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INDEPENDENT CONTRACTOR OR EMPLOYEE?

— by Neil E. Harl*

For several decades, the battle has raged over whether an individual is an employee or independent contractor for payroll tax purposes.¹ In 1978, Congress attempted to clarify the situation by protecting most employees from a retroactive finding that an employer-employee relationship existed and by temporarily freezing the common law definition of employee.² The 1978 legislation also prohibited the Department of the Treasury from issuing rulings and regulations on common law employment status.³ That moratorium was continued several times and made indefinite in 1982⁴ except as to qualified real estate agents and direct sellers who were deemed to be statutorily self-employed where substantially all of the remuneration paid for their services is directly related to sales or other output and where the services are performed under written contracts providing that the individuals will not be treated as employees for federal tax purposes.⁵

In a 1990 ruling, a farmer employed an adult son to perform agricultural labor on the farm. The son was generally paid hourly with all of the work done under the father's control and direction. The Internal Revenue Service determined that the son was an employee.⁶ More than 60 letter rulings with farm facts have held similarly.⁷

The 20-factor test

In Rev. Rul. 87-41,⁸ IRS provided guidance for distinguishing between independent contractor and employee status for employment tax purposes. The 20 factors were identified to provide insight as to whether sufficient control is present to establish an employer-employee relationship.⁹ Since publication of the 20-factors in 1987, a long list of cases has applied the factors to determine whether an individual is properly classified as an employee or as an independent contractor.¹⁰

Handling business expenses

Recent cases have focused attention on the fact that the problem of whether someone is an employee or independent contractor is far broader than liability for payroll taxes. Several cases have raised the issue of employee versus independent contractor status in the setting of handling employee business expenses.¹¹ As an independent contractor, an individual can file a Schedule C or F and

deduct employment-related expenses.¹² Employees must treat all employment-related expenses as itemized employee business expenses that are only deductible to the extent the expenses exceed two percent of the employee's adjusted gross income.¹³

Participation in employee benefits

A major concern in recent months has been whether a successful drive to secure independent contractor status for payroll tax purposes or business expense purposes causes problems for continuing participation in employee benefits. Several recent cases have recited that individuals considered to be independent contractors were participating in employee benefits.¹⁴

The Internal Revenue Service issued a private letter ruling in 1995 on the consequences of a successful effort to be classified as an independent contractor where the individual was participating in employee benefits.¹⁵ In the facts of that ruling, the taxpayer had mounted a successful challenge in the Tax Court to the common law employee classification by IRS. Before the Tax Court decision in the taxpayer's favor, the individual had participated in the employer's employee benefit program. IRS ruled on three questions —

- The employer should issue a corrected Form W-2 showing zero wage income and a corrected Form 1099 showing self-employment income for the years in question.
- The continued participation of the independent contractor in the employer's employee-benefit plan would no longer be consistent with the requirements for a qualified employee-benefit plan. This part of the ruling is being reconsidered by IRS, however.
- Participation by the independent contractor in the employer's employee-benefit plan prior to the Tax Court decision would not disqualify the employee retirement plans. But it would be necessary to cancel, retroactively, the independent contractor's participation in the plans, to refund the independent contractor's elective contributions and to refund the actual plan earnings. This part of the ruling is also being reconsidered by the Internal Revenue Service.

Can you have it both ways?

After the latest IRS letter ruling,¹⁶ the Sixth Circuit Court of Appeals decided the case of *Ware v. United States*.¹⁷ That case, decided on October 16, 1995, involved

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an inside sales person in an insurance company who became an outside agent with the same company and argued, successfully, that independent contractor classification was appropriate.¹⁸ Accordingly, the taxpayer was allowed to deduct unreimbursed business expenses on Schedule C.¹⁹ The taxpayer "received extensive benefits, including paid vacation and sick days, was covered by a company-sponsored health and dental plan, and was eligible for a 401(k) and pension plan" in which the employer matched the taxpayer's contributions.²⁰

Despite the individual's participation in employee benefits, the Sixth Circuit Court of Appeals held that the taxpayer was an independent contractor. In a footnote to the decision, the court noted, "in theory, a person could be an independent contractor for [some] purposes yet remain an employee for ERISA qualification, but such instances should be rare."²¹ The court explained that how an employer chooses to compensate a worker is irrelevant to the common law tests of employee status.

