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Employment Taxes: What Can the Small Businessman Do?

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by

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INTRODUCTION

A hostile tax environment faces the person who, alone or perhaps with one or two others, goes into business for himself. In recent years, various factors have increased the adversity the small business person faces. The focus of this Article, escalating employment taxes, represent a significant barrier to survival of these businesses.

Within the past three years, the Internal Revenue Service has cracked down on small business compliance with the payroll tax regime on two fronts. First, the Service has successfully recharacterized dividend and loan payments made to S corporation shareholders as wages, subject to employment taxes.[1] Furthermore, the IRS is increasingly challenging the claim of independent contractor status by the small business person, with potentially devastating effects on the business who has contracted for his services.[2]

This article focuses on two of the employment taxes, FICA and FUTA.[3] Part I surveys the payroll tax regime and the consequences of running afoul of it. Part II considers the recent history of dividend recharacterizations in the S corporation shareholder-employee context. Part III considers what would be "reasonable (minimum) compensation" for a shareholder-employee in an S corporation. Finally, Part IV takes up current, lively developments in the perennial debate between the Service and small business over independent contractor status.

PART I. THE EMPLOYMENT TAX REGIME

FICA and SECA Taxes

While three taxes comprise the employment taxes (social security, unemployment, and wage withholding taxes), this article will address only the first two. Both FICA and SECA programs provide old-age, survivor, and disability insurance benefits and hospital insurance benefits for the aged and disabled. Taxes paid by employers and employees under the Federal Insurance Contributions Act ("FICA")[4] and by the self-employed under the Self-Employment Contributions Act ("SECA")[5] fund the program. FICA tax

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[1] *See* discussion *infra* Part II.

[2] *See* discussion *infra* Part IV.

[3] Federal Insurance Contributions Act, I.R.C. §§3101-3128 (1988 & Supp. III 1991) and Federal Unemployment Tax Act, I.R.C. §§ 3301-3311 (1988 & Supp. III 1991).

[4] I.R.C. §§ 3101-3128 (1988 & Supp. III 1991).

[5] I.R.C. §§ 1401-1403 (1988 & Supp. III 1991).

has two parts: Old-Age, Survivor, and Disability Insurance ("OASDI") at 6.20% on the first $57,600 of wages plus Hospital Insurance (HI) at 1.45% on the first $135,000 of wages. Both employer and employee pay this amount for a total of 15.3% of wages for 1990 and thereafter.[6]

SECA tax is payable on the net earnings from the self-employed person's business, at the same 15.3% rate, up to the base amount of $57,600 (OASDI taxable base) and $135,000 (HI taxable base) for 1993.[7] The main difference from FICA tax is that the self-employed individual pays the entire SECA amount with no contribution from a second participant. A deduction is allowed, though, equal to one half of the individual's self-employment tax liability in computing his taxable income.

FUTA

In contrast, the Federal Unemployment Tax Act ("FUTA")[8] imposes a tax on the employer only. In conjunction with the states, the federal program provides benefits during temporary periods of unemployment. The rate here is 6.2% on the first $7,000 of wages through 1996 and 6.0% for 1997 and after.[9] Payment of state unemployment taxes gives credits significantly reducing the amount due the federal government. Finally, self-employed individuals do not pay FUTA nor do they receive the unemployment benefits.[10]

These taxes represent a significant burden to small businesses. Particularly in the start-up phase, they contribute to the high rate of new business failures. The very small and/or new business lacks the established income stream and client base, the economies of scale, and the buying and bargaining power of older, larger companies. The employment taxes, with ever-upward rates and taxable base,[11] loom large to the small business person.

The Costs to Business of Recharacterization

A far worse fate than actually paying the taxes, though, is to be assessed for unpaid employment taxes by the Internal Revenue Service. As will be shown in Parts II and IV, this happens most commonly to the small business in two contexts: where the Service recharacterizes dividends paid to shareholder employees as wages and where the Service reclassifies an independent contractor as an employee.

[6] I.R.C. §§ 3101, 3111 (1988).

[7] 57 Fed. Reg. 48, 619 (1992).

[8] I.R.C. §§ 3301-3311 (1988 & Supp. III 1991).

[9] I.R.C. §§ 3301, 3306 (1988 & Supp. III 1991).

[10] *See* Peter J. Allman, *Withholding, Social Security and Unemployment Taxes on Compensation*, 392 T.M. (1992) (provides much of the information for the above introductory material).

[11] As recently as 1987, the combined FICA percentage for employer and employee was 1.3% less than the 1993 rate (14.00% versus 15.30%); and the 1991 HI taxable base in 1991 was $125,000 and the OASDI base, $53,400 compared to the current $135,000 for HI and $57.600 for OASDI. I.R.C. §§ 3101(a)-(b), 3121(x) (1988 & Supp. III 1991).

Serious consequences to an employer flow from a successful IRS recharacterization of dividends as wages or a reclassification of an independent contractor as an employee.[12] The liability will fall on the employer primarily in two ways. First, assessments for the employer's share of past withholding, FICA and FUTA taxes will be due in any case. As to the employee's share, § 3509 limits the *employer's* liability in some circumstances to: 1.5% of the wages paid to the employee[13] (for withholding tax) and 20% of the employee's share of the tax[14] (for FICA). These percentages increase to 3% and 40% respectively if the employer did not file informational returns due for the worker in his independent contractor status.[15] Section 3509 will not apply where the worker was treated as an employee just for withholding purposes but not for FICA tax.[16] Nor will the § 3509 limits be available if the employer intentionally disregarded the duty to deduct and withhold these taxes.[17] In addition to the limitations inherent in § 3509 itself, the courts appear to apply it with a restrictive hand.[18]

Second, in addition to the actual taxes which must be paid, penalties and interest will likely be added: for failure to file a return, up to 25% of the tax due[19] (up to 75% if fraudulent); for failure to deposit taxes, up to 10% penalty;[20] plus interest at the federal short-term rate plus three percentage points.[21]

Even beyond the actual taxes, penalties, and interest which hit the employer upon a reclassification, other serious consequences may result. Where distributions are recharacterized as wages, this may create a second class of stock as the distributions to shareholders in the S corporation are no longer in proportion to their holdings with the result that the S corporation election could be terminated.[22] In the independent contractor area, a potential side-effect stemming from reclassification of a worker as an employee

[12] The reclassification of independent contractors will be discussed in Part IV.

[13] I.R.C. § 3509(a)(1) (1988).

[14] I.R.C. § 3509(a)(2) (1988).

[15] I.R.C. § 3509(b)(1) (1988).

[16] I.R.C. § 3509(d)(2) (1988). This could happen, for example, because the definitions of "employee" in the withholding and FICA tax sections are not the same.

[17] I.R.C. § 3509(c) (1988).

[18] In one of the dividend recharacterization cases, *Fred R. Esser, P.C. v. United States*, the court denied the taxpayer the benefit of § 3509, saying that "in light of the established law in this area, it is clear that plaintiff intentionally disregarded" the FICA tax requirements. Fred R. Esser, P.C. v. United States, 750 F. Supp. 421, 423 (D. Ariz. 1990). Considering that the first dividend recharacterization case had been decided only the year before, this court was showing little sympathy for the taxpayer. Congress enacted two relief provisions (§3509 and §530 of the Revenue Act of 1978) to aid in the independent contractor reclassification area, but the courts have tended to be strict in their application of both sections; limiting the relief.

[19] I.R.C. § 6651 (1988).

[20] I.R.C. §§ 6651 (f)(2), 6656 (1988 & Supp. III 1991).

[21] I.R.C. §§ 6601, 6621 (1988 & Supp. III 1991).

[22] Prop. Treas. Reg. § 1.1361-1(l)(2), *cited in* Jack Robison & Richard S. Mark, *Setting Salaries for S Corporation Shareholders*, 47 TAX'N FOR ACCT., 88, 90 (1991).

would be the retroactive loss of tax qualification for pension contributions, due to the IRS finding the plan discriminatory. "The employer could lose its deduction for contributions to the plan, thereby resulting in a tax deficiency and taxable income to the recipients."[23] In addition, it could cause the worker's contributions to an IRA or Keogh plan to be nondeductible.[24]

PART II. THE RECENT SUCCESS OF THE SERVICE IN RECHARACTERIZING S CORPORATION DIVIDEND PAYMENTS AS WAGES

The Radtke Legacy

Since 1989, the Service has succeeded in recharacterizing as wages, payments made to shareholder-employees of S corporations which were labeled "dividends." Traditionally, the pattern has been the reverse, that is, the Service has frequently attacked wages paid to shareholder-employees as constructive dividends. The reason for the switch lies in the rising popularity of S corporations. The single layer of tax for dividends coupled with the considerable bite of current payroll tax rates[25] invites an S corporation stockholder who provides services to the business to avoid the payroll tax by taking his money out as dividends. Formerly too, the maximum tax rate of 50% for personal services income was topped by a still higher rate for unearned income, applied to dividends, a situation no longer existing.[26]

To a small businessman who is sole shareholder of an S corporation, the corporate entity seems a hollow sort of "employer." No one shields this shareholder from the cares and risks of self-employment. While there is only one person to do the work, he questions why two "persons" must be counted at employment tax time. A sole shareholder also realizes few of the touted benefits of corporation status, such as limited liability and continuity of life. Indeed Congress seems to have acknowledged the "self-employment" flavor of S corporations by treating them similarly to partnerships in regard to fringe benefits.[27] The corporation entity is swept aside and S corporations receive little

[23] Debra H. Oden, *Independent Contractor: A Legitimate Classification with Reclassification Protection*, 69 TAXES 319, 320 (1991).

