

7-1-1996

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## Recommended Citation

Marilyn Barrett, *Independent Contractor/Employee Classification in the Entertainment Industry: The Old, the New and the Continuing Uncertainty*, 13 U. Miami Ent. & Sports L. Rev. 91 (1996)

Available at: <http://repository.law.miami.edu/umeslr/vol13/iss1/5>

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# **INDEPENDENT CONTRACTOR/EMPLOYEE CLASSIFICATION IN THE ENTERTAINMENT INDUSTRY: THE OLD, THE NEW AND THE CONTINUING UNCERTAINTY**

**MARILYN BARRETT\***

## **EMPLOYEE/INDEPENDENT CONTRACTOR CLASSIFICATION**

A critical question faced by any business, including those in the entertainment industry, is whether the business is obligated to withhold and pay over employment taxes to the Internal Revenue Service on wages it pays to its workers. This determination hinges upon whether the workers are properly classified as employees or as independent contractors. The importance of this issue cannot be overstated. Business has faced daunting challenges in determining the proper classification of its workers. The tests historically applied by the Internal Revenue Service and the courts are inconsistent, ambiguous, applied unevenly, and dependent upon the weighing of numerous factors, some of which simply have no bearing in a particular case. Adding to the difficulty is competitive restraints. If the business treats its workers as employees while its competitors treat their workers as independent contractors, the business can suffer diminished sales and revenues due to competitive pricing needs. Despite this uncertainty in how the rules apply and the competitive realities faced by business, the Internal Revenue Service has relentlessly and unabashedly assessed employment taxes against such businesses on a retroactive basis, even in cases where proper classification is at best unclear. Frequently, this has caused businesses to suffer ruinous financial liabilities, forcing dissolutions.

In 1978, Congress attempted to provide some relief by enactment of Section 530 of the Revenue Act of 1978 (a provision which is not codified into the Internal Revenue Code). Section 530 prohibits the Internal Revenue Service from issuing regulations or revenue rulings pertaining to worker classification. It also pro-

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vides safe harbors for businesses that have a reasonable basis for treating certain workers as independent contractors and, if its requirements are satisfied, prohibits the Internal Revenue Service from reclassifying those workers as employees even if such workers otherwise meet the standards for employee classification. Initially, Section 530 was enacted for a limited period pending Congressional action to clarify the definition of employee. When Congressional action failed to materialize, Section 530 was indefinitely extended.

During the recession, the Internal Revenue Service's vigorous and zealous pursuit of employee classification and seeming disregard of public concerns about loss of jobs led to even greater criticism of its policies. The 1995 White House Conference on Small Business listed worker classification as the most significant issue facing small business today. In response to mounting public and Congressional pressure, the Service recently issued four new policies designed to add clarity, fairness and expediency to the resolution of the worker classification issue. Last summer, Congress amended Section 530 to expand its availability to taxpayers. This article will discuss the 20-factor test traditionally relied upon by the Service to make worker classification determinations, the differences in tax liability and compliance obligations that result from an employee or independent contractor classification, and the consequences of an adverse determination. This article will then summarize entertainment industry cases, private letter rulings, the newly issued guidelines for the television commercial production and professional video communications industries as part of the market segment specialization programs, the newly issued training materials used by the Internal Revenue Service to instruct field agents on determining proper worker classification, a new classification settlement program initiated by the Internal Revenue Service, recent expansion of the early referral program to transfer worker classification disputes more quickly to the appeals office of the Service, and significant revisions of Section 530 by The Small Business Job Protection Act of 1996. Finally, this article will summarize the potential impact of these new programs on worker classification determinations.

### *Consequences Of Employer Classification*

A worker is classified as an employee or independent contractor for employment tax purposes under the "common law test" set out in Treas. Reg. § 31.3401(c)-1 (income tax withholding), Treas.

Reg. § 31.3121(d)-1 (FICA) and Treas. Reg. § 31.3306(i)-of the Federal Unemployment Tax Act ("FUTA"). This test generally provides that the relationship of employer and employee 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. It is not necessary that the employer actually direct or control the manner in which the services are performed; it is sufficient if he or she has the right to do so. If the worker is classified as an employee, the following consequences flow:

**FICA.** The worker's wages are subject to tax under the Federal Insurance Contributions Act ("FICA"), which is imposed equally on both the employer and worker under I.R.C.<sup>1</sup> §§ 3102(a) and 3111. Currently, the FICA tax rate is equal to 7.65% for both employer and employee (for combined rate of 15.30%). For 1996, the social security portion of the FICA tax is 6.2% (12.4% combined worker and employer), and is imposed on a taxable wage base of up to \$62,700. The Medicare portion of the FICA tax is 1.45% (2.9% combined worker and employer), and is imposed on all taxable wages and without limitation.

**FUTA.** The employer is subject to tax under the Federal Unemployment Tax Act ("FUTA"), which is imposed at the rate of 6.2% on the first \$7,000 of wages paid to the worker (partially subject to credit for state withholding).<sup>2</sup>

**Income Tax Withholding.** The employer is required to withhold and pay over federal and state income taxes imposed on the worker on the wages paid by the employer.<sup>3</sup>

**Qualified Plans.** The worker is not entitled to maintain his or her own KEOGH or corporate qualified pension plan.<sup>4</sup> The worker may be entitled to maintain an Individual Retirement Account ("IRA") and deduct up to \$2,000 (\$4,000 for spousal IRA effective January 1, 1997) per year.<sup>5</sup> If the worker or the worker's spouse is an active participant in a qualified retirement plan, the deductible IRA amount is phased out to the extent the worker's

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1. Unless otherwise indicated, all references to the Internal Revenue Code or the I.R.C. shall refer to the Internal Revenue Code of 1986.

2. I.R.C. § 3301 (West 1996).

3. I.R.C. § 3401 (West 1996); see Rev. Rul. 92-106, 1992-2 C.B. 258, for tax and withholding obligations imposed on U.S. and foreign employees for U.S. citizens and residents working abroad.

4. I.R.C. § 401 (West 1996).

5. I.R.C. §§ 219, 408 (West 1996).

adjusted gross income exceeds \$10,000. The deduction is totally phased out for single workers whose adjusted gross income equals or exceeds \$35,000, for married taxpayers filing jointly whose adjusted gross income equals or exceeds \$50,000, and for married workers filing separate returns whose adjusted gross income equals or exceeds \$10,000 or more. The employer generally is required to include the worker in its pension plans and other fringe benefit plans available to employees.

*State Taxes.* The employer may be required to withhold and pay state disability taxes from employee wages, make contributions to a state unemployment fund, and withhold and pay over state income tax from the worker's wages.

*Workers' Compensation.* The employer may be required to include the worker in its workers' compensation insurance program. In the case of injury, workers' compensation coverage may produce a lower award than that obtainable under general tort law principles that would apply if the worker was instead classified as an independent contractor.

*Itemized Deductions/Alternative Minimum Tax.* The worker will not be entitled to deduct "itemized miscellaneous deductions" to the extent they do not exceed 2% of the worker's adjusted gross income.<sup>6</sup> Such expenses include travel, transportation and entertainment expenses, and union or professional dues.<sup>7</sup> Miscellaneous itemized deductions are not deductible at all for purposes of computing alternative minimum tax<sup>8</sup> and substantial alternative minimum tax may result in the case of some employees, for example, entertainers who pay large agent fees, business management fees and the like.

An employee is also more adversely affected than an independent contractor by the provisions of I.R.C. §§ 68 and 151(d). Section 68 reduces the amount of certain itemized deductions that an individual may deduct by the lesser of (i) 3% of excess of the taxpayer's adjusted gross income over \$117,950 (\$58,975 in the case of a married taxpayer filing separately), or (ii) 80% of itemized deductions. Section 151(d) phases out an individual's personal exemptions once the taxpayer's adjusted gross income reaches a prescribed threshold (\$117,950 for single taxpayers, \$176,950 for married taxpayer filing jointly, \$147,450 for married taxpayer filing as head of household, and \$88,475 for

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6. I.R.C. § 67 (West 1996).

7. Treas. Reg. § 1.67-1T(a)(1)(i) (1988).

8. I.R.C. § 56(b)(1)(A) (West 1996).

married taxpayer filing separately). The limitation in section 68 and the phase-out in section 151(d) are based on a taxpayer's "adjusted gross income," which will generally be greater for an employee who cannot deduct certain business expenses above the line like an independent contractor can.

### *Consequences of Independent Contractor Classification*

If the worker is deemed to be an independent contractor, the following consequences flow:

**SECA.** The worker must pay tax under the Self-Employment Contributions Act ("SECA") on self-employment income.<sup>9</sup> SECA is now equal to the combined FICA rate, which is imposed for 1996 on employers and employees for a rate of 12.4% on a taxable wage base of up to \$62,700 and 2.9% on all taxable wages without limitation. The worker may deduct one-half of SECA tax paid.<sup>10</sup>

**Estimated Income Tax Payments.** The worker is responsible for making quarterly estimated federal and state income tax payments.

**Qualified Plan.** The worker is entitled to maintain his or her own qualified KEOGH plan<sup>11</sup>, or if the worker is incorporated, a qualified corporate pension plan. This allows the worker to determine how much he or she will contribute to a qualified pension plan, subject to applicable limitations, in contrast to an employee who is subject to the employer's decision. In addition, the amount of the contribution may not be dependent upon the amount that is contributed for other workers as is the case in a plan sponsored by an employer for the benefit of its employees.

**Loan-Out Corporation.** If a loan-out corporation is utilized, the worker is treated as an employee of the corporation and the corporation is required to pay employment taxes and withhold taxes as described above for employees.<sup>12</sup>

### *Motivations To Classify Workers As Independent Contractors*

There are a number of reasons why both employers and workers may prefer that their relationship be structured as an independent contractor relationship. Hiring independent contractors enables the employer to match labor to its business needs and not be encumbered by large, permanent payrolls, simplify

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9. I.R.C. § 1401 (West 1996).

10. I.R.C. § 1401(c) (West 1996).

11. Treas. Reg. § 1.401-10 (1963).

12. See discussion *infra* p.15.

accounting burdens, and avoid union and collective bargaining agreements. Hiring independent contractors further serves to reduce the employers workers' compensation insurance premiums, but may expose the employer to greater liability under general tort liability in the event of injury. From the worker's perspective, he or she may be able to earn greater income working as an independent contractor for multiple employers since his or her compensation is not reduced by the cost of employee benefit plans. In addition, the independent contractor may have greater flexibility in timing tax payments.

### TRADITIONAL IRS TEST FOR DETERMINING CLASSIFICATION

#### *Rev. Rul. 87-41*

The Internal Revenue Service is not bound by the parties' characterization of their relationship and will independently evaluate whether the worker is an employee or an independent contractor. In *Rev. Rul. 87-41*,<sup>13</sup> the Internal Revenue Service set forth 20 factors it traditionally reviewed in making this determination. These factors are:

1. *Instructions or Degree of Control.* An employer generally exercises a much greater degree of supervision and control over the details of the work being done (i.e., to instruct when, where, and how the work is to be done) by employees than by independent contractors.
2. *Furnishing of Training.* An employer generally does not provide any training to independent contractors or to employees of an independent contractor.
3. *Integration.* An independent contractor generally engages in projects that are not a part of the day-to-day operations of the company.
4. *Services Rendered Personally; Right to Delegate Work.* An employee is generally required to render the requested services personally, whereas an independent contractor has the right to bring in whomever he or she pleases to accomplish the purpose of the contract.
5. *Right to Hire, Supervise, Pay and Fire Assistants.* An independent contractor agrees to provide the labor necessary to accomplish the purpose of the contract and has the right to hire, supervise, pay and fire assistants. In contrast, if the person for whom the services are performed has these rights, an employee relationship is indicated.

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13. *Rev. Rul. 87-41, 1987-1 C.B. 296.*

6. *Continuing Relationship.* An independent contractor is generally hired for a specified time period whereas an employee is generally hired for an indefinite period of time.
7. *Control Over Hours of Work.* The employer's right to set the hours worked indicates employee status; independent contractors are generally allowed to set own hours, subject to reasonable requests from the employer, for example, that work not be performed during specified hours.
8. *Independent Trade; Full Time Work.* Where a worker must work full time for the employer for whom services are provided, such person has greater control over the worker's work. An independent contractor is generally not required to work full-time or exclusively for the employer and may work for multiple employers simultaneously.
9. *Place of Work.* Working on the employer's premises indicates employer control and employee status.
10. *Sequence of Work.* An employer does not direct an independent contractor as to the sequence in which the work should be performed; the employer directs only the outcome of the work to be obtained and not the manner in which it is obtained.
11. *Reports Required.* An independent contractor is generally not required to submit regular reports or attend regular company meetings.
12. *Payment by Hour, Week or Month.* An independent contractor is generally paid by the job whereas an employee is generally paid by the hour, week or month.
13. *Payment of Business and/or Travel Expenses.* A worker whose business and/or traveling expenses is reimbursed by the person for whom services are performed is ordinarily an employee, whereas an independent contractor typically bears his or her own expenses.
14. *Furnishing of Tools.* An independent contractor generally provides his or her own tools, whereas an employee is provided tools by the employer.
15. *Investment in Facilities.* Independent contractor status is indicated where the worker has made a significant investment in facilities used in performing services; Lack of an investment in facilities indicates dependence upon the person for whom services are provided and employee status.
16. *Profit and Loss.* An independent contractor generally bears the risk of making a profit or loss on a job, for



example, due to a real risk of economic loss from significant facility investments or through bona fide liability for expenses incurred in performing services. An employee generally does not bear a real economic risk.

17. *Working for More than One Firm.* An independent contractor frequently works for many firms simultaneously.
18. *Making Work Available to the General Public.* A worker who makes his or her services available to the general public on a regular and consistent basis is generally an independent contractor.
19. *Right to Discharge.* As an independent contractor relationship is contractual in nature, an employer cannot terminate an independent contractor who is fulfilling obligations under their contract without incurring liability for breach of contract; in contrast, an employer may terminate an employee at will, absent a written employment contract and subject to limitations under applicable labor and tort laws.
20. *Right to Terminate.* If a worker has the right to terminate the relationship at any time without incurring liability, an employee relationship is indicated.<sup>14</sup>

### Case Law

In determining independent contractor/employee status, in addition to the 20 factors listed in Rev. Rul. 87-41, the courts have frequently considered the following additional factors:

*Skill Required.* A worker is more likely to be an independent contractor if either a special or a high degree of skill is required. Generally, other attributes of independence are present as well. For example, highly skilled workers typically do not receive training, set their own order or sequence for accomplishing the work, are not given detailed instructions, and make their services available to the general public.

*Intent of the Parties.* The mutual, good faith expectations of the parties are evidentiary of the manner in which they deal with each other.

*Custom In the Industry.* The existence of an independent trade, business or profession indicates independent contractor status; generally, in these cases the workers are either highly skilled,

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14. See also, Audit Guidelines for the Entertainment Industry: Important 1040 Issues, IRS MSSP Guide (September 8, 1995); Foreign Athletes and Entertainers, IRS MSSP Guide (February 10, 1995); Audit Guidelines for the Music Industry, IRS MSSP Guide (April 8, 1994).

offer their services to the general public, are not subject to instructions, bear the risk of profit or loss, or some combination thereof.

