must have performed such services as a subcontractor for another service-recipient during the last two years, or (d) be paid exclusively on a commission basis and maintain a separate principal place of business (or pay fair market rent if not a separate place of business).

The written contract must state that the subcontractor will not be treated as an employee by the contractor, that the contractor is aware of the Federal tax obligations resulting from such treatment and that he/she will maintain separate accounting of income and expenses relating to the contract. If the tests are satisfied, the bill would generally relieve the contractor of employment tax liability. It would increase the penalty for failure to file Forms 1099 and require that independent contractors report each individual 1099 payment received on their income tax returns. H.R. 582 would also direct the Secretary of the Treasury to report to Congress proposing legislation which specifies objectively measurable criteria for determining whether an individual is an employee.

NAHB opposes the proposals to repeal Section 530 of the Revenue Act of 1978 and to delegate legislative authority to the Secretary of the Treasury. We note that Congress enacted Section 530 as the result of over zealous enforcement by the IRS of employment tax laws. Given the propensity of government to classify subcontractors as employees rather than independent contractors, we believe that any legislative proposal in this area must and should be generated by Congress.

Finally, NAHB fully supports the proposition that every American must pay his full share of Federal income tax. Independent contractors employed in the home construction industry generally satisfy the current 20-factor test. Increased IRS compliance activity would unveil dishonest construction contractors and level the playing field for honest construction employers. It is the job of the Internal Revenue Service to resolve the compliance problems in a fair and equitable manner. Improved compliance should be achieved through increasing business's compliance with the reporting requirements. In this regard, NAHB agrees with the proposals to increase IRS enforcement efforts by increasing penalties for failure to file correct payee statements.

#### **CONCLUSION**

For the reasons set out above, NAHB supports H.R. 1972 as providing reasonable criteria to establish employment status without restricting the classification of independent contractor. NAHB opposes H.R. 582 as unduly limiting the available safe-harbor protection afforded by Section 530, although we would support increased penalties for noncompliance with the employment tax form filing requirements.

The National Association of Home Builders is much appreciative of having had this opportunity to present our views on the issues relating to classification of home and remodeling industry subcontractors as independent contractors.

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**Statement of  
Patti Burglo, Director of Government Affairs  
National Association of the Remodeling Industry  
submitted to the Oversight Subcommittee  
of the House Ways and Means Committee  
regarding the Status of Independent Contractors  
June 4, 1996**



On behalf of the 6,000 member companies of the National Association of the Remodeling Industry (NARI), representing more than 40,000 home improvement professionals, I am pleased to submit testimony in support of Congressman Jon Christensen's bill, H.R.1972, the Independent Contractor Tax Simplification Act.

The status of independent contractors has been the number one concern for NARI since 1978. It is now the number one issue for the 1995 White House Conference on Small Business. We are pleased the Chairwoman has seen fit to hold these hearings, drawing greater attention to this most important small business issue.

Independent contractors are an integral part of the home improvement industry. Small business general contractors, many of whom started out as independent contractors, commonly contract with specialty craftsmen to fulfill specific aspects of a larger home improvement project. Since each remodeling project is unique, especially for full service remodeling firms, various specialty trades are needed from one job to the next. Independent contractors or subcontractors are well suited to serve in these cases. They provide general contractors with flexibility and cost efficiency in offering varied multi-service projects to the homeowner. They allow remodeling firms to meet fluctuating service demands created by short term projects and specific client needs.

For years, remodelers have struggled with the ambiguities surrounding the definition of an independent contractor. Remodeling firms have suffered financially due to the broad discretion afforded IRS agents in applying the 20 question, common law tests. Despite the Congressional moratorium issued in 1978, the IRS continues to aggressively audit and reclassify subcontractors as employees for federal tax purposes. It is obvious that a bias exists in favoring employee status rather than allowing entrepreneurs to remain in business for themselves.

The ramifications of a reclassification go far beyond federal withholding, unemployment, Social Security and Medicare payments. Besides back taxes, penalties and interest, remodelers are often held liable for state employment taxes, workers' compensation insurance, pension plan payments, and other employee benefits. An IRS or state employment audit often results in the unfortunate dissolution of the company.

The time is now for Congress to enact a clear, fair and objective standard that puts an end to the confusion once and for all. H.R.1972 provides the answer. This is a simple test that anyone can understand. There will be no question as to who is and who is not an employee for federal and state tax and employee benefit purposes.

We have testified in the past in support of such a solution. NARI member, Wayne Kaufman of United Homecraft in St. Louis, Missouri, testified in January 1995 before the House Small Business Committee that this issue was of primary concern to himself and his colleagues in Missouri. Mr. Kaufman is truly representative of most remodeling firms in America.

We are extremely pleased Congressman Christensen and more than two hundred of his colleagues have found a solution to the problem. We believe H.R.1972 is a workable bill that will provide clarity to thousands of general contractors and independent contractors. Many of the inconsistent findings and industry mistakes are made because the existing rules are so vague. This bill spells out the requirements for independent contractors and provides the greatest opportunity for entrepreneurial growth.

Subcontractors are a very independent breed. They prefer to pick and choose which projects they would like to work on. They want to be their own boss. They do not want to be employees; that is why they have struck out on their own. This bill allows that maverick spirit to flourish, creating new companies and new jobs.

Given the recommendation of the White House Conference on Small Business and the new Congressional climate, the time is ripe for Congress to tackle this issue head on and provide small businesses and the IRS with clear guidance that will allow us to easily determine who is and who is not an employee. **The first step is to enact H.R.1972.**

Second, the focus of the IRS must change to matching Forms 1099 with the actual income reported by independent contractors rather than reclassifying workers. If the subcontractors are under reporting their income, then the IRS should go after them.

Finally, compliance should be enforced consistently. It seems that the IRS likes to set an example in a community by aggressively penalizing one company, the news of which spreads like a wildfire, in hopes that other similar companies will be frightened into hiring their

subcontractors as employees. All subcontractors should not be reclassified as employees simply to benefit the IRS in revenue collections or the Administration in providing employee benefits.

We appreciate the concern of this Subcommittee and truly hope that action is taken soon to clarify the rules regarding the definition of independent contractors. It is extremely difficult for small remodeling firms to continue to operate under such a cloud of uncertainty. Enactment of H.R.1972 will go a long way in clearing the air.

*NARI is a not-for-profit trade association with nearly 6,000 member companies nationwide, representing more than 40,000 remodeling industry professionals. NARI members are primarily residential home improvement contractors, and include national manufacturers and distributors of home improvement products and services.*

*Residential remodeling constitutes a \$100 billion industry that has grown more than 130 percent in the last ten years. With more than 50 years of experience, NARI is committed to enhancing the professionalism of the remodeling industry and serving as an ally to homeowners. NARI is dedicated to the growth and betterment of the remodeling industry and related small businesses. For more information about NARI, contact Patti Burgio, director of government affairs, NARI, 4301 North Fairfax Drive, Suite 310, Arlington, VA 22203, 703/276-7600, ext. 3014.*

## STATEMENT OF THE NATIONAL CLUB ASSOCIATION

The National Club Association (NCA) submits these comments for the record on the issue of worker classification and H.R. 1972, The Independent Contractor Tax Simplification Act of 1995. NCA is the trade association representing the legal, legislative and business interests of private social, recreational and athletic clubs. Member organizations include country, golf, city, yacht, tennis, and athletic clubs.

The scope of these clubs ranges from small clubs with limited membership and facilities to larger, full-scale operations with dining and extensive recreational facilities. Some clubs are operated on a seasonal basis while many are open year round.

### Overview of the Issue

For many years, there has been a lack of clear definition and explicit guidelines for determining the status of workers as employees or independent contractors. Because of the uncertainty of the law in this area, many businesses have in good faith attempted to classify workers properly, only to be challenged by a zealous and determined Internal Revenue Service (IRS) agent. This issue has become critical for many businesses because of the increasingly aggressive employment tax audits used by the IRS. Many small businesses simply do not have the resources or time to properly defend and litigate adverse IRS determinations.

An issue for clubs, particularly golf and country clubs, is how the IRS views workers such as caddies, golf professionals, tennis professionals and musicians. In a recent survey of our member golf clubs all but one club classified caddies as independent contractors. Many of these workers--caddies in particular--have maintained independent contractor status through a long tradition.

Caddies have in fact been an essential part of the game of golf since the first golf club was formed in Scotland in 1746. Today the close relationship between caddie and golfer remains unique in sport.

The number of caddies at each particular club varies, depending on the number of rounds played and whether golf carts are also available. Some clubs use caddies exclusively. Most of the country's caddie programs tend to be located in the Midwest and Northeast. These areas have an advantage over other parts of the country because of a strong tradition of caddies and a golf season that coincides with the school year, making it easy for teenagers to caddie. Caddie programs provide an outstanding work ethic for young men and women who often are working at their first job.