[24] William J. Falk & Randy J. Gegelman, *Defending Employee vs. Independent Contractor Issues*, 71 J. TAX'N 380, 380 (1989).

[25] *See supra* Part I.

[26] I.R.C. § 1348, repealed in 1981, provided for a 50% maximum tax rate for personal services income at a time when the top individual rate was 70%. I.R.C. § 1 (1988 & Supp. III 1991). This 20% differential more than made up for any loss of payroll taxes on salaries. Thus the Service during that period saw no reason to crack down on S corporation shareholder-employees who received no salaries, only dividends. In a 1972 case, Paula Constr. Co. v. Commissioner, 58 T.C. 1055 (1972), the Service argued for and the court upheld allocating nothing to salaries, even though substantial services were admittedly performed, in a context where the taxpayer was attempting to recharacterize dividends as wages. *See* Robison & Mark, *supra* note 22, at 88. When § 1348 was repealed and dividends and salaries were subsequently taxed at the same rates, the loss of payroll taxes on salaries suddenly became an issue.

[27] I.R.C. § 1372 (1988).

of the favorable tax treatment accorded C corporation fringes. One response both to the practical realities and to the employment tax regime has been for shareholders in very small S corporations to pay themselves dividends, primarily or exclusively. This avoided both the double tax bite of C corporation dividends and the employment taxes due on wage payment.

However, in 1989, an IRS victory in a dividend recharacterization case, *Joseph Radtke, S.C. v. United States*,[28] brought matters to a head. Radtke, the sole director/shareholder and worker of an S corporation, received no salary from the corporation but did get substantial dividends. The Internal Revenue Service challenged the "dividend" designation and assessed deficiencies against the corporation for failing to pay FICA and FUTA taxes. Courts, Congress and the Service had all been building toward this point. The Service's success in *Radtke* has been followed quickly by several other victories,[29] indicating *Radtke* represents the wave of the future.

The dividend recharacterization cases center on the definition of wages.[30] Section 3121(a) of the Internal Revenue Code broadly defines wages for the purpose of taxes under the Social Security Act as "all remuneration for employment, including the cash value of all remuneration (including benefits) paid in any medium other than cash. . . ."[31] Wages for the Federal Unemployment Tax Act are defined with identical language.[32]

Historical Build-up Toward the Dividend Recharacterization Cases

1. A Neglected Revenue Ruling

In 1974, a revenue ruling[33] squarely addressed the issue of the liability of an S corporation for FICA, FUTA and withholding taxes on "dividends" paid to shareholders who receive no wages but nevertheless perform substantial services. The "dividends," the Service determined, were paid in lieu of reasonable compensation for services and therefore were wages, subject to the federal employment taxes. At the time this ruling was issued, however, substantially lower rates for these taxes presented less impetus to avoid them and the ruling received little attention.

2. The *Rowan* Case

The next step toward the current dividend recharacterization cases came in a sequence of cases and legislation. A Fifth Circuit case, *Rowan Companies, Inc. v. United*

[28] Joseph Radtke, S.C. v. United States, 712 F. Supp. 143 (E.D. Wis. 1989), *aff'd*, 895 F.2d 1196 (7th Cir. 1990).

[29] Fred R. Esser, P.C. v. United States, 750 F. Supp. 421 (D. Ariz. 1990); Spicer Accounting, Inc. v. United States, 918 F.2d 90 (9th Cir. 1990).

[30] The case law revolves around two issues: who is an employee and what constitutes wages. Employee status, the heart of the independent contractor debate, will be considered in Part IV.

[31] I.R.C. § 3121(a) (1988 & Supp. III 1991).

[32] I.R.C. § 3306(b) (1988).

[33] Rev. Rul. 74-44, 1974-1 C.B. 287.

States,[34] held that the regulations interpreting "wages" for FICA and FUTA purposes[35] were valid even though more expansive than the definition of "wages" for withholding tax purposes.[36] The Supreme Court reversed in 1981, concluding that Congress intended "wages" to be interpreted consistently for both income tax withholding on the one hand and FICA and FUTA on the other.[37] The Court pointed to the similarity of statutory language between the provisions plus the legislative history of the withholding tax which spoke of congressional concern for "the interest of simplicity and ease of administration."[38]

3. Congress' Response

Subsequent to the Supreme Court decision in *Rowan* were the Social Security Amendments of 1983.[39] The legislative history specifically stated that Congress intended to override the Supreme Court's *Rowan* holding that the definitions of "wages" for social security tax and for withholding tax must be interpreted in the same way in the regulations absent statutory provision to the contrary.[40] The committee reports point to the different goals of the two taxes:

> The social security program aims to replace the income of beneficiaries when that income is reduced on account of retirement and disability. . . .Since the security system has objectives which are significantly different from the objective underlying the income tax withholding rules, the committee believes that amounts exempt from income tax withholding should not be exempt from FICA unless Congress provides an explicit FICA tax exclusion. . . .Accordingly, an employee's 'wages' for social security tax purposes may be different from the employee's 'wages' for income tax withholding purposes.[41]

Congress' overwhelming concern was solving the crisis in social security financing.[42] Various steps taken in the 1983 Amendments included this expansive definition of wages for FICA tax purposes and the raising of the self-employment taxes to a virtual

[34] Rowan Companies, Inc. v. United States, 624 F.2d 701 (5th Cir. 1980), *cert. granted*, 449 U.S. 1109 (1981), *rev'd*, 452 U.S. 247 (1981).

[35] Treas. Reg. §§ 31.3121(a)-1(f) (1960), 31.3306(b)-1(f) (1960).

[36] I.R.C. § 3401(a) (1988 & Supp. III 1991). "[T]he term 'wages' means all remuneration. . .for services performed by an employee for his employer, including the cash value of all remuneration (including benefits) paid in any medium other than cash. . . ."

[37] Rowan Companies, Inc. v. United States, 452 U.S. 247 (1981).

[38] S. REP. NO. 1631, 77th Cong., 2d Sess. 165 (1942).

[39] Social Security Amendments of 1983, Pub. L. No. 98-21, 97 Stat. 65 (1983).

[40] S. REP. NO. 23, 98th Cong., 1st Sess. 42, *reprinted in* 1983 U.S.C.C.A.N. 183; H.R. REP. NO.25, 98th Cong., 1st Sess. 80, *reprinted in* 1983 U.S.C.C.A.N. 299.

[41] S. REP. NO. 23; H.R. REP. NO. 25.

[42] *See* 129 CONG. REC. H1779 (daily ed. Mar. 24, 1983) (statement of Rep. Rostenkowski); 129 CONG. REC. S4084 (daily ed. Mar. 25, 1983) (statement of Sen. Dole).

parity with the FICA tax.[43] Faced with the political dynamite of a failing national retirement system, Congress needed to find ways to resuscitate the system. Small business appears to have been one group recruited.[44] This financial crunch in the social security system also seems to be the moving force behind the enforcement community's crackdown on small business in the past few years: countering the use of S corporations to avoid social security taxes[45] and stepping up attacks on independent contractor classification.[46]

4. Compensation Must Be Paid First

Given this strong movement to shore up the social security system, this causes significant effects to the small S corporation shareholder. Following the lead of C corporation stockholders before them, S shareholders have tried to draw their money out of the corporation in the most tax-advantageous manner possible, whether through salaries, fringe benefits, rents, loans, dividends or more sophisticated forms of executive compensation. The message from the Service, sounding loud and clear in the cases considered next, is this: *first* pay "reasonable compensation" to shareholder-employees performing substantial services for the S corporation or else face potential recharacterization of whatever other payments have been made to the shareholder.

Thus a district court in 1981[47] recharacterized contractual payments made between corporation officers' family trusts and the corporation as compensation to the officers with liability for employment taxes. Similarly, another district court found that loans made from an S corporation to its sole shareholder-employee, even though repaid, constituted wages with past FICA and FUTA taxes due.[48]

The most recent cases recharacterize dividends as wages. In *Radtke*,[49] the sole shareholder/director and only full-time worker in an S corporation received no wages, only dividends. As "[h]is 'dividends' functioned as remuneration for employment,"[50] the court concluded, "[A]n employer should not be permitted to evade FICA and FUTA by characterizing *all* of an employee's remuneration as something other than 'wages.'"[51] The court held for the Service, recharacterizing *all* of the dividends as wages.