### SECTION 530 OF THE REVENUE ACT OF 1978

Section 530 of the Revenue Act of 1978, as amended by Section 269 of the Tax Equity and Fiscal Responsibility Act of 1982 and Section 1706 of the Tax Reform Act of 1986,<sup>15</sup> prohibits the Internal Revenue Service from issuing regulations or Revenue Rulings classifying workers for employment tax purposes as employees or independent contractors. It further prohibits the Internal Revenue Service from reclassifying independent contractors as employees in certain limited circumstances. Section 530 provides that if a business:

- did not treat an individual as an employee for any period;
  - filed all tax returns (including Form 1099) on a basis consistent with its tax position for all post-December 31, 1978 tax periods; and
  - had a "reasonable basis" for treating the worker as an independent contractor,
- then the business will not be liable for back taxes or penalties or obligated to withhold employment taxes in the future. For this purpose, "reasonable basis" means:
- reliance on a case or published ruling or technical advice memorandum, private letter ruling or a determination letter pertaining to the taxpayer, that supports the taxpayer's classification.<sup>16</sup>
  - reliance on a previous IRS audit in which the independent contractor treatment resulted in no assessment;<sup>17</sup> or
  - reliance on long-standing practice of a significant segment of the taxpayer's industry in treating workers of the type in question as independent contractors.<sup>18</sup>

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15. Section 1706 of the Tax Reform Act of 1986 amended section 530 to exclude certain technical workers from section 530 relief, including engineers, designers, draftsmen, computer programmers, systems analysts or other similarly situated workers engaged in a similar line of work where the worker provides services pursuant to an arrangement entered into by the taxpayer and another person, e.g. a broker. A technical service worker providing services through a personal service corporation would appear to be subject to this amendment. Section 530 applies only to employment taxes and not with respect to other matters, for example, eligibility to establish a qualified pension plan.

16. See Tech. Adv. Mem. 87-11-004 (Dec. 3, 1986); Tech. Adv. Mem. 82-16-003 (Dec. 28, 1981); and Tech. Adv. Mem. 81-27-010 (Mar. 12, 1981).

17. See *Lambert's Nursery and Landscaping, Inc. v. United States*, 894 F.2d 154 (5th Cir. 1990); Rev. Rul. 83-152, 1983-2 C.B. 172.

18. Rev. Proc. 85-18, 1985-1 C.B. 518, generally discusses the applicability of section 530.

The Internal Revenue Service has taken a very restrictive view as to the scope of section 530 and the breadth of its applicability has been the subject of considerable litigation. In *General Investment Corp. v. United States*,<sup>19</sup> the Service argued that, to obtain section 530 relief, the taxpayer must show that the industry practice in question was nationwide and not only regional. The Ninth Circuit Court of Appeal rejected this view, agreeing with the taxpayer that it need only prove the practice of like companies operating in the taxpayer's immediate vicinity. In Tech. Adv. Mem. 87-33-004 (Apr. 23, 1987), the Service interpreted the phrase "significant segment" to mean "nearly all" and ruled that 60% of similarly situated employers in the applicable area was insufficient. In Tech. Adv. Mem. 87-49-001 (Feb. 10, 1987), the Service ruled that the industry practice safe harbor is not available in the case of a new industry that did not exist in 1978 when section 530 was originally enacted and the industry practice therefore was not "long-standing."

Rev. Proc. 85-18<sup>20</sup> provides that withholding of either income taxes or FICA taxes or the filing of any employment tax return with respect to a worker constitutes "treatment of the worker as an employee" in which case section 530 is not available. This does not include the filing of a delinquent or amended tax return for the tax periods under audit so long as the filing is a result of Internal Revenue Service "compliance procedures." If the taxpayer withholds employment taxes or files employment tax returns for tax periods subsequent to those that were under audit, such actions may constitute inconsistent treatment and section 530 relief will be denied. In *Henry v. United States*,<sup>21</sup> the "consistent treatment" limitation was invoked to deny section 530 relief where the taxpayer began treating its workers as employees following a Service imposed change. The Internal Revenue Service ruled in Rev. Rul. 81-224<sup>22</sup> that the "consistent treatment" requirement precludes section 530 relief if Form 1099 was not timely filed for the worker in question. Treatment of some similarly situated workers as employees and others as independent contractors also violates the consistency requirement.

If a taxpayer does not satisfy one of the safe harbors, the taxpayer may nevertheless qualify for section 530 relief if it can

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19. 823 F.2d 337, 340 (9th Cir. 1987).

20. Rev. Roc. 85-18, 1985-1 C.B. 518, ¶ 3.03.

21. 793 F.2d 289 (Fed. Cir. 1986).

22. Rev. Rul. 81-224, 1981-2 C.B. 197.

demonstrate that another reasonable basis exists for not treating the workers as employees.<sup>23</sup>

Two cases involving truck drivers have been rendered recently which suggest that the long-standing practice in the industry basis for independent classification in Section 530 will be interpreted more leniently by the courts than by the service.

In *IRS v. Joey Bentley*,<sup>24</sup> a federal district court affirmed the bankruptcy court's grant of summary judgment on the independent contractor issue to the taxpayers. The Bentleys operated a trucking company and also supplied drivers for another trucking company. They treated all their workers as independent contractors. After filing for bankruptcy, they contested the Service's proof of claim, which had treated all of the workers as employees. The debtor claimed relief under section 530 of the 1978 Revenue Act, with the only issue being whether they had a reasonable basis for treating the workers as independent contractors, based on "long-standing industry practice of a significant segment of the trucking industry." The court held for the taxpayer based only on the submission of two affidavits. One affidavit was from the debtor and a second was from the debtor's bookkeeper, who testified that about 25 percent of her clientele are truckers, and that quite "a significant number" are hired on an independent contractor basis. The Service submitted a third affidavit from an unrelated trucker, who stated that the trend in the trucking industry was to treat drivers as employees and that he treated his drivers as employees.

He acknowledged, however, that he was aware of owners who treated drivers as independent contractors. The bankruptcy court and the district court concluded that the conflict in the affidavits simply meant that both methods — employees and independent contractors — are used in the industry. The district court further held that, while the taxpayer must offer more than "his own, self-

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23. See *Am. Inst. of Family Relations vs. United States*, 79-1 T.C. (CCH) ¶ 9364 (C.D. Cal. 1979) (holding that a taxpayer is entitled to section 530 relief where it had reasonably concluded that it did not exercise sufficient control over the workers in question to be deemed employees under the common law test); *Priv. Ltr. Rul.* 90-04-040 (Nov. 2, 1989) (acknowledging that a letter from the Social Security Administration provides a reasonable basis for section 530 relief); *but see* *Tech. Adv. Mem.* 89-25-001 (Nov. 21, 1988) (wherein the Internal Revenue Service narrowly read the *American Institute* case) and *Tech. Adv. Mem.* 90-33-003 (May 2, 1990) (wherein the Internal Revenue Service ruled that a written statement by a IRS Revenue Officer, made in connection with a compliance interview, that it was local industry practice to treat a certain type of worker as an independent contractor was not sufficient authority to constitute a reasonable basis for such treatment).

24. 94-2 T.C. (CCH) ¶50,560 (E.D. Tenn., 1994).

serving testimony about industry practice," and while the bookkeeper may even be viewed as the taxpayers' captive witness for this purpose, the undisputed fact that both methods are used, according to the affidavits, including the Service's declarant, meant that by definition a significant segment of the trucking industry does in fact treat its drivers as independent contractors.

The court in *Sanderson v. United States*,<sup>25</sup> used the bankruptcy court decision in *Bentley* in part to grant summary judgment in favor of another trucking enterprise. The plaintiff submitted his own affidavit, as well as sworn statements by others demonstrating a long-standing practice to treat drivers as independent contractors. The plaintiff's own experience also counted. Further, he named others who treated drivers as independent contractors, and also stated that his own drivers, who had worked for other owner-operators, were treated as independent contractors. Finally, he had affidavits from other owner-operators, and his independent contractor agreement had been reviewed by his accountant. The court held for the plaintiff based on the following factors. First, the taxpayer was treated as an independent contractor when he was a driver. Second, the plaintiff's accountant had reviewed the independent contractor agreement (even though that accountant repudiated that endorsement later). Third, the taxpayer "knew of other owner-operators" who treated drivers not as employees. Finally, plaintiff had an understanding of the common law factors that, in his mind, gave him a reasonable basis for treating his workers as independent contractors. The court endorsed every one of these factors, especially "given the liberal construction Congress intended to be given the statute." The court further stated that the relevant "significant segment" of industry practice that had to be evaluated for this purpose was not a national segment, as the government posited, but only "owner-operators." The Small Business Job Protection Act of 1996 revised Section 530 to clarify its application and generally expands the circumstances in which taxpayers will qualify for relief thereunder.<sup>26</sup>

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25. 962 F. Supp. 196 (N.D. Ohio, 1994).

26. The provisions of the Small Business Job Protection Act of 1996 amending Section 530 are discussed in the section entitled Recent Developments, *infra*.

## CONSEQUENCES OF ADVERSE DETERMINATION

### *Employer Liability For Unpaid Employment Taxes And Other Consequences*

If workers treated by an employer as independent contractors are successfully reclassified as employees, the employer is liable for its share of FICA, FUTA, the employee's share of FICA, employee income tax withholding, and applicable state taxes. Interest accrues on unpaid taxes and numerous civil penalties may be imposed, including late filing<sup>27</sup>, failure to deposit employment taxes<sup>28</sup>, negligence or intentional disregard of the rules, understatement of tax<sup>29</sup>, fraud<sup>30</sup>, and aiding the understatement of tax liability.<sup>31</sup>

The employer may also lose favorable tax treatment with respect to retirement or other employee benefit plans it maintains if omission of true employees causes it to violate applicable non-discrimination requirements.<sup>32</sup> Under ERISA, the employees could sue for benefits. On the other hand, if workers are incorrectly classified as employees when they are in fact independent contractors, employee benefit plans could also be adversely affected as not maintained for the "exclusive benefit of employees."<sup>33</sup>

Income withholding taxes and the employee's share of FICA (the so-called "trust fund" taxes), section 6672 penalties and liabilities under I.R.C. §§ 3505 and 3509<sup>34</sup> are not dischargeable in the bankruptcy of an individual debtor but are with respect to corporate and other non-individual debtors.<sup>35</sup> FUTA and the employer's share of FICA are dischargeable for corporate taxpayers and may be dischargeable for individual taxpayers provided

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27. I.R.C. § 6651 (West 1996).

28. I.R.C. § 6656 (West 1996).

29. I.R.C. § 6662 (West 1996).

30. I.R.C. § 6663 (West 1996).

31. I.R.C. § 6701 (West 1996).

32. See, e.g., *Jim's Window Service, Inc. v. Commissioner*, 33 T.C.M. (CCH) 563 (1974); *Dooley vs. United States*, 75-2 T.C. ¶ 13,085 (E.D. Tenn. 1975).

33. See *Professional and Executive Leasing, Inc. v. Commissioner*, 88-2 T.C. (CCH) ¶ 9622 (9th. Cir. 1988).

34. See discussion *infra* pp. 12-14.

35. 11 U.S.C. §§ 507(a)(7)(C), 523(a)(1), 1141; See also *United States v. Sotelo*, 436 U.S. 268 (1978); *Krueger v. Push & Pull Enter., Inc.* (In re Push & Pull Enter., Inc.), 84 B.R. 546 (N.D. Ind. 1988); *Middel v. Jake's on the Pike* (In re Jake's on the Pike), 78 B.R. 461 (E.D. Va. 1987); *In re John Billingsley*, 146 B.R. 775 (Bankr. S.D. Ill. 1992).

required returns were filed and the tax is for a period at least three years prior to the filing of the bankruptcy petition.<sup>36</sup>

### *Responsible Officer Liability - I.R.C. § 6672*

I.R.C. § 6672 imposes a 100% penalty on persons responsible for the willful failure to withhold the employee's income tax and the employee's share of FICA taxes, thereby making them personally responsible for such taxes. Section 6672(b) defines "person" for this purpose to include an officer or employee of a corporation, or a member or employee of a partnership, who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs. In determining who is a "responsible person", the courts seem to look primarily at the following factors:

1. Who had the power to disburse funds, i.e., actually sign or co-sign corporate checks or had the authority to sign checks;
2. Who had responsibility for preparation and payment of the payroll; and
3. Who had final word as to what bills and creditors should and should not be paid.

In determining whether a failure to pay over employment taxes was "willful," the courts have held that neither an intent to defraud or deprive the government of taxes collected, nor a bad motive is required to establish "willfulness." A voluntary, conscious, and intentional act to prefer other creditors of the corporation over the government was held to be "willful" conduct in *Bloom v. United States*.<sup>37</sup> In *Feist v. United States*,<sup>38</sup> the court held that "willfulness" may be proven by "showing that the responsible person recklessly disregarded his duty to collect, account for, and pay over the trust fund taxes or by showing that the responsible person ignored an obvious and known risk that the trust funds might not be remitted." A fear that failure to pay creditors would be a criminal offense under state law did not negate "willfulness" in *High v. United States*.<sup>39</sup>

Under Internal Revenue Service policy, it will look to the corporation first to satisfy the liability for failure to withhold trust

36. 11 U.S.C. § 507(a)(8)(a)(i).

37. 272 F.2d 215 (9th Cir. 1959).

38. 607 F.2d 954 (Ct. Cl. 1979).

39. 506 F.2d 755 (5th Cir. 1975).

fund taxes and, to the extent the corporation cannot pay, only then will it seek payment from the responsible officers.<sup>40</sup>

In a Policy Statement, the Service indicated that it will not impose the section 6622 penalty against non-owner employees who are under the dominion and control of others, and who are not in a position to make independent decisions on behalf of the business entity. In addition, the penalty will not be imposed against a person who was not actively involved in the corporation at the time the tax was not being paid, unless that person intentionally withholds information to impede the Service's investigation. Volunteer members of a Board of Trustees or Directors of a tax-exempt organization will not be subject to the penalty to the extent they serve only in an honorary capacity, do not participate in day-to-day or financial operations of the organization, or do not have knowledge of the failure to pay tax.<sup>41</sup>

Where more than one person is responsible, their liability for unpaid trust fund taxes is joint and several and the Internal Revenue Service may collect from both of them or from only one of them. In *Greiger v. United States*,<sup>42</sup> the court held that the payer could not seek contribution from other responsible persons because I.R.C. § 6672 does not authorize such a claim and the court has no jurisdiction. Other courts have denied contribution on the ground that the section 6672 penalty is a true penalty and allowing contribution would subvert its punitive purpose.<sup>43</sup> However, other courts have viewed the section 6672 penalty as a collection device and allowed contribution.<sup>44</sup> For penalties assessed after July 30, 1996, the Taxpayer Bill of Rights 2 amends Section 6672 to expressly provide a cause of action for contribution from other responsible officers.<sup>45</sup>

### *Third Party Liability Under I.R.C. § 3505*

I.R.C. § 3505(a) provides that a lender, surety, or other person who is not an employer, but who pays wages directly to employees

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40. Internal Revenue Manual MT 1218-56 (February 25, 1976).

41. I.R.C. Section 6672(e)(added by the Taxpayer Bill of Rights 2(P.L. 104-168) and effective on July 30, 1996); IRS Policy Statement P-5-60 (Feb. 2, 1993), Internal Revenue Manual-Administration (CCH), at 1305-14.

42. 78-1 T.C. (CCH) ¶ 9395 (D. Md. 1978).

43. *Conley v. United States*, 773 F. Supp. 1176 (S.D. Ind. 1991); *Marine Bank of Champaign-Urbana v. United States*, 739 F. Supp. 1257 (C.D. Ill. 1990).

