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Employee/Independent Contractor: Time to Retire the 20-Factor Test

Wendell R. Bird

The IRS's 20-factor test for determining a worker's status as employee or independent contractor can lead employers into making costly classification errors.

Employers hoping to save money on payroll or employee benefit costs, or seeking to avoid adding full-time staff for special projects or for their busy seasons, have often resorted to using independent contractors. However, if the IRS makes a determination that a worker, considered an independent contractor by the employer, is in reality a misclassified employee, the employer can be liable for back payroll taxes, plus any benefits to which the worker would have been entitled if properly classified. Such a redetermination can seriously affect an employer's welfare benefit plans, to the point of losing tax-qualified status.

While the IRS has promulgated a 20-point test for differentiating between employees and independent contractors (see Exhibit 1, page 40), the test is so riddled with counterexamples, statutory exceptions, and inconsistencies that it can hardly be called a test at all. Therefore, being able to determine properly which workers are employees and which are independent contractors can help the employer avoid the significant costs associated with a reclassification of its workers.

Why should an employer have different tax treatment if it pays \$500 per month for payroll processing and tax reporting to ADP rather than to a person working from their home? Or if it pays \$500 per month for computer system support to a one-person corporation rather than to a one-person proprietorship? Or if it pays \$500 per month for copier service and repair to a small business rather than to an outside individual? Yet, in each instance the IRS says that the first alternative involves an independent contractor, not requiring any payroll tax reporting,¹ while the second involves an employee, requiring full monthly, quarterly, and annual payroll tax reporting and also requiring inclusion in many benefit plans. The obvious results are inconsistency and complexity for employers.

Reasons for Employee and Independent Contractor Status

In a review of private letter rulings involving nonprofit organizations, the author has found that the IRS concludes well over 90% of the time that workers are employees rather than independent

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EXHIBIT 1

IRS 20-Factor Test Under Rev. Rul 87-41, 1987-1 CB 296

1. **Instructions.** A worker who is required to comply with other persons' instructions about when, where, and how he or she is to work is ordinarily an employee. This control factor is present if the person or persons for whom the services are performed have the right to require compliance with instructions. See, for example, Rev. Rul. 68-598, 1968-2 C.B. 464, and Rev. Rul. 66-381, 1966-2 C.B. 449.
2. **Training.** Training a worker by requiring an experienced employee to work with the worker, by corresponding with the worker, by requiring the worker to attend meetings, or by using other methods, indicates that the person or persons for whom the services are performed want the services performed in a particular method or manner. See Rev. Rul. 70-630, 1970-2 C.B. 229.
3. **Integration.** Integration of the worker's services into the business operations generally shows that the worker is subject to direction and control. When the success or continuation of a business depends to an appreciable degree upon the performance of certain services, the workers who perform those services must necessarily be subject to a certain amount of control by the owner of the business. See *United States v. Silk*, 331 U.S. 704 (1947), 1947-2 C.B. 167.
Rev. Rul. 87-41, 1987-1 CB 296 — IRC Sec. 3121
4. **Services Rendered Personally.** If the services must be rendered personally, presumably the person or persons for whom the services are performed are interested in the methods used to accomplish the work as well as in the results. See Rev. Rul. 55-695, 1955-2 C.B. 410.
5. **Hiring, Supervising, and Paying Assistants.** If the person or persons for whom the services are performed hire, supervise, and pay assistants, that factor generally shows control over the workers on the job. However, if one worker hires, supervises, and pays the other assistants pursuant to a contract under which the worker agrees to provide materials and labor and under which the worker is responsible only for the attainment of a result, this factor indicates an independent contractor status. Compare Rev. Rul. 63-115, 1963-1 C.B. 178, with Rev. Rul. 55-593, 1955-2 C.B. 610.
6. **Continuing Relationship.** A continuing relationship between the worker and the person or persons for whom the services are performed indicates that an employer-employee relationship exists. A continuing relationship may exist where work is performed at frequently recurring although irregular intervals. See *United States v. Silk*.
7. **Set Hours of Work.** The establishment of set hours of work by the person or persons for whom the services are performed is a factor indicating control. See Rev. Rul. 73-591, 1973-2 C.B. 337. <Page 299>
8. **Full Time Required.** If the worker must devote substantially full time to the business of the person or persons for whom the services are performed, such person or persons have control over the amount of time the worker spends working and impliedly restrict the worker from doing other gainful work. An independent contractor, on the other hand, is free to work when and for whom he or she chooses. See Rev. Rul. 56-694, 1956-2 C.B. 694.
9. **Doing Work on Employer's Premises.** If the work is performed on the premises of the person or persons for whom the services are performed, that fac

Cont'd.

tor suggests control over the worker, especially if the work could be done elsewhere. Rev. Rul. 56-660, 1956-2 C.B. 693. Work done off the premises of the person or persons receiving the services, such as at the office of the worker, indicates some freedom from control. However, this fact by itself does not mean that the worker is not an employee. The importance of this factor depends on the nature of the service involved and the extent to which an employer generally would require that employees perform such services on the employer's premises. Control over the place of work is indicated when the person or persons for whom the services are performed have the right to compel the worker to travel a designated route, to canvass a territory within a certain time, or to work at specific places as required. See Rev. Rul. 56-694.