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[43] *See supra* Part I.

[44] H.R. REP. NO. 47, 98th Cong., 1st Sess. 32 (1983): "[T]he present tax treatment of self-employed individuals accounts for a major portion of the financial difficulties of the social security system."

[45] Dale W. Spradling, *Are S Corporation Distributions Wages Subject to Withholding?*, 71 J. TAX'N 104, 104 (1989): "Practitioner comments indicate that both the Kansas and Austin service centers are sending to S shareholders deficiency notices that recharacterize nontaxable draws as wages." This occurred in the wake of the Service's victory in *Radtke*.

[46] *See infra* Part IV.

[47] Automated Typesetting, Inc. v. United States, 527 F. Supp. 515 (E.D. Wis. 1981).

[48] Gale S. Greenlee, Inc. v. United States, 661 F. Supp. 642 (D. Colo. 1985).

[49] Joseph Radtke S.C. v. United States, 712 F. Supp. 143 (E.D. Wis. 1989), *aff'd*, 895 F.2d 1196 (7th Cir. 1990).

[50] *Id.* at 145.

[51] *Id.* at 146.

Fred R. Esser P.C. v. United States,[52] involved an S corporation that made regular "loans" to its sole incorporator-director, but paid him no salary. The loans were repaid yearly by Esser leaving declared dividends in the corporation while paying the income tax on the dividends. Again the court upheld the IRS assessment for employment taxes on the dividends, pointing to the *Radtke* precedent and to statements in Treasury Regulations §§31.3121(a)-1(c) and 31.3306(b)-1(c) that the form of payments constituting wages is immaterial.

5. The Confused Role of Intent

The Ninth Circuit recently considered a situation similar to *Radtke,* in which a married couple, the only stockholders of an S corporation and the husband, the sole worker, withdrew only dividends.[53] In holding that the payments to him constituted "wages" for FICA and FUTA purposes, the court announced, "Mr. Spicer's *intention* of receiving the payments as dividends has no bearing on the tax treatment of these wages."[54]

By rejecting "intent" as a relevant consideration in the dividend/salary determination, the court turned away from a test used in a line of cases extending back to the 1960's.[55] In two of these cases, discussed below, the *taxpayer* tried to recharacterize as wages, payments (dividends or loans) made to a shareholder-worker who received little or no salary. Each time, the Tax Court refused to allow the recharacterization.

Electric & Neon, Inc. v. Commissioner,[56] involved purported loans made to the shareholder of a C corporation. Alternatively to the loan argument, the taxpayer contended this was compensation. In either case, the taxpayer was hoping to escape the double tax bite for dividends. Before deciding these were actually dividends, the court first considered whether they could be compensation. The test of deductibility for compensation, the court stated, has two prongs: the compensation must be reasonable and the amounts paid must have been intended as compensation. "It is settled law that such intent must be shown as a condition precedent to the allowability of a deduction to the corporation."[57] "[T]he decisive criterion is whether the parties to the alleged loan really intended to create a bona fide indebtedness each time the money was disbursed."[58]

[52] Fred R. Esser P.C. v. United States, 750 F. Supp. 421 (D.Ariz 1990).

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

[54] *Id.* at 93 (emphasis added).

[55] *See* Paula Constr. Co. v. Commissioner, 58 T.C. 1055 (1972); Electric & Neon, Inc. v. Commissioner, 56 T.C. 1324 (1971) *aff'd,* 496 F.2d 876 (5th Cir. 1974); *See also* Charles McCandless Tile Serv. v. United States, 422 F.2d 1336 (Ct.Cl. 1970); Northlich, Stolley, Inc. v. United States, 368 F.2d 272 (Ct.Cl. 1966); Irby Constr. Co. v. United States, 290 F.2d 824 (Ct.Cl. 1961).

[56] Electric & Neon Inc. v. Commissioner, 56 T.C. 1324 (1971), *aff'd,* 496 F.2d 876 (5th Cir. 1974).

[57] *Id.* at 1340.

[58] *Id.* at 1338-39.

The following year, the Tax Court in *Paula Construction Co. v. Commissioner*,[59] reaffirmed, "it is now settled law that only if payment is made with the intent to compensate is it deductible as compensation."[60] Two of the three stockholders performed substantial services for the corporation but received no wages, only dividends. When the S corporation election was involuntarily terminated by the corporation's receiving more than 20% of its income as interest, the taxpayer tried to argue that part of the dividends were in fact compensation for services. In refusing to recharacterize part of the dividends as wages, the court brushed aside the fact of substantial unpaid services. Pointing out that no corporate authorization existed for payment of salaries, that the payments made were not treated as compensation on books or tax returns, and that disbursements were in proportion to stock holdings, the court stressed the intent factor. "Aside from the fact that substantial services were performed, nothing . . . indicates that compensation was either paid or intended to be paid."[61] "None of the evidence indicates that at the time those payments were made they were intended to be compensation for services performed."[62]

In *Gale Greenlee, Inc. v. Commissioner*,[63] the S corporation's sole shareholder had executed a "Memorandum of Understanding" between himself and the corporation, providing, "[n]o dividends or distributions of taxable income are intended and no salaries are intended."[64] Books and tax returns of both corporation and stockholder similarly reported that no salaries were paid. The district court, however, without any comment concerning the "intent" factor, held that, in substance, the "loans" made to the stockholder constituted wages.

The courts and the Service seem to have adopted a double standard. In the context of taxpayer attempts at recharacterization, "intent" has dominated the decisions. But the courts have found intent irrelevant where the Service is arguing for recharacterization. This outcome may be justified to the extent the taxpayer is distorting the actual character of payments received from the corporation for tax advantage. However, the consequent recharacterization as wages of *all* the dividends paid to an S corporation shareholder seems a harsh penalty. Though the Service had previously condoned and even argued for no salary payments to shareholder-employees who performed substantial services, it has now cracked down where only dividends were paid, the change largely due to the technical factor of the repeal of the maximum tax on personal service income.[65] It would seem more just to allow an allocation between compensation and dividends by admitting evidence as to "reasonable compensation."

[59] Paula Constr. Co. v. Commissioner, 58 T.C. 1055 (1972).

[60] *Id.* at 1058.

[61] *Id.* at 1059.

[62] *Id.* at 1057-60.

[63] Gale W. Greenlee, Inc. v. United States, 661 F. Supp. 642 (D. Colo. 1985).

[64] *Id.* at 642.

[65] I.R.C. § 1348, *repealed by* Pub. L. 97-34, title I § 101 (c)(1), 95 Stat. 183 (1981).

PART III. REASONABLE MINIMUM COMPENSATION FOR S CORPORATION SHAREHOLDER-EMPLOYEES

Why Pay Salaries to Shareholder/Employees?

With the courts turning a deaf ear on taxpayer arguments that no compensation was intended and therefore the Service should not be allowed to recharacterize dividend payments as wages, planners' thoughts are turning to paying a minimum level of compensation in order to forestall such reclassification.[66]

Two main reasons exist for paying little or no wages to an S corporation shareholder-employee.[67] Since shareholders are taxed on corporate profits whether distributed or not and since paying a salary decreases corporation profits by the same amount it increases shareholder compensation, the net income subject to income tax is the same whether or not the shareholder receives a salary. However, the employment taxes imposed on the wages tips the scales toward favoring dividends. Furthermore, a stockholder's share of S corporation income (whether or not distributed) is *not* self-employment income and therefore is not subject to self-employment tax.[68] Again, the key difference comes down to the imposition of employment taxes on wage payments.

With the dividend recharacterization cases, though, a distinct incentive is created to pay at least a minimal salary. In addition, other factors indicate the wisdom of paying some salary. Paying salaries can accomplish important objectives in addition to compliance with tax laws. In view of the one class of stock limitation in S corporations, salaries can give to a shareholder who makes a more valuable contribution to the business a larger interest in profits, a result otherwise not achievable in S corporations. Second, some states do not recognize S corporations, treating them like C corporations. Wages paid to shareholder/employees in that situation avoid the double tax bite. Furthermore, where a shareholder's basis is insufficient to cover a cash distribution from the corporation, wage payments may result in lower over-all taxes than a cash distribution.[69] Also, in order for the shareholder to participate in corporation retirement plans and other fringe

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[66] *See* Robison & Mark, *supra* note 22, at 88. *See also* A. Bruce Clements & Paul J. Streer, *How Low Can Owner-Employee Compensation Be Set to Save on Employment Taxes*? J. S CORP. TAX'N, Jan., 1990, at 37.