44. *Schoot v. United States*, 664 F. Supp. 293 (N.D. Ill. 1987); *Swift v. Levesque*, 614 F. Supp. 172 (C.D. Conn. 1985).

45. I.R.C. 6672(d)(West 1996).



or their agent, is liable for withholding FICA and income tax from the employees' wages.

I.R.C. § 3505(b) further provides that, if a lender, surety, or other person lends funds to an employer for the purpose of paying wages and such person has actual knowledge (or would have had actual knowledge through the exercise of due diligence) that the employer does not intend to collect and pay over FICA and income tax, then the lender, surety, or other person shall be personally liable for such taxes, limited, however, to 25% of the amount of funds provided. The employer is entitled to credit for any taxes collected from third parties under Section 3505.

### *Reduced Employment Tax Liability Under I.R.C. § 3509*

I.R.C. § 3509 provides for reduced employment tax liability to employers where workers are re-characterized from independent contractors to employees if certain conditions are met.

If Form 1099 was filed, the employer's liability is reduced to 1.5% of wages paid to the employee (for income tax that should have been withheld), 100% of the employer's share of FICA, and 20% of the employee's share of FICA. If Form 1099 was not filed, the employer's liability is reduced to 3% of wages paid to the employee, 100% of the employer's share of FICA, and 40% of the employee's share of FICA.

No reduction is allowed where the employer intentionally disregarded its withholding obligations. Moreover, section 3509 does not apply to FUTA, does not permit any adjustment for interest and penalties, and does not apply where the employer withheld income taxes but did not withhold FICA taxes.

### *Abatement Of Tax Under I.R.C. §§ 3402(d); 6521; And Related Provisions*

Under I.R.C. § 3402(d), an employer is entitled to a credit against income tax required to be withheld for taxes actually paid by the employee. However, this section does not provide relief from liability for any penalties or additions to the tax applicable as a result of the employer's failure to withhold.<sup>46</sup> Relief under section 3402(d) does not apply if the reduced tax rates under section 3509 apply.

Section 6521 provides for the mitigation of the effect of the statute of limitations on obtaining a refund of FICA or SECA

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46. Treas. Reg. § 31.3402(d)-1. (1957).

taxes. In other words, if SECA was erroneously paid when the income was employee wages and FICA should have been withheld, then credit shall be given for SECA paid even if a refund of such tax would otherwise be precluded because of the statute of limitations. This type of relief is not available if the reduced tax rates under section 3509 apply.

Section 6205 allows an interest-free adjustment of erroneous payments of FICA and employee income tax withholding (but not FUTA) if the underpayment is corrected at the time the error is ascertained and proper procedures set forth in regulations under section 6205 followed.

If an employer overpays FICA, it typically can receive credit for such overpayment only through adjustment of its FICA liability in future periods. The employer cannot qualify for a refund unless it shows that adjustment is not possible.<sup>47</sup>

### *Controversy Proceedings*

The United States Tax Court does not have jurisdiction over employment tax cases, so an employer is not able to obtain a judicial determination as to the status of workers before paying the tax due. However, employment taxes are deemed to be "divisible taxes" and an employer can pay the assessed tax attributable to a single employee for a single quarter and file a suit for refund based thereon in either a district court or the Claims Court.<sup>48</sup> The Internal Revenue Service typically cross-claims for all employment taxes due.

Refund claims must be filed within the latter of (i) two years after the date of payment of the tax, or (ii) three years after the filing of the tax return.<sup>49</sup> For FICA and employee income tax withholding, the three-year period does not commence until April fifteenth of the succeeding taxable year.<sup>50</sup> A suit for refund cannot be filed until the earlier of (i) receipt of notification that the refund claim has been disallowed, or (ii) the expiration of six months from the date the refund claim was filed. A suit must be filed within two years of the disallowance.<sup>51</sup> A taxpayer can informally request an expeditious disallowance in order to commence a lawsuit.

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47. Treas. Reg. § 31.6413(a)-(2) (1995).

48. See *Flora v. United States*, 362 U.S. 145 (1960).

49. I.R.C. § 6511 (West 1996).

50. I.R.C. § 6513(c) (West 1996).

51. I.R.C. Section 6532(a) (West 1996).

*Loan-Out Corporations In The Entertainment Industry*

An entertainer providing services through a loan-out corporation may avoid classification as an employee of the employer. A loan-out corporation is typically a corporation wholly-owned by the worker ("shareholder-employee") where the shareholder-employee has an exclusive, long-term agreement to provide services to the corporation as the corporation designates. Generally, the ultimate recipient of the shareholder-employee's services contracts with the loan-out corporation and pays all compensation to the loan-out corporation. In turn, the loan-out corporation pays compensation to its shareholder-employee, under the employment agreement, generally zeroing out its income through payments of compensation to its shareholder-employee, contributions to qualified pension plans, and payment of other benefits for the employee and other business related expenses. A variation of this structure in the entertainment industry is the so-called rent-a-star company that has service agreements with a number of artists who may or may not be shareholders.

Historically, a number of benefits were available to loan-out corporations that were not available to individuals, including greater deductible pension plan contributions, ability to defer income through use of a fiscal year, deduction of more fringe benefits such as medical insurance, and lower corporate tax rates. Legislation over recent years have dramatically narrowed these benefits. Loan-out corporations are a form of entity clearly disfavored by both the Service and Congress. A myriad of Congressional enactments and Service theories have sought to limit the benefits derived from this form of entity.

*Attacks On Loan-Out Corporation Structure.*

The Service has employed numerous weapons to attack loan-out corporations. These include: I.R.C. § 269A<sup>52</sup>, I.R.C. § 269<sup>53</sup>,

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52. I.R.C. § 269A provides that, if substantially all of the services of a personal service corporation is performed for one other corporation, partnership, or entity, and the principal purpose for forming the personal service corporation was to obtain some tax advantage not otherwise available, then the Internal Revenue Service can reallocate income and expenses between the personal service corporation and its shareholder-employee to the extent necessary to prevent avoidance or evasion of taxes or to reflect their income.

Section 269A was enacted to reverse the holdings in *Keller v. Commissioner*, 77 T.C. 1014 (1981); *Foglesong v. Commissioner*, 691 F.2d 848 (7th Cir. 1992) *rev'g* 77 T.C. 1102 (1982); *Pacella v. Commissioner*, 78 T.C. 604 (1982); and, *Archiro v. Commissioner*, 77 T.C. 881 (1981). These cases held that the Internal Revenue Service could not apply I.R.C. §§ 269 and 61 and other tax doctrines to corporations

## I.R.C. § 482<sup>54</sup>, Sham Corporation<sup>55</sup>, and Assignment Of Income<sup>56</sup>. The most recent form of attack, and potentially the most serious,

formed to take advantage of tax benefits such as qualified pension plans. Additionally, these cases allowed only limited application of section 482.

The term "personal service corporation" in section 269A is defined as a corporation the principal activity of which is the performance of personal services which are substantially performed by "employee-owners." The term "employee-owner" is defined as any employee who owns, on any day during the taxable year, more than 10% of the outstanding stock of the personal service corporation. The attribution rules of section 318 apply with modification. Prop. Reg. § 1.269A(c) provides a safe harbor and section 269A's sanctions will not apply if the federal income tax liability of each employee-owner is only reduced by an amount which is less than \$2500 and 10% of the employee-owner's hypothetical tax liability absent incorporation. Prop. Reg. § 1.269A-1(b)(6) excludes certain retirement plan contributions from the list of tax benefits associated with the tax avoidance or evasion motive. *See also* Tech. Adv. Mem. 87-37-001 (Apr. 13, 1987). However, the tax benefit derived from retirement plan contributions by a person who would otherwise be classified as an employee that exceed the benefits the person would have been entitled to as an employee is not excluded. Prop. Reg. § 1.269A-1(d)(2)(ii).

53. I.R.C. § 269 provides, in part, that if any person acquires, directly or indirectly, control of a corporation and if the principal purpose for the acquisition was the evasion or avoidance of federal income tax by securing the benefits of a deduction, credit, or other allowance which the person would not otherwise be entitled to, then the Internal Revenue Service may disallow such deduction, credit, or other allowance. Section 269 has been most frequently used by the Service to disregard the acquisition of companies acquired to utilize their net operating losses or to gain multiple surtax exemptions. While section 269 should not have wide applicability to loan-out corporations, it is advisable to stress non-tax reasons for incorporation wherever possible.

54. The Internal Revenue Service has recently attempted to reallocate income from loan-out corporations to their shareholder-employees under I.R.C. § 482. Section 482 allows the Service to reallocate income, deductions, creditors or allowances between two or more organizations, trades or businesses that are commonly controlled by the same interests where necessary to prevent the evasion of taxes or to clearly reflect the income of any of the organizations or trades or businesses.

In *Pauline W. Ach v. Commissioner*, 42 T.C. 114 (1964), *aff'd*, 358 F.2d 342 (6th Cir. 1966), *cert. denied* 385 U.S. 899, the Tax Court allowed reallocation of profits from a personal service corporation involved in dress-making where the shareholder-employee had sold the business to the corporation on a non-recourse basis, did not transfer the intangibles to the corporation, and did not enter into an employment agreement with the corporation. Only profits allocated to her services were reallocated; profits attributable to the efforts of other corporate employees and capital invested by the corporation were taxable to the corporation.

In *Borge v. Commissioner*, 26 T.C.M. (CCH) 816 (1967), *aff'd*, 405 F.2d 673 (1968), *cert. denied sub nom*, *Danica Enter. v. Commissioner*, 395 U.S. 933 (1969), a famous piano player, who had incurred substantial losses in the operation of a poultry business, transferred the poultry business to a newly formed corporation wholly owned by him and at the same time entered into an entertainment contract with the new corporation to provide entertainment services. The Tax Court found that Mr. Borge was engaged in two separate businesses, poultry and entertainment, and that he continued to be separately engaged in the entertainment business. Accordingly, a portion of the entertainment income was allocated to Mr. Borge individually and the remainder was allocated to the corporation.

is illustrated in *Sargent v. Commissioner*,<sup>57</sup>. The Tax Court held that two professional hockey players were employees of their NHL team instead of their loan-out corporations. The Tax Court found that the "team," and not their loan-out corporations, exercised the requisite control under the common law test for determining employees, and compensation paid to their loan-out corporations for the teams were allocable to the players under I.R.C. §§ 61 and 482.

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The question of whether the shareholder-employee is engaged in a trade or business separate from that of his or her loan-out corporation has been the subject of several cases. In *Fogelson*, the court held that an individual who works exclusively for his loan-out corporation does not have a separate trade or business and section 482 does not apply. The Service announced in Rev. Rul. 88-38, 1988-1 C.B. 246, that it will not follow this decision and it adheres to the position that the provision of services by a shareholder-employee to his or her loan-out corporation is separate from the corporation's business of providing services.

55. This was one of the first arguments used by the Service against loan-out corporations - that the corporation was a sham, not a legal entity separate from its shareholder-employee.

Two early cases involved persons involved in the entertainment business - *Fox v. Commissioner*, 37 B.T.A. 271 (1937) (cartoonist) and *Laughton v. Commissioner*, 40 B.T.A. 101 (1939) (actor). These corporations had observed proper corporate formalities and the Board of Tax Appeals concluded that they were validly existing corporations. In *Moline Properties, Inc. v. Commissioner*, 319 U.S. 436 (1943), the Supreme Court held that a corporation is not a sham if it is organized for a legitimate business purpose and is engaged in a substantial business activity.

Since *Moline Properties*, the Service has rarely relied solely on the sham doctrine to avoid recognition of a loan-out corporation, but it has been successful in particularly egregious cases. See *Patterson v. Commissioner*, 25 T.C.M. (CCH) 1230 (1966), *aff'd*, AFTR 2nd 5810 (2nd Cir. 1968) (where the corporation was held to be a sham where it did not conduct business activities, enter into contracts, and performed no function with regard to Mr. Patterson's performances; corporate formalities were not observed; some income was paid directly to Mr. Patterson; and money was generally commingled with Mr. Patterson's own funds). See also, *Lamborn v. Commissioner*, 50 T.C.M. (CCH) 835 (1985); *Kimbrell v. Commissioner*, 371 F.2d 897 (5th Cir. 1967); *Kessler v. Commissioner*, 36 T.C.M. (CCH) 514 (1977).

56. Under I.R.C. § 61, income must be taxed to the person who earned it, regardless of whether he or she actually received it or assigned the rights to receive it to some other person. This has become known as the "assignment of income" doctrine. In the leading case on assignment of income, *Lucas v. Earl*, 281 U.S. 111 (1929), the Supreme Court held that all income earned by the husband would be taxed to the husband, even though the husband and wife entered into an agreement under which all earnings were to be held as joint tenants.

In the case of a loan-out corporation, the basic question is whether the corporation or the shareholder-employee has control over the income-producing activity. To avoid assignment of income, the corporation should be validly formed and operated, all corporate formalities should be observed, the corporation should be the party entering into agreements with third parties, funds should not be commingled, and the corporation should be able to exercise meaningful control over the employee.

57. 93 T.C. 572 (1989).

The Eighth Circuit Court of Appeal reversed the Tax Court's decision.<sup>58</sup> The court rejected the Tax Court's "team" concept and established two factors to look to in determining whether the loan-out corporation, rather than the team, was the true controller of the service provider:

1. The service provider must be an employee of the loan-out corporation, whom the corporation has the right to direct or control in some meaningful sense;
2. There must exist between the loan-out corporation and the service recipient a contract or similar indicator recognizing the loan-out corporation's controlling position.

The Eighth Circuit held that the bona fide, arm's-length contracts between the team and the loan-out corporations provided the requisite control for the players to be considered employees of the loan-out corporations. The court also rejected the assignment of income doctrine by finding valid contracts between the team and the loan-out corporations and between the loan-out corporations and the shareholder-employees.

In an Action on Decision dated October 22, 1991<sup>59</sup> the Internal Revenue Service stated that it will not follow the holding in *Sargent* in other circuits, and it has pursued the *Sargent* theory aggressively in the other circuits. The Service's position in the *Sargent* case is in accord with its position in several private letter rulings and a general counsel memorandum wherein it distinguished the *Keller* and *Fogelson* line of cases on the ground that those cases involved corporations controlled by individuals who were originally self-employed persons as opposed to professional athletes who were employees of a team before forming their loan-out corporations.<sup>60</sup>

The Service scored another victory in the Tax Court in *Leavell v. Commissioner*.<sup>61</sup> Allen Leavell was a basketball player who created a personal service corporation and then executed a Uniform Player Contract (a form prescribed by the National Basketball Association) with the Houston Rockets. The Rockets required Mr. Leavell to sign a "Personal Guarantee by Player" in which Mr. Leavell agreed to be bound by the terms and conditions set forth

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58. 929 F.2d 1252 (8th Cir. 1991).

59. *Sargent v. Commissioner*, 93 T.C. 572 (1989), *action on decision*, 1991-122 (Oct. 22, 1991).

60. See Priv. Ltr. Rul. 88-47-007 (Aug. 23, 1988); Tech. Adv. Mem. 86-24-007 (Feb. 28, 1996); Tech. Adv. Mem. 86-25-003 (Feb. 28, 1986); Gen. Couns. Mem. 39,553 (Sept. 3, 1996).

61. 104 T.C. 140 (1995).

in said contract. The Service sought to reallocate income from his personal service contract to Mr. Leavell, individually, under the theory it espoused in *Sargent*, namely that the Rockets and not Mr. Leavell's personal service corporation exercised such control over the manner in which Mr. Leavell performed his services that the Rockets were his true employer.