10. **Order or Sequence Set.** If a worker must perform services in the order or sequence set by the person or persons for whom the services are performed, that factor shows that the worker is not free to follow the worker's own pattern of work but must follow the established routines and schedules of the person or persons for whom the services are performed. Often, because of the nature of an occupation, the person or persons for whom the services are performed do not set the order of the services or set the order infrequently. It is sufficient to show control, however, if such person or persons retain the right to do so. See Rev. Rul. 56-694.
11. **Oral or Written Reports.** A requirement that the worker submit regular or written reports to the person or persons for whom the services are performed indicates a degree of control. See Rev. Rul. 70-309, 1970-1 C.B. 199, and Rev. Rul. 68-248, 1968-1 C.B. 431.
12. **Payment by Hour, Week, Month.** Payment by the hour, week, or month generally points to an employer-employee relationship, provided that this method of payment is not just a convenient way of paying a lump sum agreed upon as the cost of a job. Payment made by the job or on a straight commission generally indicates that the worker is an independent contractor. See Rev. Rul. 74-389, 1974-2 C.B. 330.
13. **Payment of Business and/or Traveling Expenses.** If the person or persons for whom the services are performed ordinarily pay the worker's business and/or traveling expenses, the worker is ordinarily an employee. An employer, to be able to control expenses, generally retains the right to regulate and direct the worker's business activities. See Rev. Rul. 55-144, 1955-1 C.B. 483.
14. **Furnishing of Tools and Materials.** The fact that the person or persons for whom the services are performed furnish significant tools, materials, and other equipment tends to show the existence of an employer-employee relationship. See Rev. Rul. 71-524, 1971-2 C.B. 346.
15. **Significant Investment.** If the worker invests in facilities that are used by the worker in performing services and are not typically maintained by employees (such as the maintenance of an office rented at fair value from an unrelated party), that factor tends to indicate that the worker is an independent contractor. On the other hand, lack of investment in facilities indicates dependence on the person or persons for whom the services are performed for such facilities and, accordingly, the existence of an employer-employee relationship. See Rev. Rul. 71-524. Special scrutiny is required with respect to certain types of facilities, such as home offices.

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- 16. Realization of Profit or Loss.** A worker who can realize a profit or suffer a loss as a result of the worker's services (in addition to the profit or loss ordinarily realized by employees) is generally an independent contractor, but the worker who cannot is an employee. See Rev. Rul. 70-309. For example, if the worker is subject to a real risk of economic loss due to significant investments or a bona fide liability for expenses, such as salary payments to unrelated employees, that factor indicates that the worker is an independent contractor. The risk that a worker will not receive payment for his or her services, however, is common to both independent contractors and employees and thus does not constitute a sufficient economic risk to support treatment as an independent contractor.
- 17. Working for More Than One Firm at a Time.** If a worker performs more than de minimis services for a multiple of unrelated persons or firms at the same time, that factor generally indicates that the worker is an independent contractor. See Rev. Rul. 70-572, 1970-2 C.B. 221. However, a worker who performs services for more than one person may be an employee of each of the persons, especially where such persons are part of the same service arrangement.
- 18. Making Service Available to General Public.** The fact that a worker makes his or her services available to the general public on a regular and consistent basis indicates an independent contractor relationship. See Rev. Rul. 56-660.
- 19. Right to Discharge.** The right to discharge a worker is a factor indicating that the worker is an employee and the person possessing the right is an employer. An employer exercises control through the threat of dismissal, which causes the worker to obey the employer's instructions. An independent contractor, on the other hand, cannot be fired so long as the independent contractor produces a result that meets the contract specifications. Rev. Rul. 75-41, 1975-1 C.B. 323.
- 20. Right to Terminate.** If the worker has the right to end his or her relationship with the person for whom the services are performed at any time he or she wishes without incurring liability, that factor indicates an employer-employee relationship. See Rev. Rul. 70-309.

contractors. (See Exhibit 2, page 45). In general, the reasons for these determinations are:

- The IRS can more easily collect FICA, Medicare and income tax from employers, rather than collecting self-employment tax and income tax from workers, and can collect it in one employer audit rather than in multiple individual audits.
- The IRS can collect more income taxes by disallowing employees' business expense deductions until they exceed 2% of adjusted gross income, rather than having to allow independent contractors' deductions of all business expenses.

The IRS is enforcing its concerns in Coordinated Examination Program (CEP) audits. In the college audit guidelines, the IRS instructed auditors to "[d]etermine whether the institution has properly classified its workers. Be alert to treating employees, such as adjunct professors, as independent contractors."² In the hospital audit guidelines, one of the six substantive areas was employment tax and benefit issues.³ In the 30 CEP audits closed in 1994, all had a tax assessment averaging six figures, and a large percentage of the audits involved worker reclassification.⁴ In the first 14 CEP audits closed in 1996, the IRS found payroll tax deficiencies in 11, primarily from reclassifying independent

contractors.⁵ In business audits, the first on the list to be questioned are independent contractors.

Employer Bias for Independent Contractor Status.

Conversely, employers prefer that some workers be classified as independent contractors, even though employers clearly have classified the great majority of workers as employees. There are several reasons why this has occurred. Payroll tax reporting can be a nightmare of paperwork and red tape, fraught with penalties for calculation and filing date errors, and costly to administer, while independent contractors receive a Form 1099 once a year. Also, employers are not responsible for paying an independent contractor's FICA and Medicare.

Further, coverage, participation, and other requirements of employee benefit plans are complex and expensive, and independent contractors are excluded from these plans.⁶ Employer legal liability (civil and criminal) may be far greater for employees' acts, than for independent contractors' acts. Many regulatory laws apply to employees (e.g., minimum wage and overtime, employment discrimination, workers' compensation, and unemployment compensation laws). This type of labor regulation generally does not apply to independent contractors.

Current test. Internal Revenue Code (IRC) Section 3121(d) defines

"employee," for purposes of FICA, to include corporate officers, common law employees, and statutory employees. There are also a few statutory exceptions. An individual is not an employee if he has a substantial investment in facilities used in connection with the performance of services (other than in facilities for transportation), or if services are in the nature of a single transaction not part of a continuing relationship with the person for whom the services are performed.