[67] Robison & Mark, *supra* note 22, at 88.

[68] I.R.C. § 1402(a)(2) (1988). Dividends on shares of corporate stock are specifically excluded from definition of net earnings from self-employment. Also, Rev. Rul. 59-221, 1959-1 C.B. 225 states that S corporation income does not constitute net earnings from self-employment for purposes of tax on self-employment income.

[69] Dennis R. Lassila, *Compensation and Fringe Benefits: Cash Compensation vs. Cash Distributions to S Shareholder-Employees*, 1 J. S CORP. TAX'N 241, 245 (1990). Lassila gives an example of a shareholder who has no stock basis and who is owed a large sum with a relatively small basis in the debt. If a cash distribution were made, such a shareholder would be taxed on both his share of the corporation's net income and the cash distribution as his share of the net income would have to go first to restore his basis in the debt owed him before it could increase his stock basis. I.R.C. § 1367(b)(2) (1988). A payment of compensation would be better than a distribution here.

benefits, he must receive compensation since employer contributions or benefits payable are tied to his level of income from the corporation or to his being considered an employee.

If the Service reclassifies dividends as wages, the distributions made to the shareholders will no longer be in proportion to their holdings if some shareholders do not have their dividends recharacterized. Potentially, a second class of stock thereby could be created which, in turn, could lead to termination of the S corporation election with disastrous consequences.[70] Finally, with S corporations which previously were run as C corporations, the built-in gains tax also provides a reason to pay shareholders a salary. By reducing or eliminating taxable income, in part at least by paying deductible wages, the S corporation may minimize the built-in gains tax.[71]

What Is Reasonable Compensation?

In determining what constitutes "reasonable compensation" in any given situation, courts have conducted a factual inquiry. No real percentage guidelines exist. The recent trend, unfortunate when one wants to set a *minimum* reasonable salary, shows much larger salaries being considered reasonable.

Litigation of the issue has been under two sections of the Code: §162 and §1366(e). Cases involving §162 involve C corporations where the Service contends that executive salary levels are unreasonably high. Nonetheless, the common law criteria developed in these cases indicates the type of evidence a taxpayer must be prepared to present in defending the salary level set. *Mayson Manufacturing Co. v. Commissioner,*[72] a Sixth Circuit case, contains the traditional common law factors used in making the "reasonable compensation" determination.[73] The first four factors relate to the qualifications of the employee and the employment setting. Although they are the most relevant criteria, they involve difficult and subjective estimates of the value of an employee's services to the

[70] Robison & Mark, *supra* note 22, at 90.

[71] I.R.C. § 1374 (d)(2) (1988). Stephen R. Looney & Richard B. Comiter, *S Corporations: Reasonable Compensation: Dividends vs. Wages—a Reverse in Positions*, 7 J. PARTNERSHIP TAX'N 364, 369 (1991).

[72] Mayson Mfg. Co. v. Commissioner, 178 F.2d 115 (6th Cir. 1949).

[73] *Id.* at 119: THE FACTORS INCLUDE:

1.) the employee's qualifications;
2.) the nature, extent, and scope of the employee's work;
3.) the size and complexities of the business;
4.) prevailing rates of compensation for comparable positions in comparable businesses;
5.) salaries paid compared to gross income and net income of business;
6.) prevailing general economic conditions;
7.) relationship between salaries and distributions to shareholders;
8.) salary policy of taxpayer for all employees;
9.) compensation paid to particular employee in prior years where business is a closely held corporation; and
10.) preconversion business profits of the enterprise where the business is a newly formed S corporation; *id.*

The last factor comes from Bianchi v. Commissioner., 66 T.C. 324 (1976).

business. If no direct market measurements can be made (e.g. sales made by the employee), then comparison to "comparable positions in comparable business" must be undertaken.[74] Factors 5-9 comprise less vital but also more objective data with which to support the chosen salary level.[75] In setting compensation, the goal here is to be able to justify and document as reasonable the amount of wages. As always, salary arrangements in the closely held family corporation or S corporation will merit special scrutiny as they lack the arm's length bargaining that helps establish "reasonableness."[76]

For a brand new S corporation, the early years' salaries can naturally be set at a low level while losses or only low profits are being realized. One threshold amount comes from the fact that the first $7,000 of wages are subject to FUTA tax;[77] a reasonable minimum salary should be set at least that high. Where a business is a new S corporation but previously was a sole proprietorship or partnership, the last of the common law factors comes into play. The Tax Court in *Bianchi v. Commissioner*,[78] held that business profits made before conversion to an S corporation were relevant and admissible in judging the reasonableness of compensation in the new S corporation. In such newly converted S corporations, the business can achieve employment tax savings by setting salaries at levels lower than the pre-conversion self-employment business income.[79]

The Service might contend that the business profits in the former business should be the measure of the shareholder's compensation in the S corporation. However, two strong arguments counter such an assertion. First, in attacking as excessive, salary levels in C corporation cases, the Service has used the ratio of employee-owner wages to pre-salary corporation income as one measure of excessiveness.[80] The Tax Court in *Cromer v. Commissioner*,[81] accepted the IRS contention that payment of 99% of the corporation's pre-salary income was excessive where the corporation had paid the sole shareholder no dividends. Rather, the court settled on only 37% of pre-salary business income as reasonable compensation for the S corporation shareholder.[82] This should provide a good opening for businesses which want to convert from a sole proprietorship or partnership to S corporation status. By choosing to apportion only a part of the business profits to wages, the business will come out better on employment taxes.[83] The corporation, however, will need to justify the salary levels chosen.

[74] Clements & Streer, *supra* note 66, at 45-46.

[75] *Id.* at 46.

[76] Logan Lumber Co. v. Commissioner, 365 F.2d 846, 851 (5th Cir. 1966).

[77] I.R.C. §§ 3301, 3306 (b) (1988).

[78] Bianchi v. Commissioner, 66 T.C. 324 (1976).

[79] Clements & Streer, *supra* note 66, at 38. The authors demonstrate how to calculate the amount of employment taxes saved.

[80] *Id.* at 47.

[81] Cromer v. Commissioner, 40 T.C.M. (CCH) 701 (1980).

[82] *Id.* at 706.

[83] SECA tax must be paid on the whole profits, at the same 15.30% rate, up to the base wage amount of $57,600 (OASDI taxable wage base) and $135,000 (HI taxable wage base) for 1993. 57 Fed. Reg. 48619 (1992).

Second, the profits of a business cannot be wholly attributed to the contributions of any employee's services.[84] Goodwill and return on physical and financial capital must also be given proper weight. Likewise, the role of the general economic conditions in the level of business profits must be considered.

These contentions receive support from the Service's position in reasonable compensation cases like *Charles McCandless Tile Service v. United States*.[85] While no dividends had ever been paid by the C corporation here, the two shareholders received substantial salaries. The Claims Court, despite finding that the amounts paid were "reasonable" as wages, nevertheless accepted the IRS position that some portion of the payments must be allocated to a return on equity capital: "[A]s surely as the McCandlesses contributed substantially in their employee roles to plaintiff's success, it is equally clear that they were responsible also in their stockholder roles (i.e. supplying risk capital, assuming corporate obligations, and participating in corporate decisions) for that success."[86] As the corporation's profit-making ability "justifies substantial compensation, we are of the further view that it also justifies a substantial investment return."[87]

In cases where the Service is trying to recharacterize as wages, amounts paid out as dividends, the return due to these other factors should be brought up. In each of the dividend-recharacterization cases, the entire dividend paid has been successfully recharacterized as salary. On the basis of the Service's own arguments, a taxpayer should be able to prevail to the extent that not everything should be reclassified.

Planning Considerations

In the "minimum" reasonable compensation area, a variety of potential planning opportunities and problems exist. As previously mentioned, litigation under I.R.C. § 1366(e) relates to the minimum compensation question. In that context, the Service is given statutory authority to reallocate dividend payments made by an S corporation to family members of a shareholder/employee where the shareholder/employee is not receiving sufficiently high compensation.

In a case brought partially under the predecessor of § 1366(e) (§ 1375(c)), *Davis v. Commissioner*,[88] an orthopedic surgeon separated the X-ray and physical therapy portions of his business, incorporated them as two S corporations, and gave almost all of the stock to his children. The Tax Court upheld the taxpayer against the IRS contention that the income of these corporations should be taxed to the doctor. The court found that the income earned by the corporation came, not from the labors of the surgeon (who spent

[84] Clements & Streer, *supra* note 66, at 48.

[85] Charles McCandless Tile Serv. v. United States, 422 F.2d 1336 (Ct.Cl. 1970).

[86] *Id.* at 1340.

[87] *Id.* at 1340.