The majority in *Leavell* held for the Service. The court listed numerous ways in which the Rockets controlled the manner in which Mr. Leavell performed his services. For example, the contract required the "player" to attend each training camp; play the scheduled games during the regular season; play all scheduled exhibition games; when invited, play in the All-Star game; and, attend every event associated with those games. The contract also required Mr. Leavell to play in all playoff games, report at all times in good physical condition, give his best services and loyalties to the Rockets and agree to give immediate notice of any injury suffered by him and submit to a medical examination and treatment by a physician designated by the Rockets.<sup>62</sup> The court concluded that the requirements evidenced that the Rockets maintained such control over Mr. Leavell that, under the common law test of employee status, he was properly characterized as an employee of the Rockets and not of his personal service corporation. Thus, the compensation paid to his personal service corporation was properly reallocated to him in his individual capacity. The court specifically stated that it did not reach the holding because of any "team sports doctrine" allegedly created in *Sargent* which the Eighth Circuit rejected, but, instead, based its holding on the degree of control exercised by the Rockets over Mr. Leavell.<sup>63</sup>

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62. Additional terms of the contract were highlighted by the court, but their listing would be cumulative.

63. Judge Swift concurred only in the result in *Leavell*. He stated that the analysis should be controlled by the Tax Court's opinion in *Johnson v. Commissioner*, 78 T.C. 882 (1982), *aff'd without published opinion*, 734 F.2d 20 (9th Cir. 1984), which has been used to analyze the issue of the assignment of income between a personal service corporation and its individual owner. Johnson sets forth a two part test for the personal service corporation to be deemed the earner of income: (1) the service provider must be an employee of the personal service corporation which has the right to direct or control in some meaningful sense, and (2) there must exist between the personal service corporation and the service recipient a contract or similar indicium recognizing the personal service corporation's controlling position. Judge Swift concluded that the Johnson test was not satisfied by Mr. Leavell due to the irregularities in the way in which the Uniform Players Contract had been executed by the personal service corporation. He also noted that there was no contract between Mr. Leavell and his personal service corporation and that the Rockets required Mr.

Since Leavell involved a fact pattern in which many aspects of his performance and the manner in which he conducted his public life was subject to regulation and control by the Rockets, it is unclear how broad its application will be and if it will be limited to sports teams. It may have some application to cases with actors who perform on television series, writers for television series and other similarly situated performers, although such workers typically are not subject to the exclusivity required of Mr. Leavell under his contract. It is far less probable that it will have a meaningful impact on cases where the workers do not have ongoing and exclusive arrangements with their employers as athletes on sports teams do.

A Ninth Circuit decision rendered June 9, 1995, renewed the debate on how far courts will respect the corporate entity. *Idaho Ambucare Center, Inc. v. United States*, 1995 U.S. App. LEXIS 14266, considered whether Dr. Crepps, who provided administrative services to Ambucare through his loan-out corporation was an employee of Ambucare<sup>64</sup>. Dr. Crepps was a shareholder and a member of the board of directors of Ambucare. Dr. Crepps' loan-out corporation entered into a management contract with Ambucare wherein Ambucare paid the loan-out corporation \$2500 per month to provide management services. The management contract expressly stated that Dr. Crepps was an independent contractor and was not entitled to employee benefits. The contract was effective for three years and could be terminated by either party on ninety days notice. Dr. Crepps did not have a written employment agreement with his loan-out corporation. As administrator, Dr. Crepps managed the Ambucare facility, oversaw its finances, hired employees, and supervised the scheduling of surgeries. Ambucare did not make the periodic payments to the loan-out corporation as called for under the management contract. Instead, when Dr. Crepps resigned, Ambucare paid it \$59,000 in one lump sum on which it did not withhold employment taxes. The Service assessed these taxes against Ambucare on the basis

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Leavell to sign the personal guarantee. Judge Swift continued, finding that Congress enacted section 269A of the Internal Revenue Code to allow the Service to reallocate income from a personal service corporation to its individual owner if substantially all the services are performed for another entity and if the primary purpose of the corporation was to avoid or evade federal income taxation. He suggested that the Service use this statute to address adjustments involving assignment of incomes in these situations. 104 T.C. at 169-74.

In a dissenting opinion, Judge Laro opined that the Johnson test was the correct test in this case and the Johnson was satisfied. *Id.* at 175.

64. 1995 U.S. App. LEXIS 14266.



that Dr. Crepps was its employee. Ambucare paid the taxes and filed a claim for a refund. The District Court ruled in Ambucare's favor.

In reviewing whether Dr. Crepps was an employee of Ambucare, the Ninth Circuit applied the same two-prong test utilized by the Eighth Circuit in *Sargent* and earlier created by the Tax Court in *Johnson* to evaluate whether Dr. Crepps was an employee or independent contractor:

1. The loan-out corporation must have the right to direct or control in some meaningful sense the activities of the service provider; and
2. There must exist between the loan-out corporation and the entity using the services a contract or similar indicium which recognizes the loan-out corporation's controlling position.

The Ninth Circuit, first noting that no documentary evidence existed that demonstrated that Dr. Crepps was an employee of the loan-out corporation or that the loan-out corporation had the right to control his activities, concluded that the lack of a written agreement between the two is not fatal to the assertion that the loan-out corporation controlled Dr. Crepps. The Court further noted that Dr. Crepps testified that he was employed full time by the loan-out corporation and was never employed elsewhere during that time whereas the Service offered no evidence to the contrary other than its legal argument. Based on this, the Ninth Circuit concluded that it could be said that the loan-out corporation controlled Dr. Crepps. In regard to the second factor, the Ninth Circuit said it needed to look no further than the express language of the management agreement between the loan-out corporation and Ambucare. The Service sought to negate the validity of the management contract on the ground that the loan-out corporation's articles of incorporation stated that it was formed to practice the specialty of anesthesiology. It did not refer to provision of administrative services. The Service argued that Idaho law makes it illegal for a corporation to engage in any activity other than that for which it was formed, Dr. Crepps' loan-out corporation was not formed to provide administrative services, and the management contract violates Idaho law and was invalid. The Ninth Circuit swiftly dispensed with this argument, concluding that the provision of administrative services was incidental to Dr. Crepps' services as an anesthesiologist.

## ENTERTAINMENT INDUSTRY CASES AND RULINGS

### *Historical Cases And Rulings*

Over the years, the Service has issued rulings, and courts have rendered decisions, concerning application of the common law test of employees and workers in the entertainment industry. Summaries of some of the more significant cases and rulings are included below.

In Rev. Rul. 57-155,<sup>65</sup> the Service ruled that the actresses and the narrator were employees of a company engaged in the production of industrial and commercial films. The actresses and narrator were subject to technical instruction by the company; the actresses were paid the prevailing rate at the time; and the narrator was paid at a prescribed rate for narrators or a flat fee.

In *Radio City Music Hall Corp. v. U.S.*,<sup>66</sup> the participants of some 117 different acts under contract with Radio City Music Hall were held to be independent contractors, even though the company required auditions, sometimes required changes in an act, required rehearsals, and furnished the stage, scenery, lighting, orchestral music, attendants, and sometimes costumes. The staging was rehearsed at such times and as many times as directed by the company.

In contrast, the court found in *Ringling Brothers-Barnum and Bailey Combined Shows, Inc. v. Higgins*,<sup>67</sup> that the performers were employees because they were an integral part of the taxpayer's business and had an ongoing and durable relationship with the taxpayer. In Rev. Rul. 68-428,<sup>68</sup> the Service announced that it would follow both *Radio City Music Hall* and *Brothers Ringling* where substantially similar facts exist.

In *Williams v. United States*,<sup>69</sup> an orchestra leader was held to be an independent contractor and not an employee of the establishments where his orchestra performed. The orchestra leader was further held to be the employer of the orchestra members, since he, and not the establishment, had the power to hire and fire the members.

The Supreme Court reached the same result with respect to band leaders in *Bartels v. Birmingham*,<sup>70</sup> notwithstanding an

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65. 1957-1 C.B. 333.

66. 135 F.2d 715 (2nd Cir. 1943).

67. 189 F.2d 865 (2nd Cir. 1951).

68. 1968-2 C.B. 444.

69. 126 F.2d 129 (7th Cir. 1942).

70. 332 U.S. 126 (1947).

express agreement between the band leader and the ballroom operator that the ballroom operator would be the employer for both the band leader and the members of his band so that operator, and not the band leader, would bear the financial burden of employment taxes. The agreement was a standard form developed by the American Federation of Musicians and previously accepted by the Internal Revenue Service. The Court reasoned that the band leader was the person who really exercised control over the members of the band and not the ballroom operator. The band leader organized and trained the band. He selected its members whose relationship with him was ongoing in contrast to their transient relationship with ballroom operators. In addition, the band leader bore the risk of loss or profit after payment of wages to band members and other band expenses.

In Rev. Rul. 68-107,<sup>71</sup> the Internal Revenue Service set forth several situations involving band members and the employment tax consequences of each situation. Essentially, if the band leader exercises the type of control considered in *Bartels*, he will be deemed the employer of the band members notwithstanding an agreement between he and the ballroom operator that the latter will bear the employment tax cost. If the operator is in charge, it will be deemed the employer. If the band itself contracts with the ballroom operator, designates the band leader as the person to negotiate contracts on its behalf, and otherwise operates as a true partner with the leader, then both the band leader and the members of the band will be considered independent contractors.

In Rev. Rul. 55-718,<sup>72</sup> the Service ruled that a disc jockey was an employee of the radio station where he contracted to provide his exclusive services to the station, the station designated the hours and on what programs he worked, the station had the right to use the disc jockey's name for publicity, it controlled the type of material he put on the air, and other indicia of control existed.

Several reported decisions concerning dancers has found them to be employees.<sup>73</sup> The Service agreed in Rev. Rul. 62-157.<sup>74</sup> One commentator has expressed the view that these decisions may reflect that a distinction was drawn based on the control exercised by the operators in order to comply with obscenity laws. Several unreported cases have apparently reached the

71. 1968-1 C.B. 427.

72. 1955-2 C.B. 411.

73. See *Filipidis v. United States*, 71-2 T.C. (CCH) ¶ 9734 (4th Cir. 1971); *T.L. Squared, Inc. v. United States*, 74-1 T.C. (CCH) ¶ 9260 (S.D. Ohio 1974).

74. 1962-2 C.B. 216.

opposite conclusion and held that go-go dancers were independent contractors.

In Rev. Rul. 56-694,<sup>75</sup> the Service ruled that photographers were employees of a corporation engaged in the business of taking home portraits. The corporation would sell coupons for home portraits and would advertise for photographers to go take the pictures purchased through the coupons. The photographers were given instructions as to the methods of operation and required to follow a set pattern of poses for each age groups. A company representative would occasionally accompany the photographer to insure that its policies were being observed. The photographers reported to the corporation weekly and were paid on a piece-meal basis. The corporation furnished the film and envelopes for exposed film, but the photographers furnished their own transportation, facilities and camera equipment.

Of particular significance are the so-called "lend a star" rulings issued by the Service in 1974. In Rev. Rul. 74-330,<sup>76</sup> the Service set forth examples to illustrate the tax consequences of contracts between a U.S. producer and a U.K. corporation for the performance of services by a foreign entertainer (referred to therein as a "single loan-out" arrangement).

In example (1), "E", a U.K. entertainer, is sole owner of "UKC", a U.K. personal service corporation, with whom E has an exclusive employment contract. UKC negotiates a contract with "X", a U.S. person, to provide E's services within the U.S. E can veto the terms of the contract; UKC pays E a percentage of monies paid X to UKC and keeps the remainder as a commission fee; X requires E's services and requires that E guarantee all contracts with UKC; X furnishes E with costumes; E performs services on X's premises and under X's control. The Internal Revenue Service ruled that UKC is only E's agent. E is an employee of X and, under applicable treaty provisions, E's income is taxable in the U.S. and subject to withholding under I.R.C. § 3402. UKC's commissions are business profits which are not taxable under the U.S./U.K. treaty so long as UKC does not maintain a permanent establishment in the U.S.

In example (2), E does not own stock in UKC, but the nominal shareholders of UKC receive only token dividends since most of UKC's profits are paid out to E in salary and bonuses. E assumes most of the risk of loss through personal guarantees. The Internal

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75. 1956-2 C.B. 694.

76. 1974-2 C.B. 278.

Revenue Services reaches the same conclusions as to the tax consequences as in example (1).

In example (3), UKC has numerous entertainers who are residents of the U.K. and nonresident aliens of the U.S. under exclusive long-term contracts. The entertainers own no stock in UKC. UKC contracts with X for the services of E. X requires E to sign and guarantee its contact with UKC. X pays UKC a salary for E's services in accordance with salaries paid by X to other entertainers of E's stature. E receives a fixed salary from UKC and UKC retains a fee for services performed by E. E performs services for X and is under X's control. The Internal Revenue Service ruled that E is an employee of X rather than UKC and is subject to tax in the U.S. and subject to withholding under I.R.C. § 3402. The fees retained by UKC are not subject to U.S. tax under all applicable treaty provisions so long as UKC does not maintain a permanent establishment in the U.S.

In example (4), UKC is a motion picture production company and has a number of entertainers under exclusive contract to render services for it in exchange for a fixed salary. The entertainers own no stock in UKC and have no veto power over loan-out contracts negotiated by UKC. During a period in which UKC does not need E's services, it loans E out to X for a fee. E continues to be paid by UKC and is subject to the control and direction of UKC. Here, the Internal Revenue Service ruled that E is an employee of UKC even while on temporary loan-out to X. E's salary is therefore exempt from U.S. tax under a provision of the U.S./U.K. treaty (which exempts compensation paid U.K. residents who are in U.S. for less than 183 days and are paid by U.K. employers). Fees paid UKC are exempt from U.S. tax under the business profits exemption in the treaty.

Rev. Rul. 74-331, 1974-2 C.B. 282, sets forth examples to illustrate the tax consequences of contracts between a U.S. producer, a Channel Islands corporation, and a U.K. corporation, for the services of a foreign entertainer (referred to therein as a "double loan-out" arrangement).

In example (1), "E" is an entertainer resident of the U.K. and a non-resident alien in the U.S. E is the sole shareholder of "CIC", a Channel Islands corporation, with whom E has an exclusive employment contract. E may veto any arrangement proposed by CIC. CIC, as agent for E, contracts for the performance of services by E with "UKC", a U.K. corporation which may be either related or unrelated to CIC and which does not maintain a permanent

establishment in the U.S. UKC, as agent for CIC, contracts with "X", a U.S. person, for E's services. X pays UKC. UKC deducts its agency fee and remits the balance to CIC which in turn deducts an agency fee and pays the balance to E. The Internal Revenue Service ruled that E is not an employee of either CIC or UKC as neither of them has the right to control E in the performance of his services. The fee retained by CIC is subject to 30% withholding since it, as a Channel Islands corporation, is not covered by the U.S./U.K. treaty. The fee retained by UKC is exempt under the business profits provision of the treaty. E is an employee of X and subject to U.S. tax and withholding.