The IRC also creates exceptions from income tax withholding for real estate

agents and direct sellers.⁷ 1996 changes provided that newspaper distributors and carriers may be treated as independent contractors (direct sellers) for employment and income taxes, and that fishing boat crews may be treated as self-employed if they average fewer than ten persons for the four preceding calendar quarters.⁸ Under 1997 changes, ministers, who are treated as self-employed for FICA purposes, may still be employees for church retirement plan purposes,⁹ and retail securities brokers would not be treated as following employer instructions merely because they complied with investment protection laws or rules imposed by government or regulatory bodies.¹⁰

The Treasury Regulations make clear that contractual designations are "immaterial" "[i]f the relationship of employer and employee exists."¹¹ The Regulations identify control as the most significant factor:

Generally such [employee] relationship exists when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished. That is, an employee is subject to the will and control of the employer not only as to what shall be done but how it shall be done. In this connection, it is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he has the right to do so ... In general, if an individual is subject to the control or direction of another merely as to the result to be accomplished by the work and not as to the means and methods for accomplishing the result, he is an independent contractor.¹²

Other factors expressly listed by the Regulations include the right to discharge, and the furnishing of tools and a place to work.¹³

Many regulatory laws apply to employees that do not apply to independent contractors.

Because these factors could easily be read to classify physicians, attorneys, and others as employees of each of their multiple clients, the Regulations carved out another statutory exception:

Individuals such as physicians, lawyers, dentists, veterinarians, construction contractors, public stenographers, and auctioneers, engaged in the pursuit of an independent trade, business, or profession, in which they offer their services to the public, are independent contractors and not employees.¹⁴

The IRS test did not identify the weight that should be given to each factor.

The IRS has been very stingy in extending this exception (which could easily swallow up the rule) to the many new professions that are offering services to the public, such as computer programmers, management information system consultants, media consultants, and outside sales representatives. The need for the statutory exception shows the rule's overinclusion.

Administrative 20-factor test. The IRS promulgated Rev. Rul. 87-41, 1987-1 CB 296, ostensibly to clarify the classification of employees for FICA and FUTA purposes. Ironically, it gave three examples involving a worker who, pursuant to an arrangement between a firm and a client, "provides services for the Client as an engineer, designer, drafter, computer programmer, systems analyst, or other similarly skilled worker." Despite the late-20th century ring of the fact situation, the 20-factor test was loaded with archaic references to 19th-century unskilled laborers, such as tools, established routines, and significant investments.¹⁵ The test was devoid of any recognition that virtual offices, telecommuting, a growing consulting and service sector, a globally expanding market, or retaining services via the Internet, might arise.

The "test" also did not identify the weight that should be given to each factor ("[t]he degree of importance of each factor varies"), or how many factors must be

met to constitute an employment relationship. It is impossible to say with any certainty that a worker meeting only two factors is an independent contractor, or that a worker meeting 18 factors is an employee (hence the carveouts for physicians, lawyers, real estate agents, etc.). The one factor that clearly does not matter is what the parties agree on in a written contract.¹⁶

The IRS also issued a training manual centered around the 20-factor test, in October 1996.¹⁷ As of the date of this writing, it has not updated that training manual to account for changes in SBA '96 that were designed to override aggressive IRS interpretations.

The 20-factor test generally cannot be avoided by forming a personal service corporation, at least according to Rev. Rul. 87-41:

The analysis would not differ if the facts of Situation 1 [an employee] were changed to state that the Individual provided the technical services through a personal service corporation owned by the Individual.¹⁸

However, the IRS gave a different rule in its training manual on employee vs. independent contractor status: "[P]rovided that the corporate formalities are followed and at least one non-tax purpose exists, the corporate form is generally recognized." Thus, disregarding the corporate entity is generally an extraordinary remedy, applied by most courts only in instances of clear abuse. Therefore, the worker usually will not be treated as an employee of the business, but as an employee of the personal service corporation. The Eighth Circuit took a similar approach in reversing IRS disregard of a personal services corporation, in *Sargent*, 929 F.2d 1252, 67 AFTR2d 91-718 (CA-8, 1991), *rev'g* 93 TC 572 (1989).

Judicial definitions. The IRS did not choose the 20 factors at random. Most of

EXHIBIT 2

PLRs/TAMs Involving Exempt Organizations and Worker Classification

The following are examples of IRS private letter rulings and technical advice memoranda involving exempt organizations and employee/independent contractor classification from two recent years.

- Assistant to state university president was employee despite part-time work and limited projects. Ltr. Rul. 9351025.
- Community college part-time teacher was employee. Ltr. Rul. 9345046.
- Computer consultant was independent contractor. Ltr. Ruls. 9320020, 9320036.
- Coordinator was independent contractor. Ltr. Rul. 9325010.
- Counselor on infectious diseases was municipal employee. Ltr. Rul. 9345030.
- Dentist was employee. Ltr. Ruls. 9325014, 9325028.
- Dentist was employee of military fixed-fee contract. Ltr. Rul. 9326021.
- Emergency medical technician was employee of city-operated ambulance service despite part-time work and per-response pay. Ltr. Rul. 9350012.
- Housekeeper was employee. Ltr. Ruls. 9316034, 9317015.
- Judge was city employee despite part-time work. Ltr. Rul. 9351015.
- Medical director was employee. Ltr. Rul. 9320038.
- Medical examiner was municipal employee despite part-time on-call work. Ltr. Rul. 9352019.
- Nurse for single patient paid for by family was personal care facility employee. Ltr. Rul. 9342008.
- In-house nurse was employee. Ltr. Rul. 9321029.
- Nurse was employee of federal medical center despite similar services for others. Ltr. Rul. 9350024.
- Nurse was employee of veteran's hospital. Ltr. Rul. 9326024.
- Nurses were employees of home health care firm although part-time. Ltr. Rul. 9350029.
- Personal care health attendant was employee. Ltr. Rul. 9313012.
- Physical therapist (part-time) working at students' homes was school district employee. Ltr. Rul. 9343020.
- Physical therapist, occupational therapist were employees of school district. Ltr. Ruls. 9337018, 9336033.
- Physician's professional corporation contract to serve as chief anesthesiologist was employee because exempt hospital assumed financial risk, furnished space and equipment, and established terms and conditions of services. Ltr. Rul. 9219020.
- Physician was employee. Ltr. Ruls. 9313007, 9323013, 9323014.
- Physician was employee of university health clinic. Ltr. Rul. 9326015.
- Physicians running emergency room were employees of hospital. Ltr. Rul. 9335055.
- Program coordinator for senior citizens was municipal employee despite no benefits. Ltr. Rul. 9350006.