Current uncertainty

At present, the question of independent contractor versus employee status and the consequences of the determination, are in a state of substantial uncertainty. The Commissioner of Internal Revenue has been quoted as saying that, "it does not matter to the IRS whether a worker is classified as an employee or as an independent contractor so long as the worker...is paying his or her proper amount of taxes."²²

Several bills have been introduced in Congress to streamline the definition of who may be properly classified as an independent contractor.²³ Unfortunately, none of the bills introduced to date takes an appropriately broad view of the problem. All focus on the payroll tax issue only. That's important, but it's not the whole story.

FOOTNOTES

- ¹ See generally 4 Harl, *Agricultural Law* § 36.03 (1996); Harl, *Agricultural Law Manual* § 4.06[2] (1996).
- ² Revenue Act of 1978, Pub. L. 95-600, Sec. 530, 92 Stat. 2885 (1978).

³ *Id.*, Sec. 530(b), 92 Stat. 2885 (1978).

⁴ Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248, Sec. 269(c), 96 Stat. 552 (1982).

⁵ I.R.C. §§ 3508(b)(1), 3508(b)(2).

⁶ Ltr. Rul. 8040011, June 24, 1980.

⁷ See 4 Harl, *Agricultural Law* § 36.03[1], n. 18 (1996).

⁸ 1987-1 C.B. 296.

⁹ Rev. Rul. 87-41, 1987-1 C.B. 296, 297.

¹⁰ E.g., *Eastern Investment Corp. v. United States*, 49 F.3d 651 (10th Cir. 1995) (20-factor test applied to find sales representatives were employees, not independent contractors).

¹¹ E.g., *Weber v. Comm'r*, 60 F.3d 1104 (4th Cir. 1995) (United Methodist minister deemed to be employee); *Butts v. Comm'r*, 49 F.3d 713 (11th Cir. 1995) (insurance agent was independent contractor permitted to report business expenses on Schedule C; taxpayer received paid vacation, pension and 401(k) plan, 75 percent of health insurance costs, coverage under employer's malpractice policy and payment of licensing and professional fees).

¹² See I.R.C. §§ 62(a)(1), 162.

¹³ I.R.C. § 67(a).

¹⁴ E.g., *Butts v. Comm'r*, 49 F.3d 713 (11th Cir. 1995) (fringe benefits provided by employer of insurance agent).

¹⁵ Ltr. Rul. 9546018, Aug. 18, 1995.

¹⁶ *Id.*

¹⁷ 95-2 U.S. Tax Cas. (CCH) ¶ 50,553 (6th Cir. 1995).

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.*, n. 5.

²² See Stratton, "Worker Classification Issues Hound Employers, IRS, and the Courts," 68 Tax Notes 673 (Nov. 6, 1995).

²³ E.g., H.R. 1972, 104th Cong., 1st Sess. (1995); H.R. 582, 104th Cong., 1st Sess. (1995).

CASES, REGULATIONS AND STATUTES

by Robert P. Achenbach, Jr.

BANKRUPTCY

GENERAL-ALM § 13.03.*

ESTATE PROPERTY. The debtor's mother died four days before the debtor filed for Chapter 11. The mother's will was not admitted to probate until more than 180 days after the petition. During the interim, the debtor participated in settlement negotiations with the other heir. The court held that because, under state law, a beneficiary of a decedent's estate acquires an interest in the estate upon the decedent's death, the debtor acquired the interest in the mother's estate pre-petition and the interest was included in the debtor's bankruptcy estate. *In re Chappel*, 189 B.R. 489 (Bankr. 9th Cir. 1995).

EXEMPTIONS

HOMESTEAD. The debtor had used 165 acres of rural property in Texas as the home of his family, consisting of

several children and a spouse. In 1987, four days after the death of the spouse, the debtor signed a homestead disclaimer as to the property in order to obtain financing secured by the property. At the time of the petition, the children had moved away and the debtor lived alone on the property. Under Texas law, a disclaimer of a homestead was not effective if the debtor used the property as a homestead and owned no other property usable as a homestead. The court held that the disclaimer was not effective because the debtor did not own any other property at the time of the disclaimer and used the property as a homestead. The debtor claimed the entire 165 acres as exempt family rural homestead property. A creditor objected, arguing that the debtor was single and lived alone; therefore, the debtor was entitled only to the 100 acre rural homestead exemption. The court held that, under Texas law, the property became a