In example (2), CIC functions as E's managing agent. E has an exclusive personal service contract with UKC, an unrelated U.K. corporation, which contract runs for a substantial period of time and requires UKC to pay E a fix salary. E does not have veto power over any loan-out arrangement entered into by UKC and UKC is responsible for providing E with make-up, scripts, and the like. UKC contracts with X for the loan out of E's services in the U.S. UKC retains the right to control E's performance, X pays UKC the fee for E's services, and UKC pays a fee to CIC for services rendered. The Internal Revenue Service ruled that E is UKC's employee and his compensation exempt under the U.S./U.K. treaty. UKC is exempt from U.S. tax as business profits under the treaty as E's performance of services in the U.S. does not amount to a permanent establishment.

In example (3), E is the sole shareholder of CIC with whom E has an exclusive employment contract that runs for a substantial period of time and requires CIC to pay E a fixed salary. E has not retained any veto power over loan-out arrangements that CIC may enter into. CIC contracts with UKC for the personal services of E. Neither E nor CIC own any shares of UKC. UKC, as agent for CIC, negotiates a contract with X for E's services to be performed in the U.S. E continues to receive his fixed salary from CIC; X pays 1,000x dollars to UKC, and UKC pays 950x dollars to CIC keeping 50x dollars as its fees. The Internal Revenue Service ruled that the fee retained by UKC is exempt as business profits under the U.S./U.K. treaty. E is an employer of CIC and, by virtue of E's performance of services in the U.S., CIC is engaged in a trade or business in the U.S. although not through a permanent establishment. Since CIC is not covered by a tax treaty and since E controls CIC, X must withhold tax of 30% on the full compensation paid less UKC's fee. (The regulations under § 1441 regarding withholding generally exempt income for services performed by a

foreign corporation except where the person performing services owns more than 25% of such corporation).<sup>77</sup>

### *Recent Private Letter Rulings.*

Recent private letter rulings are informative of the Service's view of the issues and application of the common law test, at least prior to implementation of its new programs. In Priv. Let. Rul. 91-26-006 (Mar. 27, 1991)<sup>78</sup>, the Service ruled that outside photographers were employees and not independent contractors under the following facts. In addition, the company was not entitled to relief under section 530.

In this ruling, the company was in the business of providing photographers for "special events." The owner and the owner's brother performed some of the photography but mainly relied on outside photographers. To the extent other employees did photographic work, they were treated the same as the outside photographers. The outside photographers were not trained by the company but would accompany an experienced outside photographer to a special event before receiving an assignment of their own. The experienced outside photographer received extra compensation for training and supervising new outside photographers. Otherwise, the outside photographers were not supervised.

Services performed by outside photographers were performed in the name of the company but the photographers were not

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77. In Priv. Ltr. Rul. 86-14-021 (Dec. 31, 1985), the Service considered the following facts: "A", a citizen and resident of the U.K., entered into an employment contract with "M", a U.K. corporation, for A's services as a director of stage, television and motion picture productions. M pays A a fixed salary plus bonuses and, in addition, grants A option rights to purchase publicly trade stocks owned by M which represent the bulk of M's profits for a minimal price. M enters into a standard motion picture industry contract with "X", a U.S. producer, for A's directing services. A must deliver the complete film within six months of completion of principal photography. A may render all post-production services in the U.K. (subject to cost and scheduling constraints). Pre-production activities occurred in both the U.K. and U.S. and production was done in the U.S. It was represented that neither A nor M had a permanent establishment in the U.S. The Service concluded that A was not an employee of M and instead M was A's agent. Further, A was acting as an independent contractor and the income received by A under this agreement was excluded from U.S. tax under the U.S./U.K. treaty provision exempting compensation payments to independent contractor. The income received by M was excluded under the business profits exemption under the treaty. See also, Priv. Ltr. Rul. 85-21-062 (Feb. 26, 1985); Priv. Ltr. Rul. 84-26-060 (Mar. 27, 1984); Priv. Ltr. Rul. 83-39-012 (Jun. 23, 1983); Priv. Ltr. Rul. 82-49-047 (Sept. 8, 1982); Priv. Ltr. Rul. 81-37-115 (Jun. 18, 1981).

78. See Priv. Ltr. Rul. 93-47-018 (Aug. 25, 1993)(ruling that a photographer employed by a municipal government was an employee); Priv. Ltr. Rul. 91-23-010 (Mar. 5, 1991)(ruling that a musician who worked part time for an orchestra was an employee).

required to wear company identification. Generally, an outside photographer would advise the company periodically of his or her availability and what types of events he or she were willing to shoot. A client could request a particular photographer or advise that a particular photographer was not acceptable. If the outside photographer had to cancel an event, he or she sometimes found their own replacement and other times the company did. The company did not have the right to discharge an outside photographer once signed up but could only refuse to retain the photographer again.

The outside photographer provided his or her own camera equipment and transportation but the company provided film and development of the film. Typically, the outside photographer was compensated on the basis of saleable frames but occasionally was paid a flat fee or percentage of pictures sold. The company handled the selling, customer complaints, and determined the price of the photographs. The outside photographers were required to sign a covenant not to compete where they agreed not to perform similar services for customers of the company for five years after they quit working for the company.

The Service ruled that the outside photographers were employees on the following grounds:

1. They were integral to the company's business;
2. They performed services for the company which had to be performed personally and, if the services must be rendered personally, presumably the recipient controls the method by which the services are performed as well as the results;
3. A continuing relationship existed between the company and the photographers, the Service concluding that the 5 to 7 events the average photographer worked in a single year to be "continuing";
4. The outside photographers did not have a financial investment in the matter;
5. The covenant not to compete limited the outside photographer's ability to perform services for other persons, one of the indicia of independent contractors;
6. Section 530 relief was not available as asserted by the taxpayer based on a New York state case and an Illinois state case as such cases did not involve the interpretation of federal employment tax laws;
7. The Service would not rule whether the safe harbor of long-standing recognized practice in the industry was



available because this was a question of fact to be determined by the District Director.

Furthermore, the Service ruled that a graphic artist was an employee of an art studio under the circumstances described below.<sup>79</sup>

The graphic arts studio provided illustration, design, and production services. The graphic artist provided the studio with the commercial art services that the studio offered to others through sales representatives. The studio was in effect a for-profit match-maker providing salespeople with something to sell, artists with jobs to do and a place to do them, and relieving all parties of the burdens of paying rent, maintaining full supply cabinets, and keeping up with bookkeeping, billing, and fee collections.

The studio had treated all its artists and salespeople as employees and guaranteed them a regular salary. However, new ownership revised the studio's method of doing business and changed its treatment of its graphic artists from that of employees to independent contractors, contracting with these workers under an "Association Agreement," drafted by the studio.

Salespeople established the fees charged by the studio for each job, often without consultation with the graphic artist. Although the graphic artist was required to report the number of hours devoted to any assigned project, the graphic artist generally received no more than a flat fee per project. If the necessary time needed to complete a project had been miscalculated and the salesperson quoted a job at a flat rate, the graphic artist was still required to the job for his percentage of the rate initially set. When the graphic artist was the sole artist assigned to a project, the artist was paid 47-1/2% of the amount the studio receives from the client. However, if the studio failed to collect payment from the client, the graphic artist had no recourse against the studio. Thus, unsatisfactory work was not paid for by the studio.

The studio remitted payment to the graphic artist on the 15th and the 30th of each month. Although the studio reported that it had no policy or practice of making "advances," it had loaned money to workers pending completion of a job. Workers reported these "loans" are repaid by the studio deducting those amounts from payments due to the workers.

The majority of the work was done on premises leased by the studio, where the studio provided all reasonably necessary space,

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79. Priv. Let. Rul. 93-32-002 (Apr. 9, 1993).

utilities, support help, and tools. The studio also paid one half of the graphic artist's medical, dental, and disability insurance and awarded a Christmas bonus when profits allowed. If the graphic artist was present but without work to do provided by the studio, the artist was free to do other free-lance work on the studio's premises. In the event, the cost of any of the studio's supplies used by the artist on work not acquired through the studio had to be reimbursed to the studio.

The "Association Agreement" provided that it would automatically renew as each new job was accepted by the artist, although the studio offered no guarantee as to a specific work volume or specific dollar amount. The agreement further stated that the studio had the right to retain the services of other artists, but the artist was not allowed to take an outside work that interfered with the timely completion of any current job assigned by the studio or that would compete against the studio. Generally, the artists kept regular hours at the studio since the studio usually gave assignments to artists on site when the job was received. When the artist was not involved in an art project, the studio on occasion asked him to gather or produce reference materials for jobs assigned to other workers, pick up or deliver art materials, answer the studio telephones on a back-up basis, and make coffee.

In ruling that the graphic artist was an employee, the Service focused on the following factors:

- a. A continuing and highly integrated relationship existed between the artist and the studio;
- b. The studio, through its clients, issued highly detailed instructions to the artist;
- c. The studio required the artist to submit regular written reports concerning the time the artist spent on each project;
- d. The studio, and not the artist, had a significant investment in facilities, furnished all necessary tools and materials, and could realize a profit or suffer a loss;
- e. By demanding that the artist give preference to the studio's interests, the studio restricted the artist from performing services for others.
- f. By generally requiring the artist to be present to be assigned work, the studio set hours for the artist and further interfered with the artist's freedom to set his own schedule

In Priv. Let. Rul. 91-31-017 (Apr. 30, 1991),<sup>80</sup> the firm was in the business of publishing computer manuals and the writer was engaged to write and edit such books. The writer was not given any training or instructions by the firm and was not supervised or controlled in the performance of his services. He was engaged to perform and complete a particular job only and was not required to follow a routine or schedule established by the firm. He reported to the firm periodically by telephone to report on the status of his project. He did not furnish a time record to the firm but billed them based on the number of hours spent working on a project or the number of words. The writer provided all his own materials, equipment, and supplies, including three computers, software, and general office supplies. The writer incurred expenses for telephone calls, overnight delivery services, mail, and travel and was reimbursed by the firm for overnight mailing, copying, and telephone expenses. It was understood that the writer would perform his services personally, and he did not hire any individuals to assist him or perform the services for the firm on his behalf.

The writer performed his services for the firm at his own office in his home. He was paid either an hourly rate or on a piecework basis, depending upon the type of work done. He was not guaranteed a minimum amount of pay and was not allowed advances against future earnings. He did not receive any benefits such as a pension, paid vacations, paid sick days, or bonuses. The firm did not carry worker's compensation insurance on the writer and did not deduct federal income tax or social security taxes from his pay. The writer performed his services for the firm on a part-time basis and performed services for other businesses on a part-time basis as well. The firm did not have priority on the writer's time and did not prohibit him from performing similar services for others. The firm retained the right to discharge the writer at any time without incurring any liability. The writer performed his services for the firm under his own business name. He represented himself to the public as being in the business to perform similar services for others but did not advertise in the local telephone directory or trade journals. The writer was represented by the firm as a freelance writer and editor rather than as an employee of the firm. The writer did not have a financial invest-

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80. This ruling was issued at the request of the writer and was based solely on information provided by the worker. The Service requested information from the employer but none was provided.

ment in a business related to the performance of his services for the firm and thus did not assume the risk of realizing a profit or incurring a loss. Under these circumstances, the Service ruled that the writer was an independent contractor. The Service stated that its ruling applied to all workers who perform similar services under similar circumstances for the firm, although directed only to the writer to whom it is addressed.

In Priv. Let. Rul. 91-29-011 (Apr. 17, 1991), the firm was engaged in the business of publishing books and magazines while it employed a writer. The firm employed the writer on a full-time basis as a senior writer in one of its book divisions. Under the common law rules applicable in determining the employer-employee relationship, the writer was an employee of the firm with respect to the performance of his full-time duties.

On occasion the writer would enter into written contracts with one of the firm's magazine divisions to write an article. These contracts could be entered into either because the writer proposed an idea for an article to an editor in that magazine division and the editor accepted the idea or because the editor requested the worker to write an article on a specific topic and he agreed. The written agreement required the firm to pay the writer either by the word or by the page for the finished article. The firm could reject the article submitted by the writer and pay a kill fee of ten percent of the amount that would have been paid for an acceptable article. The writer agreed to indemnify the firm if the article violated any copyright laws or rights of third parties.

Work performed pursuant to a contract such as the one described in the preceding paragraph was referred to as free-lance work. Firm policy prohibited the writer from doing free-lance work during normal working hours; it also stipulated that the free-lance work should not conflict with overtime requests that the writer's supervisor might make of him. Firm policy also prohibited the writer from using firm resources — secretarial help, assistance from other firm personnel, telephone lines, or copying and printing equipment or supplies — in the performance of the free-lance work. The writer followed the firm policies and performed all the free-lance work at home. The writer performed similar free-lance work for other publishing companies. The firm imposed the same restrictions on free-lance work performed for other companies as it did for free-lance work performed for divisions within the firm. The writer was not required to accept offers of free-lance work from editors in other divisions of the firm, and

his rejection or acceptance of free-lance work had no bearing on his standing with respect to his full-time duties.

The Service ruled that the arrangement for the writer in this case to perform free-lance work was similar to the arrangement under which the outside readers performed their work in Rev. Rul. 69-224. In both cases the worker was not supervised in the actual performance of the work, the firm either accepted or rejected the finished work product, and if it accepted the work product it paid the worker a set fee for the work regardless of the number of hours spent performing the work. In addition, the writer in this case was free to perform free-lance work for other companies just as the outside readers were free to perform similar services for other companies.

The free-lance work performed by the writer in this case had little connection to his full-time duties. The restrictions imposed with respect to free-lance work performed within the firm were the same as those imposed with respect to free-lance work performed outside the firm. Because of the lack of connection between the arrangement for the writer's performance of his full-time services and the arrangement for his free-lance work, the writer's status as a full-time employee had little bearing on his employment status with respect to the free-lance work he performed for the firm. Because of his independence from the control of the firm in the performance of the free-lance work, the writer was an independent contractor with respect to the performance of such services for federal employment tax purposes, even though he was an employee with respect to the full-time duties he performed.

### *Non-Tax Cases*

The employee/independent contractor distinction also comes up in non-tax cases, which, while not directly bearing on the issue of tax liability, are illustrative of other justifications for employee classification.

In *Community For Creative Non-Violence Et Al v. Reid*,<sup>81</sup> the Supreme Court ruled that Reid, a sculptor hired by the Community for Creative Non-Violence ("CCNV") to produce a statue dramatizing the plight of the homeless for display at a 1985 Christmas pageant in Washington, was an independent contractor and the sculpture was not a "work for hire" within the mean-

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81. 490 U.S. 730 (1989).

ing of the Copyright Act of 1976. Reid worked on the statue in his own studio. Representatives of CCNV visited him on a number of occasions to check on his progress and to coordinate Reid's construction of the sculpture's base in accordance with the parties' agreement, and Reid accepted most of CCNV's suggestions and directions as to the sculpture's configuration and appearance. Using the common law test for classification of employees, the Supreme Court concluded that Reid was an independent contractor since he was a sculptor, a skilled occupation; he supplied his own tools; he worked in his own studio in Baltimore, making daily supervision of his activities from Washington practicably impossible; he was retained for less than two months, a relatively short period of time; during and after this time, CCNV had no right to assign additional projects to defendant; apart from the deadline for completing the sculpture, Reid had absolute freedom to decide when and how long to work; Reid was paid a sum dependent on "completion of a specific job, a method by which independent contractors are often compensated;" he had total discretion in hiring and paying assistants; creating sculptures was not a regular business for CCNV; and, finally, plaintiff did not pay payroll or Social Security taxes, provide any employee benefits, or contribute to unemployment insurance or workers' compensation funds.