If clubs are required to make caddies "employees" of the club, the financial and administrative liabilities (such as increased recordkeeping, payroll and benefits costs) would be prohibitive, and many fine caddie programs would cease to exist. As a result, many young men and women would lose valuable first-time job opportunities and would become jobless.

### Other Ramifications

There are a number of student scholarship programs that exist today solely because of caddie programs. The Evans Scholarship program, established in 1930, is the largest such program in existence and is the largest individually funded scholarship program. More than 480 golf clubs, 125,000 golfers and 22 affiliated golf associations support the Evans program, which has an annual budget of nearly \$5 million and now has over 6,300 alumni. Many other state and local golf associations and individual country clubs also sponsor caddie scholarship programs. The combined financial contributions made to these programs total in the millions each year. If the IRS continues on its course to reclassify caddies as employees many caddie programs would disappear, along with the successful scholarship programs that have enabled thousands of students the opportunity to attend college.

### Efforts by the Industry to Address Proper Employee Classification

For many years, NCA has followed independent contractor issues and related compliance requirements. We have produced numerous reference materials and articles to help our members understand the infamous 20-factor test the IRS currently uses. In addition, we have periodically met with IRS officials to obtain information on how our clubs can maintain proper worker classification, especially for caddies.

We have focused particular attention on the ways caddies should be handled. For example, the way a golf club assigns, pays and supervises caddies can determine whether caddies are classified as employees or independent contractors. Because a caddie will rarely have any significant business or financial risk in connection with his or her activities, the factors relating to the control and direction of caddie activities are of greater importance. It has become increasingly difficult to advise clubs in this area however because the interpretations IRS agents apply to various matters under the 20-factor law test have become highly subjective.

### Support for H.R. 1972

Worker classification rules needs to be changed and simplified. The current 20-point test used to determine the employment tax status of a worker is vague and subject to various conflicting interpretations. Because of its obfuscatory nature it often precludes a factual determination of a worker's classification. In addition, the IRS often ignores the existing Section 530 safe harbor provisions.

We support H.R. 1972, The Independent Contractor Tax Simplification Act of 1995. The legislation is also supported by The Coalition to Preserve Caddie Programs which is composed of state and regional golf associations and a number of caddie scholarship programs (see Appendix A). The legislation presents an easy, equitable and straightforward set of rules for determining worker classification. Further, it does not seek wholesale changes in the workplace and employment environment, but rather creates a fair basis for determining worker classification. At the same time it supports compliance and reporting efforts so that all workers, despite their classification, pay their fair share of taxes.

### One Club's Experience with Worker Classification

Last year, a private golf and country club located in New York state was assessed a significant payroll tax liability by the IRS and was informed that the golf caddies at the club must be classified as employees. The club has appealed the determination which is based on a host of inaccuracies, misrepresentations and unsound conclusions by the IRS as outlined below. This example is provided as a case study, because it clearly illustrates the problems endemic with the 20-factor test.

Among the erroneous conclusions the IRS reached in the New York case is the determination that an employment relationship exists between the caddie and the club, based on an interpretation that the golfer is acting as an "agent" of the club. The IRS concluded that since the club's members are also owner-shareholders of the club, they were acting as agents for the club in making payments to the caddies. Accordingly, the caddies were deemed by the IRS to be under the control of the club and, therefore, employees.

This line of reasoning not only seems absurd, it also fails to take into account several important points. To begin with, not all members of the club are shareholders--only resident members have certificates of membership. Secondly, there is no factual basis to imply that an agency relationship exists between the club and its members.

The IRS took several other unusual positions in this case:

- (1) The IRS virtually disregarded club practices concerning caddies and the fact that the caddies receive no remuneration unless they perform services for a

member or guest of a member. Remuneration for caddie services is paid to the caddie by the playing member directly. No work schedules are set by the club. Caddies report when they want to earn money, with no reward or sanction for working any particular hours. The club has no obligation to pay the caddies and does not pay caddies. The club neither enforces the payment, determines the amount to be paid or reconciles disputes. Finally, the club gives caddies no instruction, direction or advice on how to carry out their duties.

- (2) The IRS cited provisions of the New York State Disability Benefits Law which requires that clubs cover caddies under their Workers' Compensation Insurance. From this, the IRS concluded, "if they are employees under part of the laws that govern employees, and are not employees, why are they not under all the parts of the (germane) laws?" In fact, the New York State Disability Benefits Law specifically states that the services of golf caddies are not deemed to be employment. The Workers Compensation Law is also careful to separate caddies from regular club employees, simply stipulating that caddies should be covered as a matter of public policy.
- (3) The IRS totally disregards the fact that Revenue Ruling 69-26 (1969) had established that payment of caddies through a voucher system (members signing for their charges to be made against their club account) does not mean caddies are employees. Since the club does not permit members to sign for caddies, requiring them to pay with cash, the IRS concluded that the club is in violation of its own rules, which require all members to sign for club services. As a result, in an inconceivable stretch of logic, the IRS determined that the club does not qualify under the revenue ruling. In fact, however, caddie fees cannot be charged to the club because they are not a service supplied by the club.
- (4) The IRS also cited material from a booklet for caddies that is published by a regional golf association and made available to caddies and members of the association. The booklet contains well-established rules of golf, etiquette and safety on a golf course. Although the club neither published the booklet, contributed to the text, or established any of the rules or safety procedures contained within, the IRS incorrectly referred to the booklet as the "club's handbook" and cited it as evidence of training conducted by the club for caddies.

This club does not train caddies. It merely provides a handbook produced by a regional golf association. The IRS reasoned that caddies who follow the booklet must be employees of the club. This is tantamount to saying that a taxpayer's representative who follows Treasury Circular 230, Practice Before the Internal Revenue Service, must be an employee of the IRS. Neither conclusion follows from the facts.

- (5) The IRS also apparently ignored Section 530 relief which serves as a safeguard to protect a business from reclassification of independent contractor as employees, if certain conditions are met. These conditions are as follows:
  - The club has, since 1977, treated similar workers as independent contractors.
  - The club has filed all required forms (1099) in a manner consistent with the individuals being independent contractors.
  - The club has a "reasonable basis" for treating the individual as independent contractors.

Under current law, a reasonable basis for treating an individual as an independent contractor may include revenue rulings, industry practice, or the fact that the IRS has previously audited the club and not reclassified these individuals as employees.

Conclusion

Our member golf clubs take pride in their contribution to the game of golf, for providing substantial work opportunities within their communities and for close adherence to legal and regulatory requirements. They are careful not to establish employment relationships with sports professionals or local caddie pools by following longstanding and well established industry practices. Despite their best efforts to comply with the existing IRS guidelines for determining employment status, they have often been thwarted by IRS agents anxious to find justification for an employment determination.

The current effort by the IRS to reclassify caddies as employees is without basis. If it continues unchanged, it will substantially reduce--and potentially eliminate--the caddie programs at golf courses throughout the country. This will deny work, mentoring and significant scholarship opportunities for many young men and women. Caddying is truly a unique tradition and a special situation. Based upon the apparent interest of the IRS, its future is dependent on reasonable changes in the laws related to worker classification.

We appreciate the subcommittee's efforts to address the problems associated with worker classification and ask that it report H.R. 1972 to the full Committee for consideration.

Appendix A

The Coalition to Preserve Caddie Programs

American Junior Golf Association  
Caddie Master  
Carolinas Golf Association  
Colorado Golf Association  
Colorado Women's Golf Assn  
Georgia State Golf Association  
Golf Association of Michigan  
Golf Association of Philadelphia  
Indiana Junior Golf Association  
Massachusetts Golf Association  
Metropolitan Golf Association  
Minnesota Golf Association  
New Hampshire Golf Association  
New York State Golf Association  
Northern Ohio Golf Association  
South Dakota Golf Association  
Southern California Golf Association  
Southern Texas Golf Association  
Tarheel Youth Golf Association  
Toledo District Golf Association  
Vermont Golf Association  
Virginia State Golf Association  
Western Golf Association/Evans Scholars Foundation  
Wisconsin State Golf Association

**STATEMENT OF  
THE NATIONAL FEDERATION OF INDEPENDENT BUSINESS  
INDEPENDENT CONTRACTOR TESTIMONY  
HOUSE WAYS AND MEANS OVERSIGHT SUBCOMMITTEE**

The National Federation of Independent Business (NFIB) appreciates the opportunity to submit testimony on the issue of independent contractors and how they are being impacted by the Internal Revenue Service (IRS) enforcement. NFIB is the nation's largest small business organization representing more than 600,000 small business owners from all fifty states. The typical NFIB member has five employees and has \$350,000 in gross annual sales. NFIB sets its public policy positions through regular polling of the membership.