Cont'd.

- Public school part-time teacher of adult education was employee. Ltr. Rul. 9350004.
- Referral registry caregivers were not employees absent control. TAM 9344003.
- Speech pathologist was not employee of school board. Ltr. Rul. 9338035.
- Student assistanceship pay was subject to FICA at university participating in Social Security. TAM 9343005.
- Student newspaper editor was employee. Ltr. Rul. 9348056.
- Student working as secretary of university-funded organization was employee. Ltr. Rul. 9350005.
- Therapist for mentally retarded children was state agency employee. Ltr. Rul. 9340037.
- Therapists were employees of management company for nursing facilities and hospitals. TAM 9351003.
- Veterinarians were employees of clinic. TAM 9350002.
- Art class instructor on military base was employee. Ltr. Rul. 9421021.
- Associate producer of public broadcast station was employee. Ltr. Rul. 9423014.
- Attorney hired to teach law enforcement academy courses was employee despite only 10% of attorney's time. Ltr. Rul. 9417015.
- Attorneys acting part-time as hearing officers were employees of state board, despite own offices. Ltr. Ruls. 9422042, 9422043.
- Barber part-time at state rehabilitation center was employee. Ltr. Rul. 9424047.
- Beautician hired by state university was employee. Ltr. Rul. 9424049.
- Caregiver was employee. Ltr. Rul. 9405025.
- Census taker hired by municipality was employee. Ltr. Rul. 9425022.
- Chaplain part-time at state rehabilitation center was employee. Ltr. Rul. 9424045.
- Clerk for state housing agency was employee. Ltr. Rul. 9437036.
- Dance instructor working part-time at various schools was employee. Ltr. Rul. 9407009.
- Doctor working part-time for state agency was employee. Ltr. Rul. 9411028.
- Doctors engaged by Catholic Church organization to provide acute care at emergency room were not employees, although 90% of services performed there (revoking Ltr. Rul. 9335055). Ltr. Rul. 9410041.
- Engineer overseeing government buildings was employee. Ltr. Rul. 9411032.
- Financial aid counselor was employee. Ltr. Rul. 9429010.
- Hair stylist in university barber shop was employee. Ltr. Rul. 9405015.
- Home health care service provider was not employee of municipal agency (Ltr. Rul. 9301013 withdrawn based on further information). Ltr. Rul. 9422015.
- Intern in public defender's office was employee. Ltr. Rul. 9405031.
- Janitor was employee. Ltr. Rul. 9421036.
- Judge appointed by mayor was employee. Ltr. Rul. 9425040.
- Judge of municipal court was state employee. Ltr. Rul. 9422032.
- Kitchen manager of elderly care center was employee. Ltr. Rul. 9423016.

Cont'd.

- Laid-off teacher met continuing employee exception from Medicare tax (amending Ltr. Rul. 9432020). Ltr. Rul. 9436046.
- Mayor of municipality was employee. Ltr. Rul. 9421035.
- Medical examiner part-time for government was employee. Ltr. Rul. 9352019.
- Minister was church employee. Ltr. Rul. 9414022.
- Nurses were employees of nurse registry/employment agency because of rule book, personal performance requirement, and fixed hours. TAM 9415001.
- Occupational therapist was employee. Ltr. Rul. 9428012.
- Painter hired by municipal water department was employee. Ltr. Rul. 9423013.
- Part-time administrator and bookkeeper of child care food distribution program was employee. Ltr. Rul. 9420011.
- Pharmacist part-time at state rehabilitation center was employee. Ltr. Rul. 9422024.
- Psychiatrist at state rehabilitation center was employee. Ltr. Rul. 9423009.
- Psychologist at public school was employee though part-time. Ltr. Rul. 9435002.
- Purchasing agent for state university was employee. Ltr. Rul. 9417016.
- Real estate appraiser was not employee of federal agency—not enough direction or control. Ltr. Rul. 9424029.
- Rehabilitation center disabled worker was not employee. Ltr. Rul. 9410012.
- Rehabilitation center's workshop workers were non-employees. Ltr. Rul. 9417008.
- Social worker for mental health clinic was employee. Ltr. Rul. 9423008.
- Teacher at municipal parks and recreation department was employee though part-time. Ltr. Rul. 9437010.
- Teacher full-time at prison was employee of prison, but state agency funding services was responsible for withholding taxes. Ltr. Rul. 9423017.
- Therapist at rehabilitation organization was employee. Ltr. Rul. 9434008.
- Worker's compensation specialist at state agency was employee. Ltr. Rul. 9436030.

them have been listed in dictum in U.S. Supreme Court decisions on another issue, agency.

In determining whether a hired party is an employee under the general common law of agency, we consider the hiring party's right to control the manner and means by which the product is accomplished. Among the other relevant factors are the skill required; the source of the instrumentalities and tools; the location of the work; the duration of the relationship between the parties;

whether the hiring party has the right to assign additional projects to the hired party; the extent of the hired party's discretion over when and how long to work; the method of payment; the hired party's role in hiring and paying assistants; whether the work is part of the regular business of the hiring party; whether the hiring party is in business; the provision of employee benefits; and the tax treatment of the hired party No one of these factors is determinative.¹⁹

The factors had also been cited by courts in tax and nontax cases involving determinations of employment status, nearly all before the beginning of the computer revolution. Such courts had mentioned the following:

- Control and instructions.²⁰
- Training.²¹
- Integration into business operations.²²
- Services rendered personally or hiring of assistants.²³
- A continuing relationship.²⁴
- Set hours of work or use of the employer's premises.²⁵
- Payment by the hour or week.²⁶
- Furnishing of tools and materials.²⁷
- A significant investment.²⁸
- Realization of profits or loss.²⁹
- Working for more than one firm or offering services to the general public.³⁰
- Being subject to discharge.³¹

The IRC carves exceptions from income tax withholding for certain workers, such as real estate agents and direct sellers.