In *Ed Marco Photography v. Accent Publishing Co., Inc.*,<sup>82</sup> Marco photographed jewelry for Accent Magazine, a monthly trade journal for the costume jewelry industry in 1990. Accent Publishing Co., Inc. had engaged Marco on the basis of his portfolio, without a written contract and without negotiation concerning copyright or licensing. Accent supplied the jewelry and the props, sketched the shots, and retained the right to have Marco reshoot unsatisfactory photographs. Accent did not name Marco on the magazine's masthead. Marco had ten years of experience, a Bachelor degree in photography, made images for about six consecutive issues of the magazine and then for one or two later issues. Marco shot the pictures in his own studio on his own time, subject to Accent's deadlines. For the most part, he worked on still-lives, without anyone from Accent present. On a few occasions, however, Accent provided live models. In this case, Accent's art director would pose the models, although the exact scope of the art director's control at the live sessions was disputed, it was agreed that he did not become involved in the technical aspects of the photographs. Marco did not receive an hourly wage or periodic salary

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82. 969 F.2d 1547 (3d Cir. 1992).

but was compensated on a per photograph or per issue basis. Accent reimbursed Marco's film and processing expenses. Accent did not withhold taxes or pay employee benefits. In remanding the case to the lower court to determine whether the photographs by Marco were "works for hire" within the meaning of the copyright laws, the court concluded that a magazine publisher's regular practice of commissioning photographs of its own conception does not create an employment relationship with an experienced photographer. The court emphasized Marco's experience by showing that he uses his own equipment, works at his own studio on days and times of his choosing without photography assistants hired by the publisher and he receives payment without income taxes withheld, without employee benefits from the magazine, and works for discrete assignments rather than for hourly or periodic work.

In *Johnson v. Berkofsky-Barret Productions*,<sup>83</sup> the court held that an actor who was injured during the production of a television commercial was limited to workers' compensation for his injury. The court looked to the following facts: the production company had the right to terminate the actor at will without cause; acting in commercials is typically done under the direction of another; the actor did not supply tools, employ workers, or provide the production facilities; the actor was paid on a time basis and not on a per job basis; the actor had not invested in any equipment or materials; and making commercials was an integral part of the production company's regular business. In contrast, in *Von Beltz vs. Stuntman, Inc.*,<sup>84</sup> the court held that a stunt person was not an employee or a special employee of the director's loan-out corporation because the stunt person retained substantial control over the details of the stunts to be performed.

In *DIC Animation City, Inc. and Animation Writers of America*,<sup>85</sup> the NLRB ruled that freelance animation writers were not employees within the meaning of the National Labor Relations Act because DIC did not substantially control the manner and means of the writing process due to the following factors: the writer created the story idea, the premise, the outline and the script; the writer determined where and when to work and owned the equipment used; the writer determined whether to write stories as part of the team and whether to form and work through a

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83. 211 Cal. App. 3d 1067 (Cal. Ct. App. 1989).

84. 207 Cal. App. 3d 1467 (Cal. Ct. App. 1989).

85. 295 N.L.R.B. 989 (1989).

loan-out corporation; and the writer negotiated the number of scripts, residuals, royalties, and work on future series.

### RECENT DEVELOPMENTS: IRS GUIDELINES ON TELEVISION COMMERCIAL PRODUCTION WORKERS

As part of its market segment specialization program, the Internal Revenue Service began several years ago working with industry representatives for a number of different industries to formulate guidelines for classifying workers as independent contractors or employees within their given industry.<sup>86</sup> On May 16, 1994, after several years of negotiation with industry associations, the Service issued the first of these guidelines for workers in the television commercial production and professional video communications industries.<sup>87</sup> The guidelines are an attempt by the Service to provide some meaningful guidance to the determination of employee/independent contractor classification without running afoul of the section 530 prohibition against issuing regulations and Revenue Rulings. The guidelines purport to be a nonbinding, safe harbor test and not a replacement for the 20-factor test.<sup>88</sup> Specifically, the Guidelines state that their purpose is "to enable examiners to make accurate and consistent determinations of employee/independent contractor status."

The guidelines are derived from the 20-factor test; however, they limit the factors to be evaluated to the factors that are directly relevant to the commercial production and professional video communication industries and add others factors that are not expressly listed in the 20-factor test. The guidelines first divide the different jobs involved in commercial production into three distinct categories and then prescribe factors for each job category that must be evaluated to determine proper classification.

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86. These guidelines are a part of the Service's effort begun in 1988 to reorganize its compliance strategies around market segments. The Service is developing market-specific training manuals for its agents to hone their expertise in specific industries. For a discussion of this program, see Guttman, *News Analysis: The Market Segment Specialization Program*, 62 TAX NOTES 1493 (Mar. 21, 1994).

87. IRS Handbook, "Classification of Workers Within The Television Commercial Production and Professional Video Communications Industries."

88. See section titled *Traditional IRS Test For Determining Classification*. The Internal Revenue Service is currently working on worker classification guidelines for other industries.



### *Job Categories.*

Category One includes jobs involving overall planning or implementation of the commercial and/or video production. Category Two includes jobs involving planning, design or implementation of specific aspects of the commercial and/or video production, and jobs involving both problem solving and technical skills. Category Three includes all other jobs.

Category One workers typically have substantial responsibilities in addition to appearing at the location where the actual commercial is filmed ("the shoot"). Examples of such workers are directors, producers, writers, music composers, directors of photography, art directors, casting directors, location scouts, production designers, and set designers.

Category Two workers typically have some responsibilities away from location of the shoot, but these are a lesser percentage of their overall responsibilities than is the case with Category One workers. These include animators, audio technicians, costume designers, editors, engineers, graphic artists, hair stylists, key gaffers, key grips, lighting directors, and make-up artists.

Category Three workers include boom operators, camera assistants, camera operators, gaffers, grips, and teleprompter operators.<sup>89</sup>

### *Critical Factors*

Under the Guidelines, there are three "critical" factors in determining whether a worker is an employee or an independent contractor. If any one of the three critical factors is present, the worker will be classified as an employee. If all three critical factors are absent, the Guidelines state that four "significant" factors are then to be evaluated. The Guidelines state that while no one of the significant factors is determinative, their presence or absence will generally differentiate between employees and independent contractors. A third group of factors bear the least weight and generally are not applicable to determine worker status.

The three critical factors are: (1) whether the employer and worker have a continuing relationship; (2) whether the employer trains the worker; and (3) whether the employer makes contribu-

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89. A more exhaustive list and description of Category One, Two and Three workers is included as Exhibit B to the Guidelines.

tions to a guild or union benefit plan on behalf of a worker who is not providing services through a loan-out corporation.

The continuing relationship factor recognizes that in the commercial production industry, workers typically work on a project-by-project basis. The guidelines summarize the reasons for this type of employment in this industry due to the subtle differences in experience required by various projects, the use of different locations for different projects, and the difficulties in worker availability caused by the inherently sporadic flow of work in the industry. A worker's relationship is considered continuing if he or she is hired for an indefinite period rather than for a specific project of finite duration. If a worker is hired for a series of project, whether the relationship is continuing depends on the true relationship between the worker and the employer. The guidelines advise examining agents to review the terms of any written contract, ascertain whether the worker was paid for time not spent on a specific project (suggesting indefinite employment), whether the worker has worked for other companies (suggesting finite employment), and whether the employer has hired other workers for the same job (suggesting finite employment).

The training factor recognizes that there is no economic incentive for an employer to incur the cost of training workers whose employment is not continuing. Accordingly, employer training presupposes a continuing employment relationship.

The guild or union benefit payment factor assumes that contributions can be made to such plans solely on behalf of employees under the Taft-Hartley Act.<sup>90</sup> The guidelines take the position that the definition of "employee" for tax purposes is the same as the definition for purposes of the National Labor Relations Act, but they expressly fail to address the treatment of workers who provide services through loan-out corporations.<sup>91</sup>

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90. 29 U.S.C. § 186(c)(5)-(8) (West 1996).

91. The Service is currently reviewing the effect of contributions made to a guild or union plan by a producer on behalf of a worker who is providing services through a loan-out corporation. Many practitioners have asserted that such workers are employees, albeit of their loan-out corporations, and accordingly the Taft-Hartley requirement is met. The Internal Revenue Service has not yet taken a position on this issue. The dominant purpose of the Taft Hartley restriction is to combat "corruption of collective bargaining through bribery of employee representatives by employers . . . extortion by employee representatives, and . . . the possible abuse by union officers of the power which they might achieve if welfare funds were left to their sole control." *Walsh v. Schlecht*, 429 U.S. 401 (1977), *citing*, *Arroyo v. United States*, 359 U.S. 419 (1959).

### *Significant Factors*

Under the Guidelines, if a worker is not deemed an employee by presence of one of the critical factors, the four significant factors are then evaluated. None of the factors is solely determinative of worker status and each factor is given different weight for the three different categories of jobs.

The first significant factor is establishment of a business presence, or whether the worker has taken steps to establish a business presence over and above merely being available to render personal services. A business presence may be established by an office away from home, shoot location and production company; by having a professional agent who markets the worker's services to the public for compensation; by maintaining books and records for his or her business separate from personal records; by using preprinted invoices, stationary, or business cards with a business name or logo; by having a separate business telephone number; by advertising his or her availability for work; and by a federal tax employer identification number.

The second significant factor is whether the worker incurs a risk of loss in his or her business activities. For example, does the worker have a significant investment in tools and equipment necessary to perform the worker's activities on the project, such as specialized computer software, professional camera equipment and trucks for transporting other equipment. Does the worker incur significant business expenses in performing the worker's activities, such as expenses for tools, training, liability insurance and employee wages. Expenses that are subject to reimbursement by the production company can be taken into account if the worker advances funds and bears the credit risk that reimbursement may not be made and the worker incurs other expenses in addition to the reimbursable expenses. Method of payment is also relevant to determining whether the worker has a risk of loss. Payment of a fixed fee out of which unreimbursed expenses must be paid evidences a risk of loss. "Day rate" payments that approximate hourly wages evidence employee status.

The third significant factor is control over worker activities not involved in the shoot. An employer's right to exercise control over the worker when the worker is not at a shoot indicates employee status. However, direction and control over the timely completion of sequential tasks are to be disregarded since some jobs must be completed before others in the production process.

Employer control over the worker's preparation for the shoot and

the order in which the worker completes his or her job is indicative of employee status. A requirement that the worker report to a specific location even though the job could be done at any location indicates employee status. Requiring that the worker maintain specific records is indicative of employee status. This does not include bid forms and invoices or other forms used by the worker to transact business.

The fourth significant factor is instructions at the job site. Since direction at a shoot is essential to a successful production, the Guidelines state that the degree of instructions at the shoot location is frequently not an important factor. Where it may be relevant, examining agents are instructed to determine whether the instructions given are limited to the results to be achieved or are regarding the method of accomplishing the result.

### *20-Factors Not Applicable*

Some factors in the 20-factor test set forth in Rev. Rul. 87-41, are deemed to be not generally applicable in determining worker status.<sup>92</sup> Generally, these factors are to be considered only if the factors described above are inconclusive. These factors include: working for more than one employer (entertainment industry workers typically work for more than one employer); working full time (the worker may be working full time for an employer on a particular day but will work for other employers shortly thereafter); preparation of reports (the only reports generally required are for time and expense reimbursement); right to discharge (the fact that discharge of a worker could disrupt the schedule of numerous other workers tends to nullify the effect of the right to discharge); right of a worker to terminate services (his or her termination would disrupt the production schedule and damage the worker's reputation and marketability); integration (the integration of numerous skills are required to produce a commercial or video); and requirement that services be rendered personally (a person's style, artistry, or expertise is frequently the basis for their employment).

### *Three Step Analysis*

There are three steps in analyzing whether a worker is an employee or an independent contractor under the guidelines:

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92. See outline of the 20-factor test *supra* pp. 5-8.

- (1) Determine whether the worker fits into Category One, Two or Three based on the worker's primary function;
- (2) Determine whether a critical factor is present; if even one critical factor is present, the worker will be treated as an employee;
- (3) If no critical factor is present, determine whether the worker meets the significant factors analysis; if the worker meets the significant factors relevant to his or her job category, then he or she is an independent contractor; if the worker does not satisfy the requisite number of significant factors relevant to his or her job category, then the worker is an employee. For this purpose, the significant factors relevant to the job categories are as follows:
  - (a) Category One: the worker must satisfy both the business presence and risk of loss significant factors to be classified as an independent contractor;
  - (b) Category Two: the worker must satisfy the significant factors as workers in Category One plus the significant factor of control over activities not involved with the shoot to be classified as an independent contractor;
  - (c) Category Three: the worker must satisfy all of the significant factors as for Category Two workers plus the significant factor of instructions at the job site to be classified as an independent contractor.

### *Example*

The guidelines include one example of their application. Joe has a sole proprietorship, Joe's Grip Service. He owns some tracks, dollies and other equipment used in providing grip services and a truck used to haul the equipment. Joe works out of his house, but has a separate business telephone line. He is hired as key grip by a production company that sees his advertisement in a trade publication for a two-day project. Three other grips will be working for Joe. Joe and the three grips are paid at hourly rates. Joe does not receive any training from the company and it will not make guild benefit plan contributions on his behalf.

Before the shoot, Joe meets with the director of photography at the company's facility to determine the equipment needed and how it will be used. Other than these meetings, Joe determines the time, place and sequence of his preparatory activities, such as renting additional equipment and hiring the other grips. At the shoot location, he closely follows the instructions of the director

and director of photography. After the job is concluded, he submits an invoice on preprinted stationary bearing the logo for Joe's Grip Service and showing his federal identification number. He is not required to submit any other reports.

Joe is deemed to be an independent contractor based on the following analysis. As a key grip, he is a Category Two worker. Accordingly, the fact that he receives detailed instructions at the shoot location is not taken into account. There is no critical factor present since there is not a continuing relationship between him and the production company, the company does not provide training to him, and the company does not make guild benefit plan contributions on his behalf. He also satisfies the significant factors relevant to Category Two workers. He has established a business presence since, even though he works out of his house, he advertises, has preprinted invoices, uses a separate business telephone line, and obtained a federal identification number for his sole proprietorship. Joe bears a risk of loss since he has significant equipment and business expenses, which may include paying employees. However, the guidelines indicate that, even if the production company pays the three grips working under Joe's supervision directly, Joe still bears a risk of loss due to the equipment and his other expenses. Finally, even though Joe must attend meetings with the director of photography at the company's facility, he otherwise controls the time, place and sequence of the overwhelming portion of his activities not involved with the shoot and he is not required to submit any reports other than invoices.

### *Limitations*

The guidelines caution that documentation, such as an independent contractor agreement between the worker and the employer or the filing of Forms W-2 or 1099 are not determinative of the worker's classification. In addition, section 530 relief may be available in some cases. With respect to loan-out corporations, the guidelines refer to Sargent and the Service's non-acquiescence in the case, implying that a loan-out corporation will not necessarily preclude the worker from being classified as an employee of the production company. The guidelines do state that use of a loan-out corporation will not negate independent contractor status if the worker would otherwise qualify as one. Finally, the guidelines note that they do not apply to workers employed by other types of entertainment companies, such as feature film production companies, network television program production companies, and

music video production companies. Many practitioners nonetheless anticipate that agents in the field will solely look to the guidelines in evaluating the status of workers in such other segments of the entertainment industry.

*Are The Guidelines An Improvement Over The 20-Factor Test?*

Under the 20-factor test, the worker's classification is not determined by any single factor. All of the factors are weighed and balanced and, if factors evidencing independent contractor status outweighs those evidencing employee status, the independent contractor status prevails. The weight that each factor is given varies from case to case, depending on the particular circumstances, and no guidance is available for determining the proper weight of each factor.