**What is an Independent Contractor?**

Independent contractors are men and women who have decided to work for themselves instead of working for an employer. They are found in a wide variety of industries, and they usually control their own hours, work with their own equipment, and are not subject to the direct control of the business owner.

Independent contractors play a very important role in both our economy and our society. An independent contractor is a budding small business. Deciding to work for yourself is the first tentative step toward establishing a business. The United States has a strong tradition in encouraging entrepreneurs and business creation. The decision to strike out on one's own as an independent contractor is often the first step in this process.

Independent contractors also serve a variety of functions that are not easily performed by employees. They allow a small business owner to temporarily hire someone with a skill that is needed by the business for a short period of time or on an occasional basis. It is not unusual for a business to have variety of jobs arise during the year that cannot be handled with the current work force but that do not require hiring an additional employee. By hiring an independent contractor, a business owner can have the job taken care of quickly without having to hire someone that may have to soon be let go. The availability of independent contractors allows small businesses to be more flexible and more competitive.

Imagine that you are a small retailer and you determine that you need to computerize your operations to keep better inventory control and to permit your business to grow. So you contract with a specialist to design the system for you, and you pay the person for the work after the product is delivered.

One or two years later the Internal Revenue Service (IRS) is performing a standard audit and you are asked for the documentation on the work that was done. It is then that the IRS tells you that you failed to treat this individual as an employee and that you should have withheld taxes for social security and income, and that you are going to be penalized 100 percent of the liability and that, if you do not agree, the IRS will place a lien on your bank accounts effective in 60 days without any right to appeal.

You never considered this person an employee, certainly the individual who did the work never considered himself an employee, but because of a vague set of rules, the IRS can come back after the fact and dictate this treatment of that individual.

Thousands of small business owners face this issue every day and yet we wonder why small business owners have no confidence in our tax system. Should we also wonder why the 1995 White House Conference on Small Business considered this the number one small business issue?

This issue has festered long enough and needs to be resolved. NFIB, along with the Small Business Legislative Council, have for the past five years co-chaired a coalition of some

50 organizations who have the common goal of reform of the independent contractor rules.

NFIB has worked with Congressman Christensen and others to support legislation to provide clarity to the independent contractor rules. Congressman Christensen is to be congratulated for realizing the importance of this issue and for the need for action in this area.

Chairwoman Johnson is also to be congratulated for holding these hearings to permit debate of the real issues. NFIB looks forward to working with all members of the committee to resolve this important economic justice issue.

### Background

The issue of Independent Contractor Classification has literally vexed Congress, the IRS, and taxpayers for more than twenty years. Current law provides little real guidance to either the IRS or taxpayers with the result being lengthy court actions and many small businesses faced with the threat of bankruptcy from government action. Congress has attempted to address this issue in the past only to find itself faced with a wide array of complex issues raised to address special situations.

The existing safe harbor under Section 530 of the Tax Reform Act of 1978 was made permanent in the Tax Equity and Fiscal Responsibility Act of 1982. However, one need only look at the changes that have taken place in the economy since 1982 to realize that a safe harbor that primarily relied on the existence of a prior audit is useless in an industry that did not exist before 1982.

The growth in small business being attested to this week -- small business week -- provides the clearest reason why the classification rules for independent contractors need to be clarified. The millions of new small businesses owners, and the many millions of more job holders that have resulted, need to know that the purpose of the tax code is to fairly collect taxes, not to destroy jobs and opportunities.

Often it appeared that the IRS, standing alone, sought to prevent the changes in the workforce that were happening in the workplace. Finally, after many years the IRS has publicly stated that it has no interest in whether a taxpayer is an employee or an independent contractor, so long as individuals properly report their taxes.

In addition, small business has no interest in turning every employee into an independent contractor contrary to what many in the labor movement believe. The resolution of this issue must provide the economic freedom for individuals to risk -- risk being the basis for our capitalist economy. Concurrently, this same law cannot be used to force individuals into independent contractor status against their wills or in violation of existing laws.

### Legislation

The more than 600,000 members of NFIB support this committee taking action to enact the bill introduced by Congressman Christensen, HR 1972. The legislation introduced by Congressman Christensen goes a long way to resolving the key issue in the independent contractor debate: What are the rules? Once everybody -- taxpayers and the IRS -- knows what the rules are, issues of enforcement can be addressed much more clearly and straightforwardly without the need for unreasonable compliance rules.

HR 1972 provides a clear outline to address the independent contractor issue. The Christensen bill does not permit wholesale reclassification of employees as independent contractors. It is important to note that the new safe harbor provided by this bill could only be available if income is properly reported. The new safe harbor requires the individual to take affirmative and definite steps to prove that he or she is an independent business owner. State employment laws prevent employers from wholesale reclassification and unemployment and workers compensation statutes in most states prevent wholesale abuses.

### Christensen Bill, HR 1972

The premise of focusing the solution of the independent contractor debate on under-reporting of income, rather than on whether the lines are drawn precisely, is borne from many at the IRS who clearly believe that the IRS has no direct interest in whether an individual is an independent contractor or an employee, so long as the individual accurately is reporting his or her income.

The Christensen legislation seeks to provide the individual with a choice, but a choice that comes with a responsibility. The bill requires a taxpayer to properly report his income to be able to use the additional safe harbor available in HR 1972.

This key factor has been left out of many analyses of HR 1972 and is fundamental to making it work so it bears repeating. **HR 1972 simultaneously requires the service provider and service recipient to properly report all income to receive the benefits of the new safe harbor.**

This proposal was designed so that both parties would have control. Its purpose is not to permit employers or service recipients to enforce wholesale changes to their workforces. Concurrently, it does provide flexibility to the service recipient. It permits a business with employees performing one function to utilize an outside independent contractor when circumstances warrant, without fear of IRS retaliation.

### HR 1972, The IC Tax Simplification Act of 1995

In general, this proposal will substitute a new set of criteria for determining whether an individual is or is not an independent contractor by providing rules on who is not an employee. Current law relies on 20 common law factors that do not permit a factual determination of the individual's status as it is determined on an industry-by-industry basis. In our proposal, the determination is made whether the individual is or is not an employee, if he or she is not an employee, the individual is an independent contractor.

This new criteria may only be used if the independent contractor and the business for whom services are being performed correctly comply with income reporting rules. If the service recipient properly reports all payments for service to the IRS, then the rules may be relied upon. If all payments are not properly reported, neither the independent contractor nor the service recipient may rely upon this new rule, and must base any determination on the existing common law rules and existing case law.

#### General Rule

If the requirements of Section b, c, d, and e of HR 1972 are met, the service provider will not be considered an employee and both the service recipient and payer will not be considered an employer.

#### Section (b)

The service provider or independent contractor will satisfy this section's requirements if the individual can exhibit:

1. a significant investment in assets and/or training;
2. incurring significant unreimbursed expenses;
3. agreement to complete a project and is liable for damages and may be terminated without cause;
4. payment on a commission basis;

5. purchasing of products for resale.

This section is intended to demonstrate training and investment in the business whether the investment is in physical assets or intellectual property and training. In addition, if products are purchased for resale or on a commission, the individual is obviously risking his or her own capital and should be considered as in business.

Section (c)

The independent contractor must demonstrate the use of a principal place of business or the service provider must demonstrate the intention to offer his services to others and to be marketing his services on a regular basis. Qualifying in this section illustrates both independence and an investment in an office. In addition, if the individual has gone to the trouble of registering a trade name with the state, it is evidence of independent contractor status.

Section (d)

A written contract must exist stating that the services are being provided and that the person will not be treated as an employee. A written contract that states the responsibilities for paying taxes by both the service recipient and service provider will help to insure compliance and awareness by both parties of their tax obligations.

Section (e)

This section prescribes that if the service recipient fails to meet his obligations to file information reporting returns, they cannot rely upon the protection in this section. They must then rely upon existing law and all of its traps.

**Tax Compliance Estimates**

As an aside, recently the IRS released a study of compliance between 1985 and 1992. The study reveals a growing tax compliance gap especially in categories where self-employed taxpayers are predominant. Troubling as this might be, one must wonder whether there is any correlation between the increase in the tax compliance gap and the overwhelming number of changes made to the Internal Revenue Code over this same time period.

Congress between 1984 and 1992 enacted nearly 10,000 changes to the Internal Revenue Code! Small business owners are among those least able to spend the time to become aware of these changes. Even large firms have increased difficulties with the tax code, and I recall the Chief Financial Officer of Mobil Corporation, in testimony before this Committee, exhibiting a pile of papers several feet high as its annual tax return.

This same individual was then asked if he thought the tax return was accurate in all respects, and he was required to give a qualified answer because he knew that some issues were open to various interpretations. Well, if a Fortune 100 company with its army of lawyers and accountants are having trouble, what do you think small business owners are having?