[88] Davis v. Commissioner, 64 T.C. 1034 (1975).

only twenty hours total per year in duties as director of the two corporations), but was due to the equipment and services of the corporation employees. In addition, the court held that there were valid business reasons for setting up the corporations, aside from a tax avoidance motive.

The favorable precedent set by this case could be used wherever a business could be split into two or more functions, with the functions of Unit II capable of being performed entirely by employees other than our shareholder. Under the "kiddie tax," dividends paid to children under 14 will be taxed at the parents' marginal rate,[89] yet this income will be shielded from being recharacterized as wages of the parent, subject to employment tax. For children 14 years of age and older, the kiddie tax won't apply. The largest potential for employment tax savings comes from reducing the salary of a family member whose earnings are not above the $57,600 OASDI tax base, presuming the other family shareholders receiving increased dividends are in a lower income tax bracket.[90]

Care needs to be taken to protect the interests of minor children receiving the stock in the corporation (a guardianship was set up in *Davis*). In another case where the taxpayer prevailed in litigation under the predecessor of §1366(e), *Kirkpatrick v. Commissioner*,[91] the parents had given stock in their S corporation to their children. Declining to attribute to the parents all of the income of the corporation, the court found the children's ownership had economic reality. The court pointed to the active role the mother played as custodian of her children's shares plus the arm's length manner in which the father handled a loan to the business from the children's profits (timely payments were made, including interest).

In a recent article on reasonable compensation in the C corporation context,[92] the authors point to a number of considerations relating to avoidance of an excessive compensation label. Viewed from the S corporation perspective, some of these may work in reverse:

1. Higher than average owner-manager salaries can be justified where a corporation's performance is better than the industry average. The converse should be true: a lower than average performance (due to competitive factors, perhaps) can establish the reasonableness of lower salaries, lessening the employment tax burden.

2. Bonuses based on sales, rather than profits, are more likely to be deemed compensation rather than disguised dividends. Thus "bonuses" paid in proportion to stock

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[89] I.R.C. § 1(i) (1988).

[90] Robison & Mark, *supra* note 22, at 91-92.

[91] Kirkpatrick v. Commissioner, 36 T.C.M. (CCH) 1122 (1977).

[92] William D. Samson & Kathi D. Morris, *Closely Held Corporations: The Feasibility of Income Splitting between an Owner-Manager and the Corporation and an Analysis of Reasonable Compensation*, 14 REV. TAX'N INDIVS. 331, 347-48 (1990).

ownership could be better supported as dividends. Bonuses in the sole shareholder context, however, will be open to challenge as unnecessary.

3. The use of contingent compensation arrangements risk being characterized as dividends because they are more likely to vary with corporation profits. Unfortunately, such arrangements, while having a dividend-like appearance, pose risks for the S corporation status if they are found to constitute a second class of stock.[93] A proposed regulation[94] suggests that such deferred compensation plans will not constitute a second class of stock if they do not convey a right to vote or if they involve stock substantially non-vested. Problems still may arise if the shareholder/employee makes a § 83(b) election unless the rights to distributions and liquidation proceeds are identical to rights under existing outstanding stock.[95]

The recent dividend recharacterization cases have reinforced the lesson that "reasonable compensation" must be paid to a shareholder performing services for the corporation. While it may pay to tend toward a reasonable *minimum* salary in order to avoid employment taxes, paying either all salary or all dividends has invariably led to a Service victory in having the *whole* amount reclassified. Payment of some wages will circumvent that fiasco while enabling the shareholder to make the argument that the salary paid was reasonable in the circumstances, if a Service challenge arises.

PART IV. INDEPENDENT CONTRACTORS AND EMPLOYMENT TAXES

Large numbers[96] of service providers claim independent contractor status. Though, since 1990, the differences between FICA and SECA taxes have been minimal,[97] in recent years the Service has stepped up its auditing of independent contractor classifications, which is the second prong in the recent IRS assault on small business. This may be due largely to the perception that the self-employed represent a group with higher noncompliance in the employment tax regime.[98] Section One below will consider why it makes a difference to the different groups involved.

The section will consider 5 areas: (A) how service providers are classified for payroll tax purposes, (B) tests used in making the determination of independent contrac-

[93] I.R.C. § 1361(b)(1)(D) (1988).

[94] Prop. Treas. Reg. § 1.1361-1(b)(4), 55 Fed. Reg. 40870-01 (1990).

[95] Robison & Mark, *supra* note 22, at 92-93. The authors discuss the second class of stock problem with deferred compensation plans.

[96] In the United States, the services of 5 million independent contractors are being utilized by 2 million firms, as reported in 1991 by Dan Mastromarco, Assistant Chief Counsel for Tax Policy at the U.S. Small Business Administration, Office of Advocacy. Dan R. Mastromarco, *The Rekindling Independent Contractor Debate*, 53 TAX NOTES 601, 602 (1991).

[97] Both are 15.30% on the same taxable wage base. *See supra* Part IA.

[98] We noted earlier Congress' belief in 1983 that the self-employed were contributing substantially to the Social Security funding crisis. *See supra* note 44.

tor status, (C) S corporation shareholders claiming independent contractor status, (D) a statutory relief provision, §530 of the Revenue Act of 1978, which shields employers who face back taxes due to worker reclassifications and (E) current events and possible future directions in this unsettled area.

The Status of Service Providers-What Difference Does It Make?

Service providers are either "independent contractors" or "employees" for employment tax purposes. "Employees" break down further into three categories: common law employees,[99] corporate officers,[100] and "statutory employees."[101]

Despite the fact that FICA and SECA rates are virtually the same, the employer still has several reasons to prefer treating service providers as independent contractors.[102] If the service provider is treated as an independent contractor the employer escapes paying his half of the FICA tax due (an independent contractor pays the whole amount himself) plus the unemployment tax (FUTA) due on an employee but not on an independent contractor. Clerical costs are reduced by not having to ascertain the amounts of FICA and FUTA due nor having to turn in the associated reports. Other benefits, expected by employees, need not be provided for independent contractors (vacation pay, sick leave, health and life insurance and pension contributions). The employer may dispense with other costs relating to minimum wage law, worker's compensation insurance, state unemployment taxes and collective bargaining. Finally, other protections for employees, such as civil rights legislation and wage and hour legislation, do not apply to independent contractors.

From the worker's point of view, the ability fully to deduct work-related expenses may be the most significant incentive to be classified as an independent contractor.[103] Independent contractors can fully deduct business expenses. "Employees" can utilize such business expenses only as miscellaneous itemized deductions to the extent they exceed 2% of the taxpayer's adjusted gross income.[104] As a practical matter, though, the workers in the gray areas between employee and independent contractor are generally classified by the business that uses their services. The individual would rarely be in the position to question, let alone protest, how the business has chosen to treat them for employment tax purposes. This lack of leverage indicates a need for these workers to

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[99] I.R.C. § 3121(d)(2) (1988).

[100] I.R.C. § 3121(d)(1) (1988).

[101] I.R.C. § 3121(d)(3) (1988). This encompasses only 4 specific occupations: certain agent-drivers, life insurance salesmen, some home service workers and traveling salesmen.

[102] Deborah H. Oden, *Independent Contractor: A Legitimate Classification with Reclassification Protection*, 69 TAXES 319, 320 (1991).

[103] *Id.*

[104] Russell B. Hollrah, *The Tax Treatment of Independent Contractors: Where We Are and Where We're Headed*, MONTHLY DIG. TAX ARTICLES, Aug., 1992, at 6, 7, *reprinted from* 43 TAX EXECUTIVE 329 (1991).

be protected from unscrupulous employers. Being classified as an independent contractor is either a mixed blessing or no blessing at all.

There are differing means by which partners, limited partners and S corporation shareholders fit in to the employee/independent contractor scheme. The definition of "net earnings from self employment" includes the distributive share of a partner from any trade or business of the partnership.[105] The distributive share of a limited partner, however, does not constitute self-employment income.[106]

S corporation shareholders represent something of a hybrid situation. Items of corporation income pass through to the shareholders "in determining the tax under this chapter," (Chapter One).[107] Since self-employment income is determined under Chapter Two, the distributive share of the S corporation shareholder should not be considered self-employment income, a fact verified by instructions to Forms 1040 and 1120S.[108] If a shareholder/employee is adequately compensated for his work, he will then be able to benefit from distributions which are not subject to employment taxes without risking an IRS recharacterization of these dividends as wages.

Tests for Determining the Employment Status of Workers

The "usual common law rules"[109] for determining the status of a worker as an employee or independent contractor focus on the issue of "control": an employment relationship exists "when the person for whom the services are performed has the right

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[105] I.R.C. § 1402(a) (1988). This is true except where the partnership is engaged in certain excluded activities such as rental real estate.