Minister definition. Ministers enjoy a confusing status. They are self-employed for Social Security purposes³² (and early in their ministry may elect out of Social Security entirely), but are generally employees for income tax purposes (though they are not subject to income tax withholding).³³ The Tax Court, in deciding a case involving a minister, noted the following:

Courts consider various factors to determine an employment relationship between the parties. Relevant factors include:

- (1) The degree of control exercised by the principal over the details of the work.
- (2) Which party invests in the facilities used in the work.
- (3) The opportunity of the individual for profit or loss.

(4) Whether or not the principal has the right to discharge the individual.

(5) Whether the work is part of the principal's regular business:

(6) The permanency of the relationship.

(7) The relationship the parties believe they are creating. . . .

The "right-to-control test" is the crucial test to determine the nature of a working relationship. . . .³⁴

In that case, the full Tax Court held that a United Methodist minister was an employee, not an independent contractor.³⁵ The Fourth Circuit affirmed the decision.³⁶

In an Eighth Circuit decision, the court held that an Assemblies of God pastor was an independent contractor.³⁷ The court ignored the eight-point test, and fashioned its own 12-factor test. Similarly, in a memorandum decision, the Tax Court held that an Assemblies of God minister was an independent contractor,³⁸ citing the same test relied on in *Weber*, 103 TC 378 (1994), *aff'd* 60 F.3d 1104 (CA-4, 1995).³⁹ The court determined that a minister working as a foreign missionary was not an employee because the denomination did not exercise sufficient control over his work, supervise him, train him, or assign him to a particular location or project. The minister set his work hours and pay, hired assistants, and could not be discharged. The court found the potential for profit or loss in the provisions that the minister was not guaranteed any minimum compensation, and would lose any funds remaining on resigning. In an earlier memorandum decision, the Tax Court held that an International Pentecostal Holiness Church minister was an independent contractor.⁴⁰

Churches often treat ministers as self-employed. TRA '97 clarifies that self-employed ministers, and ministers working for non-Section 501(c)(3) organizations with whom they have common religious bonds, may be treated as employees for purposes of participation in church retirement plans.⁴¹

Section 530 Relief

In response to overly aggressive IRS efforts to recategorize independent contractors as employees, Congress passed section 530 of the Revenue Act of 1978 (RA '78).⁴² Section 530 offers some relief from the classification dilemma for employers by providing, in part, that employers who have a reasonable basis for classifying the worker as an independent contractor will be allowed to continue doing so. "Reasonable basis" can be met under section 530 by any of three safe harbors, along with other means under subsection 530(2).⁴³ Congress expressed its intent that this provision be construed liberally in favor of taxpayers.⁴⁴

Amendment by SBA '96. One purpose of the 1996 Act was to overturn aggressive IRS interpretations of section 530 that undercut its purpose, including the following:

- That section 530 would not apply if a worker was not an employee under common law standards.
- That a business that cannot meet any of the three safe harbors cannot show it had a reasonable basis for employee treatment.
- That a "long-standing recognized practice" must have existed before 1978.
- That "a significant segment of the industry" must be at least 25%.

SBA '96 made several pro-employer changes to section 530:⁴⁵

- Section 530 applies regardless of whether workers are common law employees.
- The three safe harbors are not the only safe harbors.
- The past audit safe harbor applies only if the audit encompassed employee/independent contractor classification.
- The long-standing recognized-practice safe harbor applies even if the practice did not exist in 1977 or for more than ten years, and a significant segment of the industry cannot be construed as more than 25% and can be defended as less.
- The IRS has the burden of proof if the employer has made a prima facie case.

The shift of the burden of proof to the IRS occurs once an employer establishes a prima facie case that it was reasonable not to treat a worker as an employee under section 530, so long as the employer has cooperated fully with reasonable information requests from the IRS. However, that shift does not apply in determining whether the employer had a reasonable basis other than the three specified safe harbors. This provision, and most others of SBA '96, apply for periods after 1996.

The Deserved Extinction of the 20-Factor Test

There are three fundamental problems with the 20-factor test.

Archaic Survivor of the Computer Revolution. The first problem is that the test describes a workplace characterized by manual laborers on assembly lines who punch time cards when arriving and leav-

Generally, if an individual is subject to control merely as to the result to be accomplished, he is an independent contractor under the IRS test. Is that a meaningful standard?

The IRS 20-factor test is loaded with archaic references to 19th-century unskilled laborers, such as tools and established routines.

ing work, and not a workplace characterized by tasks performed using the computer terminal and telephone, use of innumerable consultants and services, retention of consultants by the Internet for limited engagements, compensation by commissions or fees rather than timeclocks, and employee mobility between jobs.

Ambiguity Negating Any Meaningful Test. Another problem is that the test does not really differentiate between employees and independent contractors. Instead, the first service providers that the 20-factor test carved out of the employee class (e.g., physicians, lawyers) look more and more like today's mass of workers, which the 20-factor test still leaves in the employee class. Thus, whole segments of society (real estate agents, newspaper distributors, fishing boat workers) must lobby to create additional carveouts from the employee classification.

Bias Toward Employee Status. A third problem with the test is overt bias in application. The IRS seldom finds that anyone is an independent contractor, unless that person is statutorily carved out. A test that is so subject to bias is not a test at all. To send in a Form SS-8 (Determination of Employee Work Status for Purposes of Federal Employment Taxes and Income Tax Withholding) is generally to get "employee" stamped on it.