NFIB members are not trying to avoid paying their fair share of taxes, but they want rules that they can understand the implications of and with which they can comply. Compliance gaps will only go down if we begin to move in this direction.

Clearly, the Christensen bill would only work with adequate tax enforcement mechanisms to insure that both service providers and service recipients are properly reporting these items on their tax returns. NFIB would support such efforts so long as they were consistent with realistic reporting rules.

**HR 582 -- Legislation Introduced by Congressman Jay Kim**

The Kim legislation makes several constructive proposals with regard to the Section 530

safe harbor. Since the Christensen legislation seeks to propose a safe harbor that could be used as an alternative to Section 530, and since many industries have come to rely on Section 530, the Committee may want to look at how 530 works when considering legislation.

Specifically, the Committee will want to consider proposals which address the consistency standard insofar as what is defined as a significant segment of an industry for satisfying Section 530. The proposal in the Kim bill seeks to place a 25 percent threshold on this definition. This issue is important because the IRS seems to believe that at least 95 percent of an industry must be the definition of a significant segment of an industry.

Any threshold must consider whether other factors should be applied, such as regional considerations and urban vs. rural concerns.

#### **White House Conference on Small Business**

In June of 1995, the 2,000 small business owners attending the White House Conference on Small Business told IRS Commissioner Richardson, face to face, that the classification issue was of great concern to them. The Conference then proceeded to make the classification issue its number one concern.

Earlier this year, the IRS at long last responded. The IRS offered a major revision to its training manual for IRS employees illustrating how the 20 factors should be utilized in performing a classification audit. Concurrently, the IRS also released a settlement program whereby a taxpayer under audit could settle the case for only a percentage of the current year's liability, provided the taxpayer agreed to treat the individuals whose status was in dispute as employees in the future.

#### **Comments on IRS Training Manual for Determining Employee or Independent Contractor -- Published 2/96**

Although an important step forward for the IRS, the manual only serves to illustrate the need for permanent legislation. First, since the manual does not have the force of law or regulations, neither Congress nor taxpayers have the opportunity to comment on what the manual proposes to do. The manual fails to address issues relating to operation of the Section 530 safe harbor and how to interpret the consistency standard in a way that is rational and makes sense.

While the manual states that independent contractor status is a "valid and appropriate business choice", the IRS and Congress have the responsibility of interpreting the law to prevent abuse of individuals. Concurrently, it also has the responsibility to prevent the abuse of other individuals who choose to be independent contractors and self-employed small business owners.

#### **Overview of Training Manual**

The manual seeks to dissect the 20 factor rules and provide IRS employees with a more realistic view of the way in which business is done today and the nature of how those relationships have changed. Where the manual falls short is where it fails to give the agents clear guidance on how to weigh and balance the 20 factors in different circumstances other than to tell them that certain factors are irrelevant in specific circumstances.

In many ways the manual makes the case that small business owners have made for years, i.e. that the 20 common law factors are extremely ambiguous and that the application of the 20 common law factors is highly subjective. The second issue where the manual also makes a positive although minor contribution is in the application of the Section 530 safe harbor, even though it fails to completely follow through in this area.

The manual provides that the examining agent must, even if the taxpayer fails to raise the issue, determine whether the Section 530 safe harbor can apply. Yet the guidance then fails to help the agent determine what is a reasonable basis for taking a position and what constitutes an industry practice.

## Specific Comments

### Interpreting the 20 Factor formula

#### Control Standards

The Manual on page 1-6 states three preliminary points:

There is no magic number of factors used; the factors merely point to facts to be used in evaluating the extent of the right to direct and control.

As in any examination, all relevant information needs to be explored before answering the legal question of whether the right to direct and control associated with the employment relationship exists.

The evidence that you gather must be factual and well documented and must support your determination; it is not sufficient to state a legal theory.

The subjective nature of the control factors and the interpretations of the control factors can have the result that many of the issues are neutral factors in determining whether the individual is an employee or independent contractor. While the manual is attempting to encourage IRS employees to use their initiative in developing these issues, it also fails to give them direction.

For many years IRS employees have viewed the independent contractor relationship negatively to say the least. Failing to provide a more concrete basis for the IRS employees in their analysis for relevant weighing of factors may result in an examination turning not on 20 factors but in the balance on two or three factors.

#### Behavioral Control and Financial Control

In the factors listed under behavioral control, the IRS concedes that several issues are indicative of either employee or independent contractor status. The profession or occupation which required prior training and abilities lends itself to being independent of control and indicative of independent contractor status.

Many of the financial control factors can be of neutral importance, or significant relevance, depending on how the taxpayer has built the relationship. Clearly the auditor is warned not to take the taxpayer's word for the relationship evidenced by the discussion about written agreements.

#### Burden of Proof

The basis for most tax return examinations is that the taxpayer has filed a tax return where it treats an item in a specific way, and the IRS employee is free to question the tax treatment. On the issue of independent contractor status, the burden is on the taxpayer to provide the agent with all relevant information available to the taxpayer and then the burden is on the taxpayer to provide all other relevant information requested.

The IRS is not constrained in what it can ask for and in how much it may ask for as long as the request is relevant to the issue. Under the new manual, the instructions have not changed as much as the interpretations of specific facts. Clearly, the manual does place an increased burden on the IRS to justify a finding of employee status. However, the burden can be even greater on the taxpayer who may never have considered answering all of these questions because it was confident of reliance on the Section 530 safe harbor.

#### Raising the Section 530 Safe Harbor

The Section 530 safe harbor, made permanent in the 1982 Revenue Act, permits a taxpayer to qualify for use of an independent contractor status based on a consistency test and a reasonable basis test. The proposed audit manual requires the IRS to find that an employee status exists and then to look to Section 530 issues. To many small business owners this may be taking the issue backwards. This new rule places a significantly increased burden on many taxpayers who never considered seeking relief under the 20 factors.

In the Revenue Act of 1978, and then 1982, this issue of whether the taxpayer's relationship must first be deemed employee and employer before the safe harbor can apply never is raised. The proposed manual makes this a requirement that the IRS first find that an employee relationship exists and then look to Section 530. We believe that this should be changed to provide the taxpayer an opportunity to rely on Section 530 immediately after the IRS raises the issue of employee status.

#### **Reasonable Basis Test and Industry Practice**

Another concern over the 530 safe harbor is that, after extensive analysis of the 20 factor rules, it provides the agent with little guidance on the reasonable basis test regarding industry practice.

The safe harbor permits an independent contractor relationship to exist if based on long standing industry practice that independent contractor status is a recognized practice of a significant segment of the industry. Many court cases have sought to resolve what is the meaning of "long standing", "significant", and what is "an industry".

This is reminiscent of the Soliman decision on home office deduction where the Supreme Court relied on a dictionary definition of the word "principal" in the phrase "principal place of business". Many small business owners lost out on this definition.

The IRS fails to provide any realistic guidance on how to interpret these factors in the context of a reasonable basis requirement and as many employers rely on the safe harbor, the result will be failure of the test since the IRS has already deemed them an employee.

#### **Recommendations**

- o Provide additional guidance on how the factors are to be weighed and the contexts in which the IRS employee may use his initiative to weigh the various factors.
- o Permit the agent to use the 530 safe harbor at the beginning. There is no need to have the agent find that an employment relationship exists, only to have to disprove his own theories about the taxpayer. It goes against human nature.
- o Provide more guidance to help the IRS auditor understand the possible reasonable basis standards.
- o Permit the auditor to look to significant segments on a regional and local basis when considering the industry practice standard. Provide guidance that permits a taxpayer to rely on an industry segment which does not comprise more than half of the industry.
- o Continue the process of employee education on an annual basis, as business factors are always changing.

This Committee, in addressing the worker classification issue, may wish to consider whether Section 530 should in fact be codified to protect those industries who rely on their status based on Section 530 and who have done so for the last twenty years. In addition, the Committee may wish to consider how to make Section 530 work more efficiently with regards to definitional issues.

Finally, the Committee may wish to consider eliminating rules that prevent some

industries from qualifying under Section 530, such as technical services workers. It would make no sense to have a rule that resolves the issue but which has so targeted a provision that it is unfair to one sector of the economy.

#### **Conclusion**

This Subcommittee should consider and report HR 1972 to the full Committee for positive action. Issues of concern to groups or individuals should be addressed so as to prevent the proposal from being abused by anyone. Clearly, the current enforcement pattern has severe difficulties and it is our firm belief that a line must be drawn somewhere so that taxpayers can obey the rules. It is clearly unfair to millions of small business owners and the millions of independent contractors to have this issue remain in limbo any longer.

While the revised audit manual provides better guidance to IRS employees, it does not sufficiently establish what the rules are for all sectors of the economy. The results of the new manual only place a greater burden on whether the Section 530 safe harbor rules provide any relief. Clearly, they need work.