[106] I.R.C. § 1402(a)(13) (1988). The limited partner is not considered an employee either, in his role as partner. For a narrow range of situations, therefore, the limited partnership can provide a good way to avoid both FICA/FUTA and SECA taxes. That narrow slot encompasses small businessmen/investors living in states which have adopted the Revised Uniform Ltd. Partnership Act. The Revised Act provides somewhat liberalized safe harbor activities in which a limited partner can engage without losing limited partner status:

1.) Serving as officer, director or shareholder of a corporation which is a general partner in the limited partnership;

2.) Consulting with and advising a general partner with respect to the business;

3.) Proposing, approving/disapproving dissolution and winding up of the partnership, the transfer of assets of the partnership, admission/removal of general or limited partners, or an amendment to the partnership agreement. Revised Uniform Limited Partnership Act § 303. *See also* Wayne D. Reid, *The Limited Partnership: An Ideal Vehicle for Start-up Ventures*, 70 TAXES 745, 752-53 (1992).

Where the limited partner can have a significant part in setting up the legal structure embodied in the partnership agreement and can place confidence in the individuals running the partnership on a day-to-day basis, the limited partnership certainly provides a form of business sheltered from employment taxes.

[107] I.R.C. § 1366(a)(1) (1988).

[108] Michael N. Jennings, *Subchapter S and Self-employment Tax*, 18 TAX ADVISER 881, 881 (1987).

[109] I.R.C. § 3121(d)(2) (1988). In the regulations, §31.3121(d)-1 (c)(2), a number of factors are cited. Treas. Reg. § 31.3121 (d)-1 (c)(2) (1960). Generally, the employment relationship exists "when the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished." *Id.* Other factors mentioned are the right to discharge and the furnishing of tools and a place to work. *Id.*

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."[110] The Service considers twenty factors in ruling on the existence of "control" (no single factor being determinative).[111]

In applying these factors, courts select the relevant ones, weighing often contradictory elements to arrive at a determination. One typical case, *General Investment Corp.*

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[110] Treas. Reg. § 31.3401(c)-1(b) (as amended by T.D. 7068, 1970).

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

a. Whether the "employer" can require compliance with instructions as to the time, place and methods of performance. An independent contractor is responsible only for the end result.

b. Whether the "employer" trains the worker in the manner in which services are to be performed. An independent contractor would receive no such training.

c. When a worker's services are integral to the success or continuation of the business, then the owner will more likely want to control the performance of them.

d. The personal nature of the services will likely lead to the "employer" being interested in both the methods and identity of the worker, not just the results (the latter more the focus with an independent contractor).

e. The worker's ability to provide his own assistants strongly indicates independent contractor status.

f. A continuing relationship between service provider and user of services suggests an employer/employee relationship.

g. Hours for work set by the user of the services indicates employer-type control; independent contractors can set their own hours.

h. Where the purchaser of services can require full-time work by the worker, an employee status is likely.

i. Where the service user decides where the work is to be performed, an employment relationship is indicated.

j. The worker not being allowed to set the order of his work points to an employment relationship, whereas the self-employed person is free to follow his own pattern of work.

k. A requirement of regular reports to the service user is an employer-type control.

l. Payment by the job or on straight commission favors independent contractor status while hourly, weekly or monthly payments suggest employer/employee relations.

m. If the worker takes care of incidental expenses, he is likely to be self-employed; an employer pays such expenses for an employee.

n. An independent contractor generally furnishes his own tools; an employer would supply these for an employee.

o. A significant investment by the worker in facilities for doing the work strongly indicates independent contractor status. The investment must be real, essential and adequate to perform the work. It will not be considered significant if: the worker is buying the equipment on time from the service user; the worker has only a small equity in the facilities or the employer retains title to the equipment and can keep ownership by paying the worker's equity; the equipment can only be used by the worker in performing services for this provider of the equipment. A key fact is the value of the worker's investment compared to the total value of all facilities for doing the work.

p. Opportunity for both profit *and* loss also strongly suggest independent contractor status.

q. Independent contractors may work for a number of persons at the same time.

r. Advertising, business listings in the phone directory, and maintaining his own office and assistants are marks of an independent contractor.

s. Right to fire the worker is a privilege of an employer. An independent contractor can't be discharged if he is performing up to contract specifications.

t. Right to terminate the relationship without liability belongs to an employee. An independent contractor must generally finish the contract or face liability.

See Stuart Duhl & Donna M. Shaw, *Keeping Independent Contractors from Being Reclassified*, 19 TAX'N FOR LAW. 210, 211-13 (1991).

v. United States,[112] involved mine workers hired by a small mining corporation. The workers sometimes worked for other mines but the company provided most tools and all the big equipment. The miners were unable to earn more than a daily flat-rate wage, though the company asserted that payment was on a piecework basis. The company president could hire and fire the workers. The corporation did not control every detail of the work but the court found the company had the *right* to control the workers. In concluding these were employees, the court said that the mere fact that the workers set their own hours and break times didn't make them independent contractors. As usual with such "weighing of the factors" tests, the taxpayer in a borderline situation who tries to apply the test to his business is left with much uncertainty.[113] A recent article analyzing the Service's use of the twenty factor test found this uncertainty compounded by inconsistencies in the way the Service applied the test as demonstrated by letter rulings to workers in a single business.[114] A simplified and more objective test would ease problems in this area, though at the expense of more arbitrariness.

Are Corporation Officers Always Employees of the Corporation?

For purposes of FICA tax, an "employee" is defined to include "any officer of a corporation."[115] Although the phrase "any officer of a corporation" seems categorically inclusive, the Treasury regulations have interpreted this to exempt some corporate officers.

> Generally, an officer of a corporation is an employee of the corporation. However, an officer of a corporation who as such does not perform any services or performs only minor services and who neither receives nor is entitled to receive, directly or indirectly, any remuneration is considered not to be an employee of the corporation.[116]

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[112] General Investment Corp. v. United States, 823 F.2d 337 (9th Cir. 1987).

[113] *See* Rev. Rul. 72-203, 1972-1 C.B. 324; Rev. Rul. 66-274, 1966-2 C.B. 446.

With a professional person, the twenty common law factors do not work well at all, so the IRS has selected and adapted the most relevant criteria from the longer list:

a. Is this worker integrated into the operation of the service user?

—In the manner of compensation.

—Is there risk of loss?

—May the service provider employ associates?

—May he engage in private practice?

b. The substantial nature, regularity, and continuity of work done for the service consumer. Is a fixed and definite schedule followed?

c. Does the purchaser of services require compliance with its general policies?
Is the work subject to control by a supervisor?

d. Is the service provider given the rights and privileges of the employees in the service consumer's business? *See* Rev. Rul. 72-203, 1972-1 C.B. 324; Rev. Rul. 66-274, 1966 C.B. 446.

[114] Cherie J. O'Neil & Linda Nelsestuen, *Employee or Independent Contractor Status?: Conflicting Letter Rulings Continue Controversy*, 59 TAX NOTES 961 (1993).

[115] I.R.C. § 3121(d)(1) (1988).

[116] *See* Treas. Reg. §§ 31.3121(d)-1(b) (1960) applicable to FICA and § 31.3306(i)-1(3) (1963) applicable to FUTA.

A 1988 federal district court case, *C.D. Ulrich Ltd. v. United States*,[117] noted that two approaches have been taken to the determination of whether an officer is an employee. The older view looks at the degree of control exercised by the corporation over the way the officer performs the services. However, as officers generally don't occupy subordinate positions, the "control" factor does not readily distinguish between employees and non-employees. For example, in *Ulrich*, the sole shareholder/director/officer of an S corporation had no supervisor, set his own hours and decided what services would be performed and when. These facts would typify many small S corporations. Thus the *Ulrich* court rejected the "control" test in favor of a "level of services" approach. Under this test, officers doing only minor services, who are not deemed employees,[118] are distinguished from officers who perform substantial services and are counted as employees.

A 1971 Revenue Ruling[119] determined that the president and sole shareholder of a closely held corporation was an employee of the corporation in spite of his setting his own hours and salary and being accountable to no one. Two factors decided the question: his services were material to the operation of the business and he was entitled to receive compensation for his services.

In *Automated Typesetting Inc. v. United States*,[120] the officers of a closely held corporation had set up a contractual arrangement between the corporation and family trusts to which the officers had donated their lifetime services. The corporation made payments under the contract to the trusts for the work of the officers. The court declared the set up to be nothing more than an anticipatory assignment of income, and focused on whether the services the officers performed were "substantial" enough to render them employees.

Drawing on Rev. Rul. 74-390,[121] the court cited three criteria relevant to "substantial" services: the character of the services, the frequency and duration of their performance, and the importance of the services in relation to the conduct of the corporation's business. The court contrasted these officers' day-to-day involvement in the operations of the business with occasional signing of documents or attending of infrequent meetings as relevant to the first criterion. The next two items were satisfied by over-40-hour work-weeks spent managing every aspect of the business. The court concluded that employment taxes were due on the contract payments made to the trust, and held that employee status is indicated where individuals "perform, on a continuing basis, full-time personal services which constitute an integral part of the business operations of the employer." [122]

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[117] C.D. Ulrich Ltd. v. United States, 692 F.Supp. 1053 (D. Minn. 1988).