Irrelevance of the 20 Factors. Given the shift from manual labor to an economy based more on information, the IRS's 20 factors are no longer relevant to the workplace. A point-by-point refutation of the factors follows.

1. Whether the worker must comply with instructions. Payors usually give the most comprehensive instructions that their time and knowledge will allow, whether the worker is an employee or independent contractor. Few lawyers, engineers, builders, or

other independent contractors have the liberty of operating without very extensive instructions. The instructions given are normally more a component of the relative expertise or time of the payor and worker rather than a factor relevant to classification.

- 2. Whether the payor provides training.** Payors usually provide more training for longer-term or more complicated work, regardless of whether the worker is an employee or independent contractor.
- 3. Whether the worker is integrated into the payor's "business."** Integration or lack of integration into a business is merely another name for employee or independent contractor most of the time. Otherwise, it is merely another description for full-time or part-time status, which the IRS says is irrelevant to classification.
- 4. Whether the worker must perform the services personally.** Employees who supervise one or more employees need not perform services personally. Some independent contractors, such as doctors and lawyers, are expected to perform services personally. Personal performance is a function of whether the worker at the time has a staff, or whether the payor wants a particular person's service, and is not relevant to classification.
- 5. Whether the worker may hire assistants.** This point is simply the converse of the preceding point.
- 6. Whether the worker performs services at frequent intervals.** This point is irrelevant, because the IRS does not view part-time or full-time service as pertinent to classification. All payors hope that their independent contractors, such as lawyers, computer programmers, and particularly doctors, will not have to perform at frequent intervals, but determine the intervals by whether computers or bodies work rather than by classification considerations. All employers of part-time

employees similarly hope that they can reduce the total and intervals of part-time employees. Intervals are related to need, not to classification. "A continuing relation may exist where work is performed at frequently recurring though regular intervals."

7. **Whether the worker has set hours of work.** Employees often have flex time, four-day weeks, and other non-set hours. Independent contractors often have fixed hours, such as lawyers attending board meetings, engineers working full-time when a project is active, and doctors beginning surgery at 7:00 a.m.
8. **Whether the worker must devote full time to the payor.** This is irrelevant, because the IRS does not concede that the converse (part-time work) indicates that an employee is an independent contractor. Many employees are part-time, and many independent contractors are full-time (such as outside lawyers and outside auditors for Fortune 500 clients). However, this could be turned into a legitimate factor, as described below.
9. **Whether the work is done on the premises.** This is irrelevant, because the location depends on the type of work. More and more employees are telecommuting or are in virtual offices, off the premises. Many independent contractors are required to be on the premises, such as lawyers for regular meetings, accountants for audits, and computer consultants for repair. This factor is a measure of where the work is to be done, or how much money the client has to pay for travel time—not a measure of employment status.
10. **Whether the payor sets the order and sequence of tasks to be performed.** Payors set the order and sequence of tasks—the "how" as well as the "what"—to the extent they have expertise and time, whether for employees or independent contractors. Payors give engineers and builders more detailed instructions than they give most employees, and more and more are giving lawyers and consultants precise work descriptions. This factor is a measure of the payor's personality type, not of employment status.
11. **Whether the worker must provide reports.** Payors require reports to the extent they are useful, whether from employees or independent contractors. The very reason for using one category of independent contractor—auditors—is to receive reports, and a major part of retaining lawyers is to receive analyses. Many employees do not submit any reports as part of their job.
12. **Whether the worker receives payments as commissions or by the hour, week, or month.** Many employees are paid by commission rather than by the hour, week, or month. Many independent contractors, such as lawyers and accountants, are paid by the hour. The payment method is irrelevant to classification.
13. **Whether the worker pays his own expenses.** Many employees must pay certain categories of expenses. Many independent contractors, such as lawyers and accountants, are repaid for every conceivable expense by the client. This is irrelevant to classification.
14. **Whether the worker must provide his own tools and materials.** Few non-manual workers have tools at all, whether employees or independent contractors. Payors are often charged for the photocopy machines, facsimile machines, databases, and other tools of their independent contractors. This factor is a relic of the pre-electronic age.
15. **Whether the worker makes a significant monetary investment.** More and more consultants do not need a monetary investment, beyond the computer system that would be used whether as an employee or an independent contractor. An increasing

The IRS's 20 factors were derived from U.S. Supreme Court decisions on another issue, agency.

EXHIBIT 3
Check-The-Box Employee Classification Form

Name of Employee:	S.S.N.:
(Check One Box:)	
<input type="checkbox"/> Employee	
Employer agrees to report all payments on Form 941 and Form W-2 for each calendar quarter and calendar year.	
<input checked="" type="checkbox"/> Independent Contractor	
Employer agrees to report all payments on Form 1099 for each calendar year, and to notify the Independent Contractor in writing as follows:	
"You are responsible for paying all income taxes and self-employment taxes to the IRS with Form 1040-ES on April 15, June 15, September 15, and January 15 for each calendar year, as required by IRS Publication 505."	

number of employees and independent contractors (outside manufacturing) do not require any facilities or monetary investments, and instead offer intellectual capital.

- 16. Whether the worker can make a profit or economic loss.** Many independent contractors cannot lose money, unless they overspend on overhead. Many employees can lose bonuses or advances.
- 17. Whether the worker performs services for multiple payors.** Many employees have multiple jobs. Many independent contractors serve one payor. This borders on a relevant factor, but only as suggested below. Yet the IRS, after saying that a worker for one entity is an employee, renders the

factor meaningless by saying that "a worker who performs services for more than one person may be an employee of each of the persons."