Finally, audit guidance is no replacement for statutory certainty. With all due respect, if new leadership emerged at the IRS, taxpayers would have no recourse to Congress on an audit manual.

Statutory guidance is needed to resolve this issue and NFIB supports efforts to update the existing law by adding the safe harbor included in HR 1972.



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**STATEMENT OF THE  
NATIONAL TECHNICAL SERVICES ASSOCIATION  
BEFORE THE SUBCOMMITTEE ON OVERSIGHT  
HOUSE COMMITTEE ON WAYS AND MEANS  
HEARING ON  
WORKER CLASSIFICATION ISSUES**

**I. Introduction:** Madam Chairwoman and members of the Subcommittee, thank you for this opportunity to comment on the above-referenced issue and pertinent legislation being considered by you and your colleagues. My name is Robert G. Drummer and I am Director of Government and Public Relations for the National Technical Services Association (NTSA). NTSA's comments are designed to assist you in crafting and passing legislation which will clarify and simplify the distinction between "independent contractors" and "employees" for both tax and employment law purposes. As you analyze Rep. Jon Christensen's bill, H.R. 1972, and any other comparable legislation (i.e., H.R. 582, S. 1610), please consider the following:

**II. NTSA Member Concerns**

Members have been concerned for some time over the widespread confusion concerning the tax policy standards under which technical services personnel could – reasonably – be classified as independent contractors. When the IRS, applying the common law test, has addressed the issue of worker classification in the technical services industry, the IRS has generally been of the view that the personnel are employees of the technical services firms for purposes of federal income, social security, and unemployment tax withholding.<sup>1</sup>

Some firms, especially those with a computer specialty focus, would prefer to classify their personnel as independent contractors. Still other firms would prefer to classify their workers, on a contract by contract basis, as employees or independent contractors.

Members believe that standards for classifying workers as independent contractors or employees should be clear and objective, leaving little doubt as to the outcome of an IRS audit. While NTSA has never advocated a preference for one classification over another, it has repeatedly urged that worker classification standards be applied consistently so that firms and individuals which supply like services in competitive marketplaces are subject to the same set of rules and the same set of outcomes for non-compliance.

<sup>1</sup> Rev. Rul. 87-41, 1987-1 C.B. 296; Rev. Rul. 75-41, 1975-1 C.B. 323; LTR 8552072 (Sept. 30, 1985); LTR 8324005 (technical advice memorandum, Feb. 24, 1983); Ltr 8403003 (technical advice memorandum supplementing LTR 8324005, September 22, 1983).

Unfortunately, employment status determinations currently do not provide for consistent outcomes. Each employment status determination is made on a "facts and circumstances" basis. The 20 factor common law test, which assumes some subjective interpretation on the part of enforcement personnel, often results in conflicting outcomes. Other IRS enforcement activities often result in 1) investigations of employers who have not misclassified their workers; 2) reclassification for certain employers' workers but not their competitors' workers; or 3) no action against employers who are covered under the relief provisions established under § 530 of the Revenue Act of 1978.<sup>2</sup>

### III. Practical Considerations

The application of IRS worker classification standards, whether in their current form, or as may be amended, however, apply only to tax related questions. A worker who may be classified as an independent contractor for tax purposes under any set of standards, may remain an employee under the criteria set forth in the Fair Labor Standards Act, Title VII of the Civil Rights Act, the Americans with Disabilities Act, the Family and Medical Leave Act and various state unemployment and workers' compensation laws. The idea that worker classified as an independent contractor for tax purposes might later successfully challenge a failure to pay premium overtime or make a claim for an uninsured work-related injury is perplexing.<sup>3</sup> This anomalous but very real result can only lead to more confusion and inequities.

Following, for example, is a brief listing of liability issues which can result when a worker is misclassified as an independent contractor.

#### A. Tax and FICA Liabilities

As previously noted, a worker who has been misclassified as an independent contractor is subject to retroactive reclassification as an employee making the technical services firm liable for significant tax and social security payments and penalties. Among them:

- 1) A penalty for failure to withhold income tax from the employee equal to 100% of the amount of the income tax which should have been withheld.<sup>4</sup>
- 2) One hundred percent (100 %) of the income tax itself which should have been paid by the employee unless the employer can prove that the employee paid his full income tax liability. A signed certificate, Form 4669, obtained from the employee, is generally required to meet this burden.<sup>5</sup>
- 3) A penalty equal to 100% of the FICA taxes which should have been withheld from the employee's pay.<sup>6</sup>
- 4) One hundred percent (100%) of the FICA tax itself (employer plus employee share).<sup>7</sup>

<sup>2</sup> United States Committee on Government Operations House Report 101-979, pg. 11 (Nov. 9, 1990).

<sup>3</sup> In *Robert A. Mitishen v. Otis Elevator Co., et al.*, 1990 U.S. Dis. LEXIS 12465 (9-19-90) a computer consultant was reclassified as an employee for purposes of workers' compensation coverage in the District of Columbia. In re: *T3R Consulting Services, Inc.*, 1990, N.Y. Appl. Div. LEXIS 13035 (11-1-90) a computer consultant was reclassified as an employee for New York unemployment compensation purposes; See also *Rakam, Inc., v. Thomas F. Hartness as Commissioner of Labor*, 1990 N. Y. Appl Div. LEXIS 11296 (9-20-90) and *Beau v. Commissioner of Jobs and Training*, 1991 Minn. App. LEXIS 799, (8-13-91).

<sup>4</sup> IRC Sec. 3402(a), Sec. 6672.

<sup>5</sup> IRC Sec. 3403.

<sup>6</sup> IRC Sec. 6672.

<sup>7</sup> IRC Sec. 3102(b).

- 5) In addition, there can be penalties for failure to file a return, negligence penalties, and fraud penalties in the event that it is determined that the employer's misclassification of the worker is fraudulent.<sup>8</sup> Further, these taxes and penalties are collectible from officers, directors or other "responsible persons" acting on behalf of the employer. In extreme cases, criminal penalties may also be assessed.<sup>9</sup>

#### B. Overtime Payments and Penalties

A worker who has been misclassified as an "independent contractor" may not have been paid overtime in accordance with the Fair Labor Standards Act. Once reclassified as an employee, he becomes subject to this Act and for each week in which he worked over 40 hours he becomes entitled to the following:

- 1) one-half the hourly rate for each such hour worked;
- 2) a liquidated damages amount of up to 100% of this half-time rate;
- 3) attorneys' fees;
- 4) additional FICA and unemployment tax (paid with respect to the employee) based upon the increase in the wages paid to the employees.

The statute of limitations for FLSA violations is 2 years except for willful violations, in which case the statute of limitations is 3 years. In severe cases, the firm may also become subject to criminal penalties.<sup>10</sup>

#### C. Workers' Compensation Liabilities

When a worker is reclassified as an employee, he becomes entitled to claim workers' compensation benefits for injuries incurred on the job. The technical services firm can become liable for payment of workers' compensation benefits regardless of whether appropriate coverage was maintained. The technical services firm can also become subject to fines and its principals subject to imprisonment under state law for failure to have adequately provided workers' compensation coverage for all of its employees.<sup>11</sup>

#### D. Unemployment Compensation Liabilities

Companies that retain workers as independent contractors who are subsequently reclassified as employees become liable for unemployment compensation contributions for the employees. As with income taxes, responsible persons (i.e., officers, directors, etc.) of the employer can become personally liable for these amounts.<sup>12</sup>

<sup>8</sup> IRC Sec. 6651 and IRC Sec. 6653(a)-(b).

<sup>9</sup> See 22 ALR 3rd 8; See also 51 ALR Fed. 59, Rev. Rul. 67-18, Ltr. Rul. 7905073, and Income Tax Regulations Section 31.3401(c)-1.

<sup>10</sup> See Fair Labor Standards Act, 29 USC 201-219, and 51 ALR Fed. 702.

<sup>11</sup> See, for example, The Pennsylvania Workmen's Compensation Act, P.L. 736, as amended, Sections 103, 104, 301, and 305.

<sup>12</sup> *Silverman v. Dudley*, 244 N.E. 2nd 531; *C.A. Wright Plumbing Company v. Unemployment Compensation Board of Review*, 293 A. 2nd 293.

#### E. Liability for Personal Injury or Property Damage

When a company retains a genuine independent contractor, the independent contractor generally stands on its own with respect to liability to third parties for its actions. The independent contractor is generally not acting as the representative or agent of the company and the company is not liable for any injury or damage which the independent contractor may cause to third parties or their property. However, when a person is reclassified from "independent contractor" to "employee," the employer (i.e., the technical service company) can become liable for the on-the-job acts of the "employee," including personal injuries caused to third parties and property damage caused to property.