[118] The distributions they receive from the corporation would then be treated as dividends and would not be subject to recharacterization.

[119] Rev. Rul. 71-86, 1971-1 C.B. 285.

[120] Automated Typesetting, Inc. v. United States, 527 F. Supp. 515 (E.D. Wis. 1981).

[121] Rev. Rul. 74-390, 1974-2 C.B. 331.

[122] *Automated Typesetting*, 527 F. Supp. at 520.

A recent Ninth Circuit case, *Spicer Accounting Inc. v. United States*,[123] considered the claim of the president of an S corporation accounting firm that he was an independent contractor, not an employee of the business. Based on the fact that the corporation provided him with supplies and a place to work, that he performed accounting services for no other firm, and that his services were integral to this corporation's operation, the court rejected his independent contractor argument. The court likewise found he met the test of a corporation officer "employee" on the grounds of his nearly full-time work as the accounting firm's sole accountant.[124]

§ 530 of the Revenue Act of 1978: Congressional Relief for Independent Contractors[125]

This statute, not part of the Internal Revenue Code, was enacted to provide some safe havens for small businesses involved in worker classification controversies with the Service. Perceiving a need to protect businesses from heightened IRS audit activities in this area, Congress attempted to inject greater certainty. Prior to this time, the imprecise, twenty factor, common law test determined employment status.[126]

Section 530 protects only the business user of services, not the worker. Meeting the section's tests, the business could treat the worker as an independent contractor, leaving the worker to pay the employee's share of FICA tax (not SECA), while the business would have liability for neither FICA nor FUTA.[127]

The statute falls into two main parts. Part One states that, for purposes of the business' employment tax liability, "unless the taxpayer had no reasonable basis for not treating such individual as an employee,"[128] the individual shall be deemed *not* to be an employee. A consistency requirement is imposed: the business cannot have previously treated the individual as an employee for purposes of employment taxes or on any required federal tax returns, including informational returns. Part Two then provides three statutory means of meeting the "reasonable basis" element in Part One.[129] The taxpayer (service user) reasonably relied on one of the following: judicial precedent, published rulings, or technical advice or a letter ruling to the taxpayer; a prior IRS audit of the taxpayer resulting in no assessment for employment tax purposes concerning individuals in substantially similar positions to that of the individual in question; or a long-standing, recognized practice of a significant segment of the industry in which such individual engages. Section 530(a)(3) requires consistency also in the business' treatment of individuals holding substantially similar positions as non-employees.

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

[124] *Id.* at 94. "One who performs substantial services for the corporation." *Id.* at 93.

[125] *See* Revenue Act of 1978, Pub. L. No. 95-600, § 530, 92 Stat. 2763.

[126] Hollrah, *supra* note 104, at 7.

[127] *Id.* at 8.

[128] Revenue Act of 1978, § 530(a)(1).

[129] Revenue Act of 1978, § 530(a)(2).

The three safe harbors are labeled as one method of satisfying the "reasonable basis" requirement. A service consumer can still justify its treatment of the worker "in some other manner,"[130] for example, by means of the twenty factor common law test.[131] The Ninth Circuit noted, "the statute was designed to relieve employers of the burden of surprise or uncertain imposition of retroactive tax liability resulting from an increase in IRS employment-status audits."[132] "Reasonable basis" was meant to be "construed liberally in favor of taxpayers."[133]

Regarding the first safe harbor, letter rulings or technical advice may be relied upon *only* where issued to this particular taxpayer.[134] The prior audit, the second safe harbor, must have been "of the taxpayer" business, an audit of the *individual* not qualifying.[135] The audit, however, need not be an employment tax audit.[136]

This prior audit safe harbor has been held to extend to substantially similar workers in different industries within a single corporation. In *Lambert's Nursery & Landscaping, Inc. v. United States*,[137] an audit of a business with landscape workers resulted in no reclassification. When the corporation subsequently added a janitorial division, the Service ruled that the janitors were employees. But both the district court and Fifth Circuit disagreed. The district court found that both types of workers were treated similarly in terms of control, supervision, pay and demands.[138] The Fifth Circuit on appeal held that the key element of the prior audit safe harbor was the structure of the taxpayer-worker relationship, not the type of work performed.[139]

Under the third safe haven, an employer must prove that a "significant segment of the industry"[140] treats such workers as independent contractors, not employees. The question naturally arises, "What is a 'significant segment'?" The Service has answered, "[s]mall geographic areas generally provide the most appropriate basis for evaluating a particular industry."[141] Yet in *General Investment Corp. v. United States*,[142] the government argued for examination of all mining businesses nationwide or at least all small

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[130] Rev. Proc. 85-18, 1985-1 C.B. 518.

[131] Hollrah, *supra* note 104, at 8.

[132] General Investment Corp. v. United States, 823 F.2d 337, 339 (9th Cir. 1987) (citing S. REP. NO. 1263, 95th Cong., 2d Sess. 209-10 (1978)).

[133] *Id.* at 340 (citing HR. REP. NO. 1748, 95th Cong., 2d Sess. 5 (1978)).

[134] Darrell Harris, Inc. v. United States, 770 F. Supp. 1492, 1498 (W.D. Okla. 1991).

[135] C.D. Ulrich Ltd. v. United States, 692 F. Supp. 1053, 1056 (D. Minn. 1988).

[136] Rev. Proc. 85-18, 1985-1 C.B. 518.

[137] Lambert's Nursery & Landscaping, Inc. v. United States, 894 F.2d 154 (5th Cir. 1990).

[138] *Id.* at 156.

[139] *Id.* at 157.

[140] Revenue Act of 1978, § 530(a)(2)(c).

[141] Tech. Adv. Mem. 87-33-004 (Apr. 23, 1987).

[142] General Investment Corp. v. United States, 823 F.2d 337, 340 (9th Cir. 1987).

mining concerns nationwide. In rejecting this as too cumbersome and contrary to congressional intent, the Ninth Circuit found that other small metallic mines in the county provided a "significant segment" of the industry on which an employer could reasonably rely. Thus the court found that the corporation had a reasonable basis for treating its miners as independent contractors and it relieved the corporation of employment tax liability for three years. For the fourth year, the requirement of filing informational returns for independent contractors had been added to §530. As the business had not filed such returns,[143] it failed to be eligible for §530 relief for that year under the safe haven.[144] So for that year, the court next considered whether a "reasonable basis" existed for treating these workers as independent contractors under the common law test. As previously discussed,[145] the court held that no such reasonable basis existed under the common law factors cited in the Treasury regulations.[146]

Several S corporation shareholders have attempted to claim independent contractor status in relation to their corporation.[147] In each case, the independent contractor status claim has been rejected. In such cases, the court is then obliged to investigate whether the business had a reasonable basis for not treating the individual as an employee under §530. In *Spicer Accounting, Inc. v. United States*, though Spicer had never been treated as an employee and the appropriate informational returns had been filed, the court summarily dismissed the corporation's having a "reasonable basis." The court held that as the business' sole full-time worker, Spicer "must be treated as an employee."[148]

Ulrich, discussed earlier, came closer to meeting the requirements of § 530. However, the court declared the prior audit safe haven inapplicable because the Service audited Ulrich personally, not the corporation. Similarly, the corporation's reliance on judicial precedent and a letter ruling was misplaced, in the court's view, as there was a larger body of contrary precedent and the letter ruling was addressed to another taxpayer.

While § 530 has not proved helpful to S corporation shareholders, it has given some relief from the devastating effects of a reclassification of workers by the Service to businesses using the services of independent contractors. As discussed below, though, the effect of § 530 is uneven and there is pressure from the Service and even within small business to eliminate it.

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143 Revenue Act of 1978, § 530(a)(1)(B).

144 Revenue Act of 1978, § 530(a)(2)(C).

145 *See supra* text accompanying note 112.

146 Treas. Reg. §§ 31.3121(d)-1(c)(2), 31.3306(i)-1(b), 31.3401(c)(1)(b) (1987).

147 *See* C.D. Ulrich, Ltd. v. United States, 692 F.Supp. 1053 (D. Minn. 1988); *See also* Spicer Accounting, Inc. v. United States, 918 F.2d 90 (9th Cir. 1990); Darrell Harris, Inc. v. United States, 770 F. Supp. 1492 (W.D. Okla. 1991).

148 *Spicer Accounting, Inc.*, 918 F.2d at 95.