- 18. Whether the worker offers his services to the general public.** Most part-time employees offer their services to the general public. Many independent contractors are happy to have one large client that makes other clients unnecessary. Yet their role is functionally indistinguishable from independent contractors who serve multiple clients. Some independent contractors are even restricted from offering the same services to the public.
- 19. Whether the worker can be terminated at any time.** In right-to-work states, employees or independent contractors can be terminated at will, unless there are contrary contractual provisions. In other states, either an employee or an independent contractor can still be terminated, subject to further restrictions. This is irrelevant. It is simply wrong to say that an "independent contractor, on the other hand, cannot be fired so long as the independent contractor produces a result that meets the contract specifications."
- 20. Whether the worker can quit at any time.** This is an odd factor. Most employees and independent contractors can quit at any time, but some in each category have contractual restrictions that forbid it (e.g., a contractual provision requiring a certain period of notice before quitting). This is irrelevant to classification.

Alternatives for Defining Employees and Independent Contractors

The most relevant test is not control; many businesses paying independent contractors have every desire to be sure their

money is well spent by controlling means, ends, methods, and every other aspect of the project. Rather, the most relevant test for determining a worker's status as employee or independent contractor is time: whether the worker performs a normal work week for one business, or performs similar functions for many. Yet time is not a *sine qua non*, because some true outside consultants work for a single client, and some full-time employees work two or more jobs.

Time Test. The author proposes a test that is simple and that correlates with section 530 of RA '78. Under this test, a worker who devotes all work time to a single business is presumed to be an employee, unless he makes a prima facie showing that a safe harbor under section 530 or other facts distinguish him from an employee. In that situation, he is an independent contractor unless the IRS carries the burden of proof that he is an employee. A worker who devotes more than 25% of work time to a second business is presumed to be an independent contractor toward either or both businesses that do not categorize him as an employee, unless the IRS carries the burden of proof that he is an employee.

Check-the-Box Test. The much-litigated area of entity classification has been made easier by the check-the-box regulations.⁴⁶ There is no reason why the similarly difficult area of employee classification cannot be cleared in the same manner by check-the-box regulations. Such rules could be as simple as the form set out in Exhibit 3, page 52.

Conclusion

At present, a Form SS-8 is available to send to the IRS for a determination of whether a worker is an employee or independent contractor. However, the process

is virtually meaningless because, in the author's experience, the answer usually comes back "employee," and the process is too slow to use in classifying a new employee.

The IRS has a Classification Settlement Program (CSP), with early referral to Appeals for these employment tax issues.⁴⁷ However, that only helps resolve issues late, not early, as the CSP is designed to speed the settlement of worker classification audits, and not to determine a worker's status at hiring. It should be possible for the IRS, using an unbiased 20-point test or a simple time test, to receive a faxed form, computer score, and fax it back overnight. This would give employers certainty in their worker classification determinations, removing the threat of being assessed back payroll taxes at some time in the future, or having their pension and welfare benefit plans lose their tax-exempt status. ■

¹ At least if the "small business" is incorporated. However, see *infra* on personal service corporations.

² IRS Examination Guidelines for Colleges and Universities, Ann. 93-2, 1993-2 IRB 39.

³ IRS Hospital Audit Guidelines, Ann. 92-83, 1992-22 IRB 59. Also see Bedard and Gribens, "CEP Audits Often Are Revenue Raisers for IRS and Bad News for Health Organizations," 8 J. Tax'n Exempt Orgs. 3 (Jul/Aug 1996).

⁴ Speech of Marcus Owens, Washington Non-Profit Tax Conference, March 3, 1995.

⁵ In auditing the University of Wisconsin—Madison, the IRS demanded \$81.5 million in withholding tax payments for a six-year period, although it settled the case for merely a promise to do payroll withholding thereafter. 11 E.O.T.R. 1174 (June 1995).

⁶ Exclusion from benefit plans of independent contractors reclassified as employees can disqualify plans. See Ware, 67 F.3d 574, 76 AFTR2d 95-6772 (CA-6, 1995); Butts, 49 F.3d 713 (CA-11, 1995). For ERISA purposes, an employee is generally defined using the common law test. See *Nationwide Mutual Insurance Co. v. Darden*, 503 U.S. 318 (1992).

⁷ IRC Section 3508.

⁸ IRC Sections 3508(b)(2)(A); 3121(b); and 3121(b)(20)(A); SBA '96 sections 1118(a) and 116(a)(1)(A).

⁹ IRC Sections 414(c)(5)(A); 403(b)(1)(A); TRA '97 section 1601(d)(6).

¹⁰ IRC Section 3121(d); TRA '97 section 921(a).

¹¹ Reg. 31.3121(d)-1(b)(3). See also Reg. 31.3401(c)-1(c).

¹² Reg. 31.3121(d)-1(c)(2). See also Reg. 31.3401(c)-1(b).

¹³ *Id.*

¹⁴ Reg. 31.3121(d)-1(c)(2); see also Reg. 31.3401(c)-1(c).

¹⁵ The IRS seems to have picked on engineers, designers, drafters, computer programmers, systems analysts, and other similarly skilled workers because of its reading of subsection (d) that section 1706(a) of TRA '86 added to section 530 of RA '78. The Service's reading was that the provision "eliminates the employment tax relief under section 530(a) of RA '78 that would otherwise be available to a taxpayer with respect to those workers who are determined to be employees." Rev. Rul. 87-41, 1987-1 CB at 300. Congress rejected that narrow interpretation in SBA '96 (discussed below).

¹⁶ Rev. Rul. 87-41, *supra* note 14.

¹⁷ "Independent Contractor or Employee?" IRS Training Materials (Training 3320-102 (10/96) TPDS 84233 I, October 30, 1996.

¹⁸ Rev. Rul. 87-41, *supra* note 14, at 300. See also H. Rep't No. 99-841, 99th Cong., 2d Sess. II-834-835 (Conference Report) (1986): "The effect of the provision cannot be avoided by claims that such technical service personnel are employees of personal service corporations controlled by such personnel. For example, an engineer retained by a technical services firm to provide services to a manufacturer cannot avoid the effect of this provision by organizing a corporation that he or she controls and then claiming to provide services as an employee of that corporation."