In an attempt to provide more certainty, the guidelines narrow the number of factors that will be given any weight at all and then effectively gives each relevant factor a weight of 100% since each are deemed critical to independent contractor classification. Even the so-called "significant factors" preclude independent contractor status if each one pertinent to the job category in question is not satisfied.<sup>93</sup> Accordingly, there is no real weighing or balancing of the relevant factors and the test in the guidelines is much more rigorous than that of the 20-factor test.

The guideline's narrowing of the factors to be evaluated to only those relevant to the commercial production industry is a sensible and welcome advance to the analysis. However, the guideline's rule that each of the chosen factors is critical in and of itself without any consideration of the predominance of any other factor may well preclude independent contractor status when such status is clearly appropriate. For example, an animator might be hired by a production company due to the animator's reputation for creating captivating and original cartoon characters. Since an animator is a Category Two worker, to be classified as an independent contractor the animator must meet the three so-called critical factors - continuing relationship, training, and guild benefit plan contributions - and three of the so-called significant

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93. It is not clear why the Guidelines refer to the significant factors as "significant" and not "critical," since the failure to satisfy even one significant factor precludes independent contractor status as much as failure to satisfy a "critical" factor. In reality, Category One workers must satisfy five critical factors, Category Two workers must satisfy six critical factors, and Category Three workers must satisfy seven critical factors.

factors - business presence, risk of loss and control over activities not involved with the shoot. However, even if the animator had a substantial business that included significant equipment and a number of employees, advertised extensively in trade publications, and all of the other factors, if the animator was taught to use a computer program preferred by the production company, he conceivably could be deemed an employee due to employer training. In view of rapid technological advances that are utilized in film production on an ever increasing basis, the possibility that some limited training will occur is significant. While the Guidelines state that, in the event a worker fails a critical factor and would be deemed an employee under the guidelines, the 20-factor test can then be invoked and independent contractor/employee status alternatively evaluated under that test, many practitioners question the likelihood that an agent of the Internal Revenue Service will actually be willing to apply the alternative test once one or more of the critical or significant factors under the guidelines has not been met.

The guidelines also misfire in their attempt to add certainty to the independent contractor/ employee analysis. For example, a continuing relationship between a worker and production company is considered critical and the presence of such a relationship causes the worker to be classified as an employee. If the worker is hired for an indefinite period, the worker is an employee. However, the converse apparently does not indicate independent contractor status and no clear guidance is provided on whether a relationship is continuing.<sup>94</sup>

Virtually every other factor suffers from considerable uncertainty. For example, what type of training and how much training is required before it becomes "critical" under the guidelines? Similarly, when do recommendations about how a worker does his or her job become instructions violative of the guidelines? What type and amount of expenses are required for a worker to bear a risk of loss? Perhaps the factor capable of the greatest certainty is the payment of guild benefit plan contributions. Generally, it will be possible to determine whether a payment was in fact made.

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94. The Guidelines state:

If the worker is working on a specific project with a finite duration, the worker may be either an employee or an independent contractor and the analysis should continue. The mere fact that a worker has worked on a series of projects does not mean that the worker has been hired for an indefinite period. In such a case, the examining agent should try to ascertain the true relationship between the company and the worker.



But even this factor is not completely devoid of question marks, particularly when services are provided through a loan-out corporation. This factor may allow independent contractor status only for non-union workers.

### *Classification Settlement Procedure*

Perhaps the most significant of the new developments is the new classification settlement procedure ("CSP") adopted by the Internal Revenue Service on March 5, 1996, which is designed to help taxpayers resolve their employment tax disputes without a protracted administrative or legal battle. As recognized in a Fact Sheet on the CSP issued by the Service, current administrative procedures do not permit examiners to weigh the likelihood of success in court when proposing adjustments. Accordingly, taxpayers seeking relief on the classification issue, including Section 530 relief, generally must take their case to the Internal Revenue Service Appeals Office or to the courts, which increases the cost for both taxpayers and the government. Further, the delayed resolution typically causes a significantly greater potential liability since interest on any resulting deficiency continues to accrue.

The CSP is effective immediately and will be tested for two years. Under CSP, agents in the field must offer the program to taxpayers undergoing an employment tax audit. Participation in a CSP by a business is totally voluntary, the business may accept a CSP offer at any time during examination, and the business may qualify for more than one CSP offer if it has workers in different categories. A business declining a CSP offer will retain all rights to administrative appeals and judicial review currently available.

Depending on the taxpayer's level of compliance with reporting requirements and other factors set out in Section 530, the total assessment of taxes under a CSP offer could be between 25 and 100% of the tax liability for one year. If all of the conditions set out in Section 530 are met, no assessment will be made.

The settlement that the Internal Revenue Service will offer will depend upon the degree of the taxpayer's compliance with the following three requirements for full relief under Section 530:

1. **Reporting Consistency:** All federal tax returns (including Form 1099 and other information returns) required to be filed by the taxpayers with respect to the worker for the period in question, must have been filed by the business on a basis consistent with the business' treatment of the worker as not being an employee;

2. **Substantive Consistency:** The business must have consistently treated similarly situated workers as independent contractors.
3. **Reasonable Basis:** The business must have had some reasonable basis for not treating the worker as an employee, which may include reliance on a judicial decision, published ruling, private ruling or technical advice memorandum issued to that taxpayer, "no change" audit in the past, or long standing recognized practice of a significant segment of the industry. Any other reasonable basis can suffice.

If the business meets the Section 530 reporting consistency requirement but either does not clearly meet the substantive consistency requirement or reasonable basis test, the offer will be a full employment tax assessment for the one taxable year under full examination computed under the favorable rates of IRC Section 3509 if applicable. (Under Section 3509, if the business properly filed Form 1099 for the workers it treated as independent contractors, then liability for withholding of income tax will not exceed 1.5% of the wages paid to the workers and liability for the workers' share of FICA will not exceed 20% of the amount of FICA tax due. Section 3509 relief is not available if the business did not file Form 1099's as required, withheld income tax but not FICA, or otherwise failed to comply with Section 3509.) The business must agree to prospectively classify its workers as employees.

If the business meets the reporting requirement and has a colorable argument that it meets the substantive consistency requirement and reasonable basis test, the offer will be for 25% of the employment tax liability for the audit year, computed under the favorable rates of Section 3509 if applicable. The business must agree to prospectively classify its workers as employees.

Where the business meets the reporting and substantive consistency requirements and the reasonable basis test, Section 530 will have been satisfied and no assessment will be made. The business may continue treating its workers as independent contractors. Notwithstanding compliance with Section 530, if the business wishes to treat its workers as employees, it may do so by treating the workers as employees currently or at the beginning of the next year. It will not forfeit its claim to Section 530 relief for prior years by doing so.

Generally, the examiner will develop the facts for a single year and consult with the examination group manager. If an offer is made and accepted by the business, the parties will sign a CSP

closing agreement based on a standard closing agreement provided by the Internal Revenue Service National Office.

The CSP program is not without its interpretative difficulties which may lead to less generous offers than many taxpayers and tax practitioners will think appropriate. For example, the question of whether independent contractor status is supported by a long-standing practice of a significant segment of the industry - one of the reasonable basis safe harbors - has frequently been a hotly contested issue. The requirement that "similarly situated" workers must have been consistently treated as independent contractors is also open to subjective evaluation. Nevertheless, since a CSP offer must be made to those taxpayers who filed Form 1099's when required and since the offer may not exceed one year's liabilities, this program should still offer many taxpayers a significantly less expensive settlement alternative than currently available. For taxpayers who have not filed Form 1099's for their workers, the CSP program will not be an option.

### *Early Referral to Appeals*

The early referral procedure was made public in Announcement 96-13, IR-96-7. The Internal Revenue Service will apply the provisions of Revenue Procedure 96-9, 1996-2 IRB 15, to employment tax issues for a one-year test period beginning March 18, 1996. Its purpose is to resolve employment tax issues more expeditiously by simultaneous action by the District and the Appeals Office, even when other issues remain under examination at the District level. Early referral is optional, must be initiated by the taxpayer, and is subject to approval of the district director and the assistant regional director of appeals. The request for early referral must be made in writing to the case manager. Once the case is approved for early referral, the District will write a report identifying the disputed issues and explaining the District's position. The taxpayer will have 30 days to respond in writing to the District's report. The 30 day response period can be extended in the discretion of the case manager. If the taxpayer fails to respond within the 30-day period and any extensions thereof, if any, the taxpayer's request for early referral will be considered withdrawn and the case returned to the district. This will not adversely affect the taxpayer's normal administrative appeal rights.

The taxpayer's response to the district's report will generally serve the same purpose as an Appeals protest and established Appeals procedures, including those related to taxpayer confer-

ences, will apply. If agreement on disputed issues is reached at appeals on issues that do not affect subsequent years, a Form 2504 or 2504 AD Partial Agreement, will be entered into. If the settlement is complex or affects subsequent years, a closing agreement will generally be entered into.

### *Training Manual*

On August 2, 1996, The Internal Revenue Service released the final version of its training manual on worker classification for its internal use in training employment tax specialists and revenue officers on this issue.<sup>95</sup> By its terms, the Manual "is designed specifically for training purposes only. Under no circumstance should the contents be used or cited as authority for setting or sustaining a technical position."

The Manual first points out that the applicable test is the common law test of control, i.e., whether the employer has the right to control not only the result to be obtained but also the means and details by which that result is obtained. In other words, the right to control not only *what* work will be done but also *how* it will be done. The Manual seeks to identify, simplify and clarify the 20-factor test first set forth in Revenue Ruling 87-41, and reduce the rigidity of its application by pointing out that not all factors are relevant to the question in a specific case; there are no magic number of factors that should be evaluated; there are factors in addition to the 20 factors that may be important; and that relevance of the specific factors changes over time because business relationships change over time. The Manual emphasizes that the 20-factor test is not the legal test for determining employment status (the legal test being the common law test of control), but is only an analytical tool.

The Manual makes at least a modest attempt to change the bias toward employee classification that today seems an integral part of the Internal Revenue Service fabric. The Manual points out that revenue officers and specialists must remember that the result of a worker classification examination can be *either* that the worker is an employee or is an independent contractor. A finding that "no change" is required, the trainees are informed, should not be viewed as indicative of a problem in the examination process; numerous "no change" audits may instead reflect a problem with the criteria and process used to select returns for audits rather

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95. "Employee or Independent Contractor?", IRS Training Manual 2230-102 (7-96), 96 TNT LEXIS 153-35.

than a problem with the examination process and results. Internal Revenue Service employees are required to consider Section 530 relief even if the taxpayer does not raise it. In addition, the Internal Revenue Service is obligated to furnish the taxpayer with a summary of Section 530 at the outset of the examination.

The Manual divides the primary categories to be evaluated into (i) behavioral controls, (ii) financial controls, and (iii) relationship of the parties. The criteria discussed in the Manual do not supersede the 20 factors set out in Revenue Ruling 87-41, 1987-1 C.B. 296, which are traditionally reviewed by the Internal Revenue Service in evaluating worker classification, but attempts to clarify and modify the Internal Revenue Service's application of some of the factors. The discussion below will describe the factors modified or clarified by the Manual. A complete list of the 20 factors in Revenue Ruling 87-41 is contained in the section entitled "Traditional IRS Test for Determining Classification."

### *Behavioral Controls*

*Instructions.* Under Revenue Ruling 87-41, instructions or the degree of control exercised by the business is viewed as a significant factor in applying the common law test to worker classification. Generally, an employer exercises a much greater degree of supervision and control over the details of the work being done (i.e., to instruct when, where and how the work is to be done) by employees than by independent contractors.

The Manual describes the giving of instructions as one of the behavioral controls that illustrate whether the employer has a right to direct or control how the worker performs the specific task for which he or she is hired. Instructions may include how to do the work, when to do the work, where to do the work, what tools or equipment to use, what employees to hire to assist with the work, where to purchase supplies and services, and how to receive compensation. Suggestions do not constitute the right to control. For example, a requirement that the worker obtain the business's prior approval before taking certain actions is one type of instruction that suggests employee classification. In contrast, a suggestion that the worker take a specific route to avoid traffic congestion does not. The Manual points out, however, that less extensive instruction concerning what should be done but not how it should be done may be consistent with independent contractor status. For example, if work can by its very nature be done only at one place or at a specified time, instruction about time or place is

equally consistent with employee and independent contractor status. Instructions imposed to comply with governmental or governing body regulations are to be disregarded.

The Manual specifically deals with the requirement that a worker wear a business uniform or other identification or is required to place the business' name on the worker's vehicle. While this type of requirement was historically viewed as an instruction evidencing employee status, the Manual states that in today's environment where concerns about safety are paramount, a uniform or placement of the business' name on a vehicle is a neutral fact.

*Furnishing of Training.* Revenue Ruling 87-41 recognizes that an employer generally does not provide any training to independent contractors or to employees of an independent contractor.

The Manual affirms that periodic or ongoing training about procedures to be followed and methods to be used indicate an employment relationship. The Manual distinguishes a short orientation or information session about the employer's policies, new product line, or new government regulations and voluntary programs attended without compensation, which the Manual states are not evidentiary of either status.

Where the employer lacks the knowledge and skills to train or instruct a worker on how to do his or her job (occupations that exemplify this are lawyers, accountants, doctors, engineers, computer specialists), the Manual provides that an employment relationship may nevertheless be present. In this case, control over financial aspects of how the task is to be performed is particularly important. The Manual further states that the absence of the need to control because of the simplicity of the work is not indicative that the worker is not an employee.

*Evaluation Systems.* Revenue Ruling 87-41 observes that an independent contractor is generally not required to submit regular reports or attend regular company meetings. The Manual acknowledges that evaluation systems are used by virtually all businesses to monitor the quality of work performed by all workers, whether independent contractors or employees. Internal Revenue Service employees are instructed to look for evidence of how the evaluation system may influence the worker's behavior in performing the details of the job. If an evaluation system measures compliance with performance standards concerning the details of how the work is to be performed, the system and its enforcement

are evidence of control over the worker's behavior. The lack of a formal evaluation system is a neutral fact.

### *Financial Controls*

In evaluating financial controls, the Manual lists the following items as ones that usually need to be explored: significant investment, unreimbursed expenses, availability of services to the public, method of payment, and opportunity for profit or loss. The Manual expressly rejects the question of whether the worker is economically dependent on or independent of the business for which services are performed as a relevant factor. Since most people work out of economic necessity and only independently wealthy workers would ever be able to establish that he or she was not economically dependent on the work, it is hard to figure why the Internal Revenue Service ever thought this was a defining factor. Now this fatuous test is expressly rejected.

*Investment in Facilities/Furnishing of Tools.* Under Revenue Ruling 87-41, independent contractor status is indicated where the worker has made a significant investment in facilities and/or tools used in performing services; Lack of an investment in facilities and/or tools indicates dependence upon the person for whom services are provided and employee status.

In determining whether the worker has a significant investment, the Manual states that there are no precise dollar limits that a worker must meet. It cautions revenue officers to insure that the investment has substance. For example, if the worker leases equipment from the business without any significant ongoing liability, the worker's investment may be lacking in substance.

The Manual provides that in determining whether the worker has made a substantial investment, an investment in items that can be used for personal as well as business purposes is less persuasive than items suitable for only business use. The Manual stresses, however, that a significant investment is not necessary for independent contractor status where the type of work simply does not require costly equipment or tools. Moreover, even if costly equipment or tools are required, the equipment or tools may be rented from a third party.