#### IV. Policy Recommendations

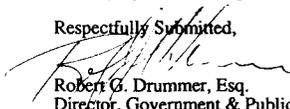
Whatever rules are finally adopted by Congress must apply equally to all companies and workers, regardless of how long a company has been in business and regardless of how it has classified its workers in the past. If rules are linked to the age of the company or how it classified workers in the past, the confusion and inequities will simply continue. NTSA continues to support repeal or substantial modification of the relief provisions offered under § 530. NTSA also believes that a limited scope taxpayer amnesty program should be instituted concurrent with the repeal of § 530. In addition, NTSA continues to urge Congress to provide significant guidance by setting forth a limited number of factors which employers, individual taxpayers, and enforcement organizations might use to qualify employment status determinations. These factors should be based on common law and expressed as safe harbors.

NTSA suggests this balance can be achieved by enacting two safe havens – one for independent contractors and one for employees. Each can be developed through the prioritization of common law test elements. Taxpayers who fall within one of these "safe havens" could rest assured that they would not be subjected to large retroactive penalties should their worker classification be questioned upon audit. Likewise, NTSA believes that if a worker's situation is such that he or she disputes the classification, he or she should be able to request a ruling from the IRS based on the broader application of the 20 common law factors. This request would be made through a version of the current Form SS-8 procedure.<sup>13</sup>

#### V. About NTSA

The National Technical Services Association (NTSA) is a non-profit 501(c)(6) organization which exists to promote the legal, legislative, regulatory, strategic business development, and continuous process improvement interests of member firms. Member firms supply a wide range of design, drafting, engineering, project management, computer programming, systems analysis, staff augmentation, and technical publication services, for profit, to industry and government clients. Member firms now number among their clients most major American corporations, thousands of small industrial companies, government agencies, and colleges and universities across the United States. Member firms employ more than 280,000 personnel who possess the training and experience required to meet America's rapidly changing technical requirements.

Respectfully Submitted,



Robert G. Drummer, Esq.  
Director, Government & Public Relations

<sup>13</sup> See "Statement of the National Technical Services Association," Hearing before the Commerce, Consumer, and Monetary Affairs Subcommittee of the Committee on Government Operations House of Representatives, 101st Cong., 1st Sess., June 8, 1993.

## WRITTEN TESTIMONY OF THE SECURITIES INDUSTRY ASSOCIATION

SUBCOMMITTEE ON OVERSIGHT  
COMMITTEE ON WAYS AND MEANS  
UNITED STATES HOUSE OF REPRESENTATIVES

July 3, 1996

The Securities Industry Association ("SIA") appreciates the opportunity to submit written testimony on the issue of independent contractor status. The SIA brings together the shared interests of about 700 securities firms throughout North America to accomplish common goals. SIA members -- including investment banks, broker-dealers, specialists, and mutual fund companies -- are active in all markets and in all phases of corporate and public finance. In the United States, SIA members collectively account for approximately 90 percent, or \$100 billion, of securities firms' revenues and employ about 350,000 individuals. They manage the accounts of more than 50 million investors directly and tens of millions of investors indirectly through corporate, thrift, and pension plans.

Our testimony addresses employment classification for U.S. federal income tax purposes of service providers in the securities industry. Under current law, a subjective "20 factor" common law test is applied to determine how a worker will be classified for tax purposes. Under the "control" factor, if the worker is required to comply with instructions given by the service recipient about when, where, and how to work, the worker is generally considered to be an employee rather than an independent contractor.

In the securities industry, as in other regulated industries, government regulatory agencies and self regulatory bodies, such as the National Association of Securities Dealers ("NASD"), tell securities firms and the "registered representatives" associated with these firms how certain aspects of the work are to be done and how they may not be done. Indeed, such agencies impose upon the securities firms a "duty to supervise" the registered representatives to ensure that these regulatory requirements are satisfied. In such an industry, the "duty to supervise" must be distinguished from the "right to control" in applying the 20 factor common law test to determine employment classification. The Internal Revenue Service ("IRS"), however, does not generally recognize this critical distinction. Accordingly, we respectfully urge Congress to clarify that actions undertaken by a business to satisfy a "duty to supervise" to ensure compliance with regulatory requirements in a regulated industry are not indicative of either employment or independent contractor status.

A. The Duty to Supervise in a Regulated Business

If the service recipient is a business in a regulated industry, such as the securities industry, the worker should not be deemed to be an employee if the business implements policies and procedures necessary to ensure compliance with regulatory requirements imposed on it by government agencies.

A business in a regulated industry must insure that its workers meet the requirements and standards set by the regulatory agencies. By implementing policies and procedures of the regulatory agencies to insure such compliance, the business is merely acting as an agent of the government agency. Any behavioral controls that the business imposes on the worker through these policies and procedures are designed to foster the regulatory goals of the government or self-regulatory agency and comply with applicable laws, not to enhance the benefits or profits that may flow to the business as a result of the workers' performance. Accordingly, if a business is required by regulatory agencies to supervise the activities of its workers to insure the workers' activities are in compliance with the regulatory agencies' rules and regulations, such supervision should not be indicative of either employee or independent contractor status.

Specifically, in the securities industry the law requires that a "registered representative" who is engaged in the investment banking or securities business must be associated with a broker/dealer. Some registered representatives spend their entire workday attempting to generate

commission income for themselves and for the benefit of the broker/dealer. Other registered representatives operate their own businesses, which may consist solely of selling securities, or may also include financial planning, investment advisory services, insurance brokerage, estate planning, business consulting, accounting, tax preparation, etc. Such registered representatives operate as separate entrepreneurs and may have employees of their own. In both situations, the registered representative, as well as the broker/dealer with which he or she is associated, is subject to the rules and regulations of the Securities Act of 1933, the Securities and Exchange Act of 1934, and the rules of self regulatory organizations such as the NASD. Under these rules, a broker/dealer does not have the right to control a registered representative associated with it; rather such a broker/dealer has the duty to supervise the registered representative with respect to his or her adherence to the regulations of the Securities and Exchange Commission and the NASD. Indeed, a registered representative may be subject to disciplinary action by the NASD on the basis of customer complaints. Such authority vested in the NASD clearly indicates that the right to control the registered representative resides with the NASD rather than with the associated broker/dealer.

#### B. Judicial Interpretation of "Control" Factor

Case law supports the view that compliance with government regulation does not indicate "control" by the broker dealer. Courts have repeatedly stated that compliance should be a non-factor in the worker classification determination.<sup>1/</sup> For example, in North American Van Lines, Inc. v. NLRB<sup>2/</sup>, the court rejected the significance of the company's compliance with the government restrictions in determining worker classification:

[R]estrictions upon a worker's manner and means of performance that spring from government regulation (rather than company initiatives) do not necessarily support a conclusion of employment status. See, e.g., Local 777, Democratic Union Org. Comm. v. Seafarers Int'l Union v. NLRB, 603 F.2d 862, 875-76 (D.C. Cir. 1978). Indeed, employer efforts to ensure the worker's compliance with government regulations, even when those efforts restrict the manner and means of performance, do not weigh in favor of employee status.<sup>3/</sup>

Additionally, efforts by a business to ensure compliance with government regulation should not be relevant to the control test. In Yellow Taxi Cab Co. v. NLRB<sup>4/</sup>, the airport established a detailed regulatory ordinance prescribing strict procedures for the operation of taxis at the airport, including the maintaining of "trip sheets."<sup>5/</sup> The court held that the compliance measures requiring the preparation of reports were not important in the determination of worker status. The D.C. Circuit stressed that "[c]ourts have consistently held that regulation imposed by government authorities does not evidence employer control."<sup>6/</sup> As this decision indicates, the broker/dealer does not exert control when he or she requires a registered representative to comply with Securities and Exchange Commission regulations by compiling account reports.

Each of these decisions is premised on the fact that service recipient compliance with government regulation does not amount to "control" exerted by the service recipient. Rather, the service recipient is performing its duty to supervise as required by law. Expressing this

<sup>1/</sup> See, e.g., Yellow Taxi Cab Co. v. NLRB, 721 F.2d 366 (D.C. Cir. 1983); NLRB v. Associated Diamond Cabs, Inc., 702 F.2d 912 (11th Cir. 1983); Air Transit, Inc. v. NLRB, 679 F.2d 1095 (4th Cir. 1982).

<sup>2/</sup> 869 F.2d 596 (D.C. Cir. 1989).

<sup>3/</sup> Id. at 599.

<sup>4/</sup> 721 F.2d 366 (D.C. Cir. 1983).

<sup>5/</sup> Id. at 371.