¹⁹ *Community for Creative Nonviolence v. Reid*, 490 U.S. 730 (1989).

²⁰ See *Kittlaus*, 41 F.3d 327, 74 AFTR2d 94-7297 (CA-7, 1994); *Samson*, 743 F.2d 884, 54 AFTR2d 84-6380 (CA-FC., 1984) (member of religious order working at county hospital); *Air Terminal Cab, Inc.*, 478 F.2d 575, 31 AFTR2d 73-1298 (CA-8, 1973), cert. den. 414 U.S. 909 (1973); *Polk*, 550 F.2d 566, 39 AFTR2d 77-1221 (CA-9, 1977); *McGuire*, 349 F.2d 644, 16 AFTR2d 5458 (CA-9, 1965).

²¹ See *Lanigan Storage & Van Co.*, 389 F.2d 337, 21 AFTR2d 742 (CA-6, 1968); *Smith*, 36 AFTR2d 75-6174 (DC Tex., 1975), aff'd per curiam 568 F.2d 435, 41 AFTR2d 78-756 (CA-5, 1976).

²² See *Avis Rent A Car System, Inc.*, 503 F.2d 423 34 AFTR2d 74-5882 (CA-2, 1974); *Air Terminal Cab, Inc.*, *supra* note 19.

²³ See *Tri-State Developers, Inc.*, 549 F.2d 190, 39 AFTR2d 77-725 (1977); Rev. Rul. 66-274, 1966-2 CB 446.

²⁴ See *Avis Rent A Car System, Inc.*, *supra* note 21; *Lanigan Storage & Van Co.*, *supra* note 20.

²⁵ See *Service Trucking Co.*, 14 AFTR2d 5488 (DC Md., 1964), aff'd 347 F.2d 671, 16 AFTR2d 5146 (CA-4, 1965); Rev. Rul. 71-273, 1971-1 CB 286.

²⁶ See Rev. Rul. 76-226, 1976-1 CB 322; Rev. Rul. 76-138, 1976-1 CB 315; Rev. Rul. 66-274, *supra* note 22.

²⁷ See *Air Terminal Cab, Inc.*, *supra* note 19.

²⁸ See *Avis Rent A Car System, Inc.* *supra* note 21; *May Freight Service, Inc.*, 462 F. Supp. 503, 42 AFTR2d 78-5821 (DC N.Y., 1978).

²⁹ See *Avis Rent A Car System, Inc.*, *supra* note 21; *Morish*, 555 F.2d 794 (Ct. Cl., 1977); *Illinois Tri-Seal Products, Inc.*, 353 F.2d 216 (Ct. Cl., 1965).

³⁰ See *May Freight Service, Inc.* *supra* note 27; *Apaca, Inc.*, 39 AFTR2d 77-631 (DC N.M., 1976).

³¹ See *Security Storage & Van Co.*, 528 F.2d 1166, 34 AFTR2d 74-5622 (CA-4, 1975); *Air Terminal Cab, Inc.*, *supra* note 19.

³² IRC Section 1402(c); Reg. 1.1402(c)-(a)(2).

³³ IRC Section 3401(a)(9).

³⁴ *Weber*, 103 TC 378 (1994), aff'd 60 F.3d 1104, 76 AFTR2d 95-5782 (CA-4, 1995).

³⁵ *Accord, Cosby*, TC Sum. Op. 1987-141 (1987); *Radde*, TCM 1997-470.

³⁶ *Weber*, *supra* note 33.

³⁷ *Alford*, 116 F.3d 334, 79 AFTR2d 97-3105 (CA-8, 1997).

³⁸ *Greene*, TCM 1996-531.

³⁹ See generally *Wylie and Dutcher*, "Two Cases Produce Different Outcomes on Employee Status of Ministers," 7 J. Tax'n Exempt Orgs. 188 (Jan/Feb 1996); *Jones, Pollard, Brazelton, and Kaenzig*, "Ministers Face Dilemma Divining the Difference Between Employees and Independent Contractors," 9 J. Tax'n Exempt Orgs. 180 (Jan/Feb 1998).

⁴⁰ *Shelley*, TCM 1994-432.

⁴¹ IRC Section 414(c)(5)(A), as amended by TRA '97 section 1601(d)(6).

⁴² That section provides: "(1) In General. If—

(A) for purposes of employment taxes, the taxpayer did not treat an individual as an employee for any period ending before January 1, 1980, and (B) in the case of periods after December 31, 1978, all Federal tax returns (including information returns) required to be filed by the taxpayer with respect to such individual for such period are filed on a basis consistent with the taxpayer's treatment of such individual as not being an employee, then, for purposes of applying such taxes for such period with respect to the taxpayer, the individual shall be deemed not to be an employee unless the taxpayer had no reasonable basis for not treating such individual as an employee."

⁴³ Section 530 (2) Statutory Standards Providing One Method of Satisfying the Requirements of Paragraph 1).—For purposes of paragraph (1), a taxpayer shall in any case be treated as having a reasonable basis for not treating an individual as an employee for a period if the taxpayer's treatment of such individual for such period was in reasonable reliance on any of the following:

(A) judicial precedent, published rulings, technical advice with respect to the taxpayer, or a letter ruling to the taxpayer; (B) a past Internal Revenue Service audit of the taxpayer in which there was no assessment attributable to the treatment (for employment tax purposes) of the individuals holding positions substantially similar to the position held by this individual; or (C) long-standing recognized practice of a significant segment of the industry in which such individual was engaged.

⁴⁴ H. Rep't No. 95-1748, 95th Cong., 1st Sess. 5 (1978), reprinted in 1978-3 (Vol. 1) CB 629, at 633.

⁴⁵ SBA '96 section 1122.

⁴⁶ TD 8697, December 17, 1996.

⁴⁷ Notice 98-21, 1998-15 IRB 14.