*Payment of Business and/or Travel Expenses.* Revenue Ruling 87-41 provides that a worker whose business and/or traveling expenses are reimbursed by the person for whom services are performed is ordinarily an employee, whereas an independent contractor typically bears his or her own expenses. The Manual

recognizes that independent contractors today frequently contract for reimbursement of specific expenses. The Manual therefore directs Internal Revenue Service employees to focus on unreimbursed expenses, which bear directly upon the opportunity to make a profit or loss. Fixed ongoing costs incurred regardless of whether work is being performed is deemed especially important.

*Payment by Hour, Week or Month.* The manner of payment is identified as a significant factor in Revenue Ruling 87-41. An independent contractor is generally paid by the job whereas an employee is generally paid by the hour, week or month.

In the Manual, the importance of the method of paying the worker is reaffirmed since it affects whether the worker has the opportunity for profit or loss. A salary or hourly wage evidences employee status whereas a flat fee evidences independent status. Commission-based workers may be either and the extent of expenses incurred by the worker is important in evaluating commission paid workers.

*Profit and Loss.* Revenue Ruling 87-41 provides that an independent contractor generally bears the risk of making a profit or loss on a job, for example, due to a real risk of economic loss from significant facility investments or through bona fide liability for expenses incurred in performing services. An employee generally does not bear a real economic risk. Significant investment, business expenses and method of payment generally combine to determine the worker's ability to realize a profit or loss. The Manual states that this is probably the strongest evidence that a worker controls the business aspects of the work.

*Making Work Available to the General Public.* Revenue Ruling 87-41 affirms that a worker who makes his or her services available to the general public on a regular and consistent basis is generally an independent contractor. The Manual affirms the importance of making services available to the general public. The Manual notes that independent contractors often advertise, maintain a visible business location, and make themselves available to work for the relevant market. Nevertheless, in today's world many independent contractors do not advertise or maintain a visible business location. When working on a single, long-term contract, the contractor may not make him or herself available to the general market. Accordingly, the Manual states that the absence of these types of activities is neutral.



### *Relationship of the Parties*

The Manual explains that the parties' relationship to each other is more difficult to evaluate in determining the right to direct and control than are factors relating to behavioral and financial controls. The Manual points out that in some court cases these factors have been important and even decisive.

*Written Contracts.* While written contracts specifying that the relationship between the parties is independent have been held significant by some courts, the Manual states that a contractual designation in and of itself is not sufficient evidence to determine worker status. Nevertheless, a contract may be relevant evidence of method of payment, who bears expenses, and the like. In addition, where it is difficult or impossible to determine the employment status of a worker, the Manual states that the intent of the parties as reflected in a contract is an effective way to resolve the issue.

*Forms W-2.* The Manual notes that filing a Form W-2 generally indicates the parties' belief that the worker is an employee. The Manual acknowledges that some workers have succeeded in obtaining independent contractor status notwithstanding the filing of a Form W-2.

*Incorporation.* The Manual states that the corporate form is generally recognized for both state law and federal law, including federal tax, purposes and that disregarding the corporate entity is an extraordinary remedy, applied by most courts only in cases of clear abuse. Thus, the worker who has a personal service corporation will generally not be treated as an employee of the business, but as an employee of the corporation. The Manual then adds a very significant caveat. It states that the fact that a worker receives payment for services from a business through the worker's corporation does not automatically require a finding of independent contractor status with respect to those services, citing the *Sargent* and *Lovell* cases.

*Employee Benefits.* The Manual states that providing a worker with employee benefits traditionally has been associated with employee status. If a worker is excluded from a benefit plan because the worker is considered not to be an employee, the exclusion is relevant to determining the worker's status, although not conclusive. However, if the worker is excluded from the plan on some other basis, the exclusion is not relevant.

*State Law Characterization.* The Manual states that state laws, or determinations of state or federal agencies, on employee

status should be disregarded since the laws or regulations may use different definitions of employee or be interpreted to achieve particular policy objectives. For example, the definition of "employee" is often broader for workers' compensation and unemployment benefits than the common law test.

*Right to Discharge/Right to Terminate.* As an independent contractor relationship is contractual in nature, Revenue Ruling 87-41 provides that no employer cannot terminate an independent contractor who is fulfilling obligations under their contract without incurring liability for breach of contract; in contrast, an employer may terminate an employee at will, absent a written employment contract and subject to limitations under applicable labor and tort laws. If a worker has the right to terminate the relationship at any time without incurring liability, an employee relationship is indicated.

The Manual recognizes this factor as one of continuing relevance but states that it should be used with considerable caution. The Manual notes that businesses rarely have complete flexibility in discharging employees, either because of applicable laws on unlawful termination, employment contracts, or other limitations. As a result, the inability to freely discharge a worker no longer constitutes persuasive evidence that the worker is an independent contractor. Moreover, independent contractors frequently enter into short-term contracts for which nonperformance remedies are not appropriate or may negotiate limits on their liability for non-performance and employees may be sued for failure to perform the services for which they were engaged. As a result, the presence or absence of limits on a worker's ability to terminate the relationship, by themselves, no longer constitutes useful evidence in determining worker status. On the other hand, a business's ability to refuse payment for unsatisfactory work continues to be characteristic of an independent contractor relationship.

*Permanency.* Courts have historically viewed the existence of a permanent relationship as relevant to determining an employment relationship. An indefinite relationship is typically viewed as indicative of an employment relationship. The Manual concludes that a relationship that is long-term, but not indefinite, is a neutral fact that should be disregarded. It also concludes that a temporary relationship is also a neutral fact. While this has been viewed as indicative of independent contractor status, the Manual acknowledges that temporary work is also common to seasonal or "as-needed" employees.

**Integration.** Revenue Ruling 87-41 cautions that an independent contractor generally engages in projects that are not a part of the day-to-day operations of the company. In other words, an independent contractor generally is not involved in the actual production of the primary product sold by the business. Instead, an independent contractor will provide other services or construct facilities used by the employees engaged in the actual production.

The Manual states that where services provided are a key aspect of the regular business, it is more likely that the business will direct or control the relationship.

### *Factors Less Relevant Today*

The Manual describes several factors contained in Revenue Ruling 87-41 as of lesser importance today.

**Place of Work / Sequence of Work.** Under Revenue Ruling 87-41, working on the business premises indicates employer control and employee status. An employer does not direct an independent contractor as to the sequence in which the work should be performed; the employer directs only the outcome of the work to be obtained and not the manner in which it is obtained.

The Manual recognizes that whether or not work is performed on the business's premises, or at a location designated by the employer, often has no bearing on worker status. In many cases, work can be provided only at one location. In other cases, work can be performed at many locations, especially with the emergence of modems, computer networks, and similar equipment and new work procedures such as telecommuting to boost employee morale, and work off site does not necessarily indicate independent contractor status. The Manual states that this factor will most likely be relevant where the worker has his or her own business office or location, which will probably have been taken into account in determining the worker's investment, unreimbursed expenses, and opportunity for profit and loss.

**Hours of Work.** The same reasoning applies to hours worked. Some work must by its nature be performed at a specific time, while modern communications have increased the ease of performing work outside of normal business hours. In today's world, flexible hours can be consistent with either employee or independent contractor status.

### *Section 530*

The Manual discusses application of Section 530 at length and much of the discussion takes positions recently reversed by The Small Business Job Protection Act of 1996. For example, the Manual confirms the Internal Revenue Service's position that, before Section 530 can be evaluated and applied, it must first be determined that the workers are employees and not independent contractors. The Internal Revenue Service reasoned that Section 530 simply does not apply to independent contractors. This has placed businesses in the untenable position of having to concede employee classification before the Internal Revenue Service will consider their entitlement to relief under Section 530, a provision greatly disfavored by the Service and infrequently applied. The Manual states that the taxpayer need not concede or agree to the determination that the workers are employees in order for Section 530 relief to be available.

The Manual states that, if a taxpayer is under audit and starts filing payroll tax returns on workers it previously treated as independent contractors for periods after the audit, the taxpayer will be deemed to be treating the workers inconsistently and will not be entitled to Section 530 relief. This also confirms prior Internal Revenue Service policy, which put taxpayers in the untenable position of having to choose between limiting their exposure for future periods by reclassifying the workers as employees and waiving possible Section 530 relief or continuing treating the workers as independent contractors and increasing their potential liability. Another provision in the Manual states that Section 530 relief may be granted for years that a business treated workers as independent contractors even though it begins treating them as employees.

The Manual provides that a prior audit, even if the issue of classification is not raised, can be reasonable reliance for Section 530 purposes.

With respect to the industry practice safe harbor, the Manual clarifies that the relevant market is the market the taxpayer competes in. The Manual further states that a practice is presumed to be "long-standing" if it has existed for 10 years or more. The Manual does note, however, that the industry practice safe harbor applies to industries that came into existence after 1978, the year Section 530 was enacted.

The Manual sets out other circumstances that may amount to reasonable reliance under Section 530. Reliance on the advice of

an attorney or accountant may constitute a reasonable basis. State and non tax federal administrative actions or determinations may constitute reasonable bases if they use the same common law rules that apply for federal employment tax purposes and the state or non tax federal agency interprets the rules similarly. A reasonable interpretation of the common law test may amount to reasonable basis even if ultimately found to be erroneous. Prior audit of a predecessor, or a private ruling or technical advice memorandum issued to a predecessor, that operated the same business may be found to constitute reasonable basis. A showing of good faith will not in and of itself suffice for Section 530 relief. Some of the guidance in the Manual on Section is now obsolete due to amendments to Section 530 by The Small Business Job Protection Act of 1996 (P.L. 104-188), discussed below.

*Amendments to Section 530 by The Small Business Job Protection Act of 1996*

As stated above, Section 530 of the Revenue Act of 1978 provides employers who treat certain workers as independent contractors a safe harbor and prohibits the Internal Revenue Service from reclassifying such workers as employees. Generally, this section allows employers to treat workers as independent contractors for employment tax purposes ( but not income tax purposes) regardless of the individual's actual status under the common law tax where the workers have been consistently treated as independent contractors and the employer has a reasonable basis for such treatment. Under Section 530, an employer may establish reasonable basis by showing that it relied upon (1)judicial precedent, published Internal Revenue Service rulings, or a private ruling or a technical advice memorandum issued to that specific employer, (2)a past Internal Revenue Service audit in which the Service made no change to worker classification, or (3)long-standing practice of a significant segment of the industry. Interpretation of Section 530 has been the subject of many disputes and the Small Business Job Protection Act of 1996 attempts to clarify its application. These provisions generally apply to periods after December 31, 1996. The provision regarding the burden of proof applies to disputes dealing with periods after December 31, 1996.

First, the Act provides that a worker does not have to otherwise be "an employee" of the employer in order for Section 530 to apply. This negates an inexplicable position previously taken by the Internal Revenue Service that a determination had to first be

made whether a worker was an employee or not before potential application of Section 530 could even be considered. Employers had protested because of the additional cost and time of making a determination which employers did not believe was necessary where relief under Section 530 was available.

Second, the Act modifies the audit safe harbor so that employers cannot rely on a prior audit commencing after December 31, 1996, to establish its reasonable basis for independent contractor treatment, unless the audit includes an examination for employment tax purposes of whether the worker or any worker in a substantially similar position was properly classified as an employee or independent contractor. This does not affect the ability of employers to rely on prior audits commenced before January 1, 1997, even though the audit was not related to employment tax matters.

Third, the Act makes a number of changes to the industry practice safe harbor. It provides that, to establish that a significant segment of the industry treats such workers as independent contractors, this does not require a showing that more than 25% of the industry does so. A lower percentage may constitute a significant segment of the employer's industry based on the particular facts and circumstances. The bill also provides that an industry need not have continued the independent contractor classification for more than 10 years in order for the industry practice to be considered "long standing." An industry practice of shorter duration may be considered "long standing" based on the particular facts and circumstances. The provision clarifies that Section 530 application is not limited to industries existing in 1978 when it was enacted and that new industries can qualify for Section 530 relief.

Fourth, the Act provides that, if an employer establishes a prima facie case that it was reasonable not to treat workers as employees within the meaning of Section 530, the burden of proof shifts to the Internal Revenue Service with respect to such treatment. Before the shift in the burden of proof will occur, however, the employer must cooperate with reasonable requests by the Internal Revenue Service for information relevant to the employer's treatment of the worker's independent contractor status under Section 530.

Fifth, the Act provides that, if an employer prospectively changes its treatment of workers from independent contractors to employees for employment tax purposes, such changes will not affect the applicability of Section 530 with respect to such workers

for prior periods. Previously, employers who contested Internal Revenue Service attempts to reclassify workers as employees but who wished to change the worker's classification prospectively in order to reduce their potential liability was put in the nonsensical catch-22 position: Section 530 requires that workers be treated consistently the same and the Service sometimes viewed employers as violating this condition if they began treating the workers as employees prospectively while the audit was pending.

Sixth, the Act also provides that in determining whether a worker holds a substantially similar position to another worker, the relationship of the parties must be one of the factors taken into account, including the degree of supervision and control of the worker by the employer.

### CONCLUSION

The 20-factor test is difficult to apply to workers in the entertainment industry since, unlike workers in most industries, they typically work on a project by project basis and incur considerable business expenses. To facilitate determination of worker status by taking into account the particular characteristics of a specific industry, the Internal Revenue Service has embarked on a program to negotiate guidelines for worker classification determination with representatives from different industries. Its first set of guidelines has been issued for the television commercial production and professional video communication industries. The lack of definitional certainty in the factors precludes clear and certain application of the Guidelines. This is particularly problematic due to the Guideline's mandate that each factor applicable to a specified job category is "critical" to a determination of independent contractor status. Where even one factor is not satisfied, employee classification automatically results, regardless of the prominence of other factors evidencing independent contractor status. It will only be where the workers do clearly satisfy or fail the factors set out in the guidelines that they provide much needed clarity and finality to the classification determination. In most of these cases, it is doubtful that an analysis based on the 20-factor test would yield a different result. The guideline's provision that, in the event a worker does not qualify as an independent contractor under the guidelines, the 20 factors should be alternatively evaluated to make a final determination is of small comfort. The 20-factor test is currently applied in an uneven manner by agents, often with a pronounced (some might describe as zealous)

bias towards employee classification. While the ultimate effect of the guidelines will largely depend upon the objectivity (or lack thereof) with which they are applied by agents in the field, we may find that the Guidelines simply prove to be an additional weapon in the IRS arsenal for securing employee classification.

The other new procedures recently implemented by the Internal Revenue Service and the expansion of Section 530 relief hold significant promise for vastly improving resolution of worker classification issues. The new training manual may encourage field agents to apply the classification tests in a more even handed manner, although it may take some years to see a significant change in approach. The CSP program may encourage business to convert to employee classification since they may be able to do so without facing insurmountable past tax liabilities. Finally, expansion of Section 530 may provide relief to taxpayers who would otherwise suffer severe competitive disadvantages and potentially ruinous liabilities from reclassification of their workers. Since the CSP and the other programs remain largely dependent upon Internal Revenue Service interpretation of the 20-factors and Section 530, the actual success of these programs will depend on how the Internal Revenue Service applies them in practice. If the Internal Revenue Service continues to interpret Section 530 and Revenue Ruling 87-41 in an intractable manner biased toward employee classification, these programs will not live up to their potential.