<sup>6/</sup> Id. at 374.

view, the court in Local 777, Democratic Union Org. Comm., Seafarers Int'l Union v. NLRB<sup>2/</sup> rejected the National Labor Relations Board's ("NLRB's") decision that compliance evidences control:

As for the Board's argument that the extensive regulation of taxi-drivers by municipal ordinance *de facto* gives the companies control over the driver's conduct on the job, the NLRB's position is not only inconsistent with precedent, but also evidences a misunderstanding of the effect of state regulation on the nature of the employer-employee relationship.

Government regulations constitute supervision not by the employer but by the state. Thus to the extent that the government regulation of a particular occupation is more extensive, the control by the putative employer becomes less extensive because the employer cannot evade the law either and in requiring compliance with the law he is not controlling the driver. Thus requiring drivers to obey the law is not more control by the lessor than would be a routine insistence upon the lawfulness of the conduct of those persons with whom one does business.

In the situation before us, whatever control is exercised is not the master's but that of the local government. That the state has chosen to so regulate cab drivers so that those who lease cabs can be reasonably confident of the conduct of the drivers while in their cabs does not mean that the lessors thereby "control" his conduct. That government regulation has made supervision or control by the lessor unnecessary is not the equivalent of the presence of actual supervision or control. [Emphasis added.]<sup>3/</sup>

Thus, we urge that Congress clarify that where a third-party regulator imposes requirements on a worker and supervisory requirements on the business to make certain that the worker meets the regulatory agency's requirements and standards, any reasonable actions taken by the business to satisfy those supervisory requirements should be treated as neutral and not as evidence of either employee or independent contractor status.

### C. Summary

Congress adopted the Exchange Act to assure securities consumers that the information they receive from registered representatives is informed and accurate. Compliance with Securities Exchange Commission and NASD regulations does not evidence broker/dealer control, but rather control exerted by the government in furtherance of its objective. Therefore, compliance with the requirements of the Exchange Act and the NASD, should not to be considered when assessing the "control" factor under the common law 20 factor test for worker classification.

Current law must be clarified to eliminate consideration of compliance with government regulations when determining worker classification. Such clarification could be accomplished either by eliminating the subjective 20 factor test in favor of objective standards, such as those contained in the legislative proposals pending in the House, or by clarifying legislatively the manner in which the common law control test should be administered by the IRS.

\* \* \*

Thank you for your consideration of this issue of great importance to the securities industry.

<sup>2/</sup> 603 F.2d 862 (D.C. Cir. 1978).

<sup>3/</sup> Id. at 875-76.

LINDA SMITH, WASHINGTON  
CHAIRWOMAN

MARTIN MEEHAN, MASSACHUSETTS  
RANKING MINORITY MEMBER

**Congress of the United States**  
**House of Representatives**  
104th Congress  
**Committee on Small Business**  
*Subcommittee on Taxation and Finance*  
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**For Immediate Release:**  
**June 20, 1996**

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***Chair Smith Applauds Chair Johnson's Independent Contractor Hearings***

Washington, D.C. - Rep. Linda Smith, Chair of the House Small Business Subcommittee on Taxation and Finance, today applauded Rep. Nancy Johnson, Chair of the House Ways & Means Subcommittee on Oversight, for holding hearings on the issue of worker classification.

"Chairwoman Johnson understands the need for new, clear criteria relating to worker classification, and her leadership is pivotal to a resolution," Smith said. "Because small business owners create the majority of jobs in America, they need clarity and consistency to continue to grow our economy," Smith added.

Chairwoman Smith held hearings on clarifying the status of independent contractors last year, after delegates from across the nation to the 1995 White House Conference on Small Business voted it their top legislative recommendation to President Clinton and to Congress. All witnesses who testified before Chairwoman Smith - including the IRS and the GAO - agreed the law must be clarified because it results in confusion and inconsistent tax treatment of workers. Yet, one year later, President Clinton's Administration has proposed no legislation to clarify the law.

"Congress must move forward *now* to protect our nation's small entrepreneurs from the large back taxes, penalties and interest they face when the IRS unfairly reclassifies independent contractors as employees," Smith urged. Chairman Johnson's first hearing last week revealed that far too many small businesses face this problem under today's law.

"H.R. 1972 is a strong bill in the right direction," Smith said about the key proposal before Congress which she co-sponsors. "In effect, slightly modified, it could provide a new, safe harbor for *small* businesses that hire *legitimate* independent contractors, so that *all* employers and workers can better *rely* on the law," Smith explained.

"But the IRS must change its focus under any new criteria Congress establishes," Smith reiterated, "or Congress' work will be in vain." While the IRS' has developed a new draft training manual which represents a good first step, it is based on today's criteria and continues to show a bias against independent contractors.

## *Software Industry Coalition*

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Policy Project  
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June 17, 1996

TO: Subcommittee on Oversight of the Committee on Ways and Means  
RE: Classification of workers as employees or independent contractors for Federal tax purposes.

This testimony is submitted for consideration by the committee and for inclusion in the printed record of the June 4<sup>th</sup> hearing of the Oversight Subcommittee of the House Ways and Means Committee.

The Software Industry Coalition, based in California's Silicon Valley, consists of several of the software industry's leading edge companies. Collectively our members have over 126,000 employees and world-wide revenues of over \$36 billion.

The software industry is one of America's most rapidly changing industries. Software products typically experience a short life cycle, yet they require extensive development work to produce. In order for software companies to compete they must stay on the leading edge of the technology. This requires that they have access to technical expertise on a project by project as-needed basis, in a timely fashion. The best technical experts, being in high demand, frequently prefer to work within their own businesses as self-employed contractors rather than as employees.

High tech companies in California frequently rely these self-employed consultants to supply technical expertise for critical projects. A recent survey by the California Employment Development Department indicated that over 25% of software professionals in California are obtained through contracts with outside sources such as self-employed consultants. These working relationships are a major source of innovation in our high tech industries. The existence of this kind of industry support infrastructure plays a major part in the industry's global competitiveness.

Unfortunately, unclear rules for determining worker status can make these professional working arrangements extremely risky for the companies which need to obtain technical expertise from self-employed individuals. IRS "employment" audits can result in extreme penalties even in situations where all tax laws have been complied with. It is not unusual for IRS settlement agreements to call for the termination of worker contracts - with no input from the worker. For the high tech worker who is self-employed the audit of a client frequently results in the loss of work or forces the consultant into an undesired employment status which is detrimental to the small business person who has made significant investments in that business.

The problems with IRS employment classification audits have been plaguing U.S. companies and small businesses for years. Congress in 1978 enacted a safe harbor (Section 530) which was intended to provide temporary protection until such time as Congress could address the classification issue. Unfortunately Congress has been unable to agree on an appropriate definition of who is an employee and the Section 530 safe harbor has not proved to be a sufficient long term

solution. In addition, since 1986, high tech industries have been denied the protection of even that safe harbor.

H.R. 1972 would resolve this problem by creating a safe harbor from employment classification for workers who are in business for themselves as indicated by specific conditions in the legislation. It would ensure that true small businesses are able to provide necessary services without threats of untimely contract termination due to IRS audits. H.R. 1972 would give our high tech companies the ability to rely on experts without fear of unjust penalties for doing so, provided that those experts were truly separate businesses as defined within the legislation.

The Software Industry Coalition has joined with the Joint Venture: Silicon Valley Tax Council in issuing a report entitled "Employment Classification Issues & Possible Solutions". H.R. 1972 implements the Coalition's recommendations. Furthermore, H.R. 1972 is strongly supported by both self-employed consultants and by the companies who need their services.

The Software Industry Coalition believes that H.R. 1972 will bring much needed relief to businesses in our industry. However, there is one technical correction should be made in H.R. 1972: the act should apply to the entire title rather than to the subtitle.

The Software Industry Coalition believes that H.R. 1972, by providing a clearly defined set of circumstances under which a service provider and service recipient can do business without fear of IRS interference, will by those provisions alone increase 1099 filing. That result would be due to the removal of the current existing disincentive to filing: the fear of an unreasonable employment classification audit. The additional requirement that 1099's be filed in order to fall under the "safe harbor" definitions of H.R. 1972 will even further increase 1099 filing. Whether any additional benefit would be provided by increasing penalties for non-filing is therefore difficult to determine. On the other hand, we believe that any increase in penalties MUST be accompanied by a safe harbor definition of who is not an employee, if we are to avoid doing additional damage to America's small businesses.

We would like to point out that it is also necessary to retarget penalties which currently exist for errors made in reporting taxpayer ID or SS #'s on 1099 forms. Currently it is the service recipient who is penalized if the worker provides an incorrect ID #. This is not appropriate, especially when the service recipient has no way to validate the correctness of that number. It is the service provider, whose ID # it is, who should be penalized for providing an incorrect ID #.