Current Activity on the Independent Contractor Front

Due to the recent two-barreled IRS attack on small business (recharacterization of S corporation dividends as wages and increased audits of independent contractor classifications), the small business community is alarmed. Particularly in regard to the worker classification question, business perceives itself as caught between the uncertainty of the facts-and-circumstances common law test and the potentially disastrous penalties for failure to comply with the standard.[149] Of course, the underlying pressure comes from the extra costs associated with classifying a worker as an "employee." These costs then spell competitive disadvantage in relation to other businesses who categorize similar workers as independent contractors. Since 1987, increasing numbers of audits conducted against employers using independent contractors have been directed at the businesses with a net worth of less than $3 million.[150] In addition, the enforcement community continually works to erode the §530 protection.[151] In particular, the Service would like to see an end to the prior audit safe harbor. Although §530 specifically forbids Treasury and the Service from issuing any regulation or revenue ruling "with respect to the employment status of any individual for purpose of the employment taxes,"[152] an IRS representative announced in September, 1992 the Service's plan to issue a revenue ruling on §530.[153] Pointing out the inadequacies of §530, the representative noted that meeting a §530 safe harbor did not change the employee status for other tax purposes. A worker protected under §530 would still be considered in determining the qualification of a pension plan, for example.

Whatever may be the truth about the effects of §530 and the classification of a worker as an independent contractor, the three major players in this area (service providers, service recipients and the enforcement community) all have strongly held beliefs on the subject. Service recipients, the "employers," bear the brunt of the Service's enforcement activities. Their disagreement with the current approach taken by the IRS focuses on two points. First, the enforcement efforts fall with devastating effect (in extreme cases, forced bankruptcy) on a few, targeted businesses. Due to the subjective, multi-factored common law standard applied, honest confusion can as easily be the basis for misclassification as deliberate evasion. Yet the amount of penalties bears little relation to culpability.[154]

Second, small business people see competitive disadvantage being created by the current situation. Testifying at a July 23, 1992 hearing on worker classification before

[149] Mastromarco, *supra* note 96, at 602.

[150] *Id.* at 603.

[151] *Id.*

[152] Revenue Act of 1978, § 530(b).

[153] The Service representative could not specify when it would be issued. Ian K. Louden & Catherine Hubbard, *Service Hopes to Issue Guidance on Classification of Workers*, 56 TAX NOTES 1541 (1992).

[154] Mastromarco, *supra* note 96, at 605-06.

the House Ways & Means Subcommittee on Select Revenue Measures,[155] a courier service representative estimated that 75-80% of his business' direct competitors erroneously classified their drivers as independent contractors under the common law factors. This resulted in loss of business to the firms who treated their drivers as employees, due to the higher costs of employee benefits and taxes.

Service recipients view current enforcement policies as raising revenue, perhaps, but not efficiently policing the use of similarly situated independent contractors by competing firms. Furthermore, a number of service users agree with the Service on disliking the prior audit safe harbor of §530. Businesses fortunate enough to have been audited (for whatever reason), without any challenge to their worker classification, are perceived by their competitors as possessing an unfair advantage: being able to misclassify workers with impunity.[156]

As to the service providers, many believe in the reality of the independent contractor status, apart from tax law definitions. For them, it defines the boundary between having a boss or having a business. The Service, in their view, should concern itself only with ensuring taxes are paid and not with restructuring the relationship between service provider and recipient.[157] They want the contracting parties' definition of the relationship to control. Finally, the enforcement community faces a severe, broad-based tax compliance problem.[158] The Service sees independent contractors as a less compliant group than employees, likely to overstate deductions or understate income or even not to file.[159] Due to employer incentives to misclassify, the Service estimates a large number of erroneously classified workers exist, resulting in large revenue losses.[160]

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155 Rita L. Zeidner, *Industries Testify For & Against Tighter Employment Status Controls*, 56 TAX NOTES 405 (1992).

156 H.R. REP. NO. 101-979, 101st Cong., 2d Sess. (1990), *cited in* Hollrah, *supra* note 104, at 9-10. The House Government Operations Committee concluded the prior audit safe harbor did create competitive disadvantage, protecting businesses blatantly misclassifying workers. Hollrah points out, however, that reliance on the prior audit safe haven must be "reasonable" under § 530(a)(2).

157 Mastromarco, *supra* note 96, at 606-07. Doubtless, however, there is another group of service providers who do not in reality have a business but are classified as independent contractors merely for the advantage of the service user.

158 *The Wall Street Journal* reports an estimated 10 million Americans don't file income tax returns. *See* Scott R. Schmedel, *Tax Report*, WALL ST. J., Feb. 10, 1993, at A1.

159 Mastromarco, *supra* note 96, at 607. "Since the income paid to independent contractors is not subject to withholding by a third party, independent contractors have a statistically greater opportunity to overstate deductions, understate income or not to file. The Service contends that because independent contractors are less compliant than employees, compliance will increase by treating these workers as employees." *Id.*

160 *Id.* Such losses are estimated by the Service at 1.6 billion dollars in 1984. *Id.* In contrast, § 1706 of the Tax Reform Act of 1986 eliminated § 530 protection for taxpayers brokering the services of certain technical service workers. Five years later, the Treasury studied the effectiveness of § 1706. Three fact patterns were analyzed with their tax effects. In each scenario, the independent contractor ended up owing *more* tax than employees in the same situation. Discussing this phenomenon, Treasury concluded, "Misclassification increases tax revenues...because direct compensation to independent contractors is substituted for tax-favored fringe benefits." Dept. of Treas., Rep. to the Cong., Mar., 1991 (Taxation of Technical Services Personnel: Section 1706 of the Tax Reform Act of 1986), *cited in* Mastromarco, *supra* note 148, at 609.

Predictably, ideas about what should be done varies with the group making the proposal. To deal with non-compliance, the IRS wants to increase efforts against small business using independent contractors. Second, it favors repeal of §530 safe havens, especially the prior audit rule and the §530(b) prohibition against the IRS issuing pronouncements in the independent contractor area (preventing it from clarifying the subject for employers).[161] Furthermore, IRS officials have privately showed interest in applying a withholding system to all payments made by businesses to independent contractors.[162]

The small business community is split over the potential for legislation to improve the situation. Working toward a more objective test of independent contractor/employee status and modifying or even repealing §530 are suggested by some in small business. Others fear opening the legislative door at all, anticipating the emergence of such things as the IRS-favored withholding concept.[163]

Witnesses at July 30, 1991 hearings before the Exports, Tax Policy and Special Problems Subcommittee of the House Small Business Committee[164] advocated a new enforcement approach by the IRS. At present, the Code penalizes worker misclassification more severely than failure to file Form 1099 (used to report business' payments to independent contractors). Thus enforcement pressure bears most heavily on compliance with the subjective common law test, with the §530 safe haven providing uneven relief.

Shifting the compliance focus onto Form 1099 filings, matched with independent contractors' self-reported income, would result in a more just and effective system. IRS compliance studies show a correlation between 1099 filings and independent contractor payment of taxes on income thus reported. The studies demonstrate the most dramatic correlation where businesses believed to be misclassifying workers are involved.[165] By emphasizing compliance through the filing system, the inequitable results stemming from the subjective common law test and the §530 safe havens could be avoided.

CONCLUSION

In view of the substantial rates and ever-expanding tax base of FICA tax, the payroll taxes represent a real threat to the health of small businesses. The enforcement community, on the other hand, faces severe compliance problems with both income and payroll taxes. The Service views small business as less compliant than many other groups. In

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[161] Mastromarco, *supra* note 96, at 607.

[162] Hollrah, *supra* note 104, at 9-10.

[163] *Id.*

[164] *Id.* at 11.

[165] 77.2% of the misclassified compensation for which Form 1099 was filed was reported, as compared to only 28.8% when no 1099 was filed. Mastromarco, *supra* note 96, at 608.

recent years, the IRS has mounted a two-pronged attack: recharacterizing as wages S corporation dividends to shareholders who perform services for the corporation and stepping up reclassification efforts in the independent contractor area.

Simplistic planning no longer suffices for even very small businesses. With the current crises in tax compliance and in the solvency of the Social Security system, the Service is demonstrating that it will no longer ignore such "small fry." Utilizing what opportunities still exist to cut down on payroll taxes may mean the difference between the survival and death of a small business. Diverse compensation methods, including fringe benefits still open to S corporation shareholders, may tip the balance toward survival.

In the independent contractor area, Congress has acknowledged that a problem exists with the Service's intensive audits of the businesses served by independent contractors. Section 530, enacted as a temporary measure in 1976 to ameliorate the situation then, is now a permanent provision. Yet dissatisfaction with both § 530 and the unwieldy, subjective common law test indicate that a more certain and objective approach is needed. The best approach is for the Service to focus its efforts on seeing Form 1099 is consistently filed by the businesses using independent contractors' services along with matching the Form 1099s with the independent contractors' tax returns.