While the IRS has developed a new classification settlement program, we note that it requires that workers be reclassified as employees in order to qualify. Unfortunately the worker's preferences are not considered in this decision. The client can agree to reclassify the worker and then can discontinue the employment relationship. Furthermore, many consultants do not work as employees and the "settlement" program merely ensures that they lose a client. While we agree that the IRS is making some improvements in this area there is no obligation on the part of the IRS to maintain those improvements once the threat of legislation is removed. That is exactly why passage of H.R. 1972 is so necessary. U.S. businesses should be able to rely on the law - not on the whims of the IRS - to protect their business relationships.

This legislation is important to our country's competitiveness in software and other high tech industries. It is time, indeed it is past time, for Congress to act on this issue. We strongly recommend that Congress move forward, amend HR 1972 to be effective for the entire title, and enact this important legislation.

Please contact Kaye Caldwell, the Coalition's Policy Project Director at 408-479-8743 if we can be of further assistance on this issue.

**STATEMENT**  
 on  
**WORKER CLASSIFICATION**  
 for submission to the  
**SUBCOMMITTEE ON OVERSIGHT**  
 of the  
**HOUSE COMMITTEE ON WAYS AND MEANS**  
 for the  
**U.S. Chamber of Commerce**  
 by  
**William T. Sinclair**  
**Senior Tax Counsel and Director of Tax Policy**  
**June 4, 1996**

The U.S. Chamber of Commerce – the world's largest business federation, representing 215,000 business members, 3,000 state and local chambers of commerce, 1,200 trade and professional associations and 76 American Chambers of Commerce abroad – appreciates this opportunity to express its views on the classification of workers as employees or independent contractors for federal tax purposes.

The proper classification of workers is a problem plaguing the small business community and was considered the most important small business issue by the delegates attending the 1995 White House Conference on Small Business. More than 96 percent of the Chamber's members are small businesses with fewer than 100 employees, 71 percent of which have fewer than 10 employees. It is vital to the growth and strength of our nation's small businesses that the current worker classification rules be clarified and simplified.

It is crucial that a business properly classify its workers since such classification establishes who is responsible for paying, collecting and/or remitting various payroll taxes, such as income, Social Security and unemployment taxes, to the Internal Revenue Service (IRS). A business that hires employees to perform services is responsible for withholding payroll taxes from the employees' wages and is subject to certain payroll taxes itself. In contrast, a business that hires independent contractors to perform services is not required to withhold payroll taxes from payments made to such workers and is not subject to any payroll taxes itself.

However, properly classifying workers can be arduous and risky for many businesses, given the complexity, ambiguity and subjectivity that exist in current law (the 20-factor common-law test and the Section 530 safe-harbor rules). The unintentional misclassification of workers can lead to costly and time-consuming audits and the assessment of significant back taxes, penalties and interest by the IRS. To satisfy these levies, businesses sometimes lay off workers, sell productive assets or -- in worst case scenarios -- file for bankruptcy protection.

### CURRENT LAW

#### **20-Factor Test**

A worker is considered to be an employee if the business is able to "control" the way in which the worker's services are performed. If the business does not have such control over the service-provider, he or she is considered to be an independent contractor.

In order to determine whether a business has the requisite control over a worker's services, a 20-factor test is applied. Some of these factors include:

- Does the business dictate how, when and where the work is to be performed?
- What is the profit-making ability of the worker?
- Does the worker provide services to others?
- Does the worker use company-provided tools and/or materials?
- What is the compensation arrangement between the business and the worker?

Determining whether "control" exists from these factors can be very subjective since they involve varying "facts and circumstances". The 20-factor test, therefore, often leads to disputes between businesses and the IRS.

### Section 530 Safe-Harbor Rules

If, under the 20-factor test, a service-provider is determined to be an employee, he or she may still be treated as an independent contractor if certain "safe-harbor rules" are met. To qualify for independent-contractor status under these rules, the service-recipient must have a "reasonable basis" for treating the worker as an independent contractor, treat all workers in similar positions the same way, and file all required forms with the IRS. To have a reasonable basis for purposes of satisfying the first condition, the business must rely on the results of a prior audit, judicial precedent, industry practice, or another acceptable basis.

### Statutory Employees / Statutory Nonemployees

Certain types of workers are considered "statutory employees" and "statutory nonemployees" and, therefore, are not subject to the 20-factor test or the safe-harbor rules. *For example*, certain types of drivers, domestic workers and traveling salespeople are statutorily treated as employees, while real estate agents and direct sellers are treated as nonemployees, *i.e.*, independent contractors.

## LEGISLATIVE PROPOSALS

Several legislative proposals have been introduced in the 104th Congress which would establish clearer and more objective criteria for determining worker-classification status.

### *The Independent Contractor Tax Simplification Act of 1995 (H.R. 1972)*

Introduced by Representative Jon Christensen (R-NE), this bill would allow a worker to be treated as an independent contractor if the following three tests are met:

- (1) The worker either:
  - (a) makes significant investments in assets and/or training,
  - (b) incurs significant unreimbursed expenses,
  - (c) agrees to perform the service for a particular amount of time to achieve a designated result and accepts liability for damages for noncompliance without cause,
  - (d) is paid primarily on a commission basis, *or*
  - (e) purchases products for resale.
  
- (2) The worker either:
  - (a) has a principal place of business other than at the firm, *or*
  - (b) intends to offers services to other recipients.

- (3) A written contract exists stating that the services are being provided and that the person providing the services will not be treated as an employee.

In order to qualify under the above tests, a service-recipient would have to comply with all income-reporting requirements.

*The Independent Contractor Tax Simplification Act of 1996 (S. 1610)*

Introduced by Senators Christopher S. Bond (R-MO) and Don Nickles (R-OK), this bill is almost identical to H.R. 1972.

*The Independent Contractor Tax Fairness Act of 1995 (H.R. 582)*

Introduced by Representative Jay Kim (R-CA), this bill would accomplish four objectives. First, it would allow a worker to be treated as an independent contractor if the services are performed pursuant to a written contract, *and one* of the following criteria is met:

- (1) The worker can make a profit or suffer a loss;
- (2) The worker maintains a separate principal place of business other than at the firm *and* has a significant investment in facilities or tools;
- (3) The worker makes his/her services available to the public on a consistent basis and has provided such services as an independent contractor to at least one other service-recipient during the current or previous year; *or*
- (4) The worker is paid exclusively on a commission basis, *and either*:
  - (a) has a principal place of business other than at the firm, *or*
  - (b) pays fair-market value for rent at the firm.

Second, it would require the Secretary of the Treasury to propose legislation that would provide objectively measurable standards for classifying workers who do not meet one of the foregoing criteria. Third, it would repeal the safe-harbor rules and codify them with modifications. Finally, it would shift the IRS' focus from reclassifying workers to enforcing tax compliance among independent contractors by (a) increasing the penalties levied against service-recipients for failing to issue information returns (Form 1099) to service-providers and (b) requiring independent contractors to list their business income separately on their income tax returns.

**IRS' REVISION OF TRAINING MATERIALS**

The IRS recently released a draft of revised training materials on the current worker-classification rules. The revised training materials, however, are limited in what they can accomplish. They cannot, and do not, change existing law. Their primary purpose is to train IRS examiners on worker classification issues. The present maze of rules needs to be simplified and made more objective. These goals cannot be met by issuing revised training materials; they can only be achieved through legislation because the IRS is statutorily precluded by Section 530(b) of the Revenue Act of 1978 from issuing public guidance -- such as regulations and revenue rulings -- on the topic.

**CONCLUSION**

The Chamber believes strongly that simplification and clarification of the current worker classification rules is long overdue, and that the foregoing legislative proposals would help alleviate many of the problems associated with such rules. In addition to providing business owners with clearer and more objective criteria on which to make classification determinations, these proposals recognize the importance of independent

contractors in today's work environment.

While the Chamber supports the foregoing legislation, there are several concerns. H.R. 1972, H.R. 582 and S. 1610, according to their sponsors, would maintain the 20-factor test and safe-harbor rules, and a literal reading of these bills supports such assertions. However, if any of these proposals, in their present or some modified form, is enacted into law, the proposal would be subject to interpretation by the IRS -- a process involving the examination of the bill's legislative history and intent. Accordingly, the IRS could, depending on such bill's legislative history and intent, interpret the bill as repealing the 20-factor test and/or safe-harbor rules. This could be detrimental to businesses that currently rely on existing law to classify workers as independent contractors, but would be unable to do so under new legislation. Therefore, it should be made absolutely clear in the bills' legislative language and/or history that neither the 20-factor test nor the Section 530 safe-harbor rules would be repealed or otherwise nullified.

Furthermore, since H.R. 582 would repeal the Section 530 safe-harbor rules and codify them in a modified form, particular attention should be given to protecting those businesses that have relied on the existing safe-harbor rules from any adverse consequences resulting from the rule's demise and codification.

We appreciate this opportunity to address this very important issue.



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