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SMALL BUSINESS TAXATION PROPOSALS

HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

ONE HUNDRED FIFTH CONGRESS

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ON

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THURSDAY, JUNE 5, 1997

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT,
COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 2:05 p.m., in room SD–215, Dirksen Senate Office Building, Hon. Don Nickles (chairman of the subcommittee) presiding.

Also present: Senator Baucus.

OPENING STATEMENT OF HON. DON NICKLES, A U.S. SENATOR FROM OKLAHOMA, CHAIRMAN, SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT

Senator NICKLES. The Subcommittee on Taxation and IRS Oversight will come to order.

I want to thank my friends and colleagues for your cooperation today. I am going to ask all of our panels to try to be fairly brief, if possible.

We have Mother Teresa in to receive a Congressional Medal of Honor today, and I would like to participate in that, which means that we need to finish this thing no later than 3:30.

I am delighted that my colleague, Senator Baucus, is here, and that Senator Bond is here as chairman of the Small Business Committee.

I think it is appropriate that we have this hearing today on National Small Business Week. I think it is a time that we should recognize that small business is the engine that drives this country with economic activity and the growth in jobs.

In many cases the Tax Code is not taxpayer friendly to small business, whether you are talking about deductibility for insurance rates, self-employed persons get to deduct 40 percent, corporations get to deduct 100 percent. I do not think that is very friendly towards small business.

Also, if you look at independent contractors, if you look at electronic filing of tax payments which have a 10 percent penalty, which I am pleased that the IRS has announced earlier this week that they would postpone the penalty for 6 months. I think the penalty should be waived and it should be made optional for small business, and we have introduced legislation to accomplish that.*

* For more information on this subject *see also*, Joint Committee on Taxation document *"JCX–19–97—Description and Analysis of Proposals Relating to the Deduction for Health Insurance Ex-*

Continued

I am pleased that my colleague, Senator Baucus, is here. Max, do you have any opening comments?

OPENING STATEMENT OF HON. MAX BAUCUS, A U.S. SENATOR FROM MONTANA

Senator BAUCUS. Thank you very much, Mr. Chairman.

Just very briefly, it is true that this Congress does not spend as much time and attention on small business as we should, though we pay a lot of lip service. It has always been a bit of a frustration for me.

I have been on this committee many years, and there are many who talk about small business, but not a lot has been done about it. I hope this is a turning point. Your holding this hearing, I think, is a good start.

I might say that when we talk about small business, Main Street is to Montana what Wall Street is to America. That is, the heart of my business in my State is Main Street business. It is small business. I dare say that is the case in most every community all across our country.

Well over 90 percent of the full-time businesses in Montana are small businesses. Two out of three of these small businesses have less than 5 employees, and almost all of them have fewer than 50 employees.

Small businesses are important to creators of jobs in States like mine. We all know that, but I think it is a statement that bears repeating.

For instance, in Montana, small businesses with fewer than 20 employees reported a 9.5 percent employment growth from 1991 to 1995, compared with 4.5 percent employment growth for the State as a whole. Small business grew twice as fast as did the State as a whole.

Small business income rose almost twice as fast for small business as wages and salaries, and minority-owned businesses increased by almost 50 percent.

That is why, Mr. Chairman, I believe it is essential that if we are to have tax cuts as part of our effort to balance the budget, we should target many of these tax cuts to the place where they will do the most good, to small business men and women that are the heart of the business in our country. I am a very strong advocate of most of the legislative proposals that we will discuss here at this hearing.

I have a small business agenda and am a sponsor of several bills. I believe that we should reduce the capital gains tax for small investors and for small business, increase the threshold of the estate tax so small businesses, farmers and ranchers can pass their businesses on to the next generation.

Also, immediately increase the deduction for health insurance for the self-employed to 100 percent, restore the home-office deduction, provide one-stop shopping for businesses that deal with government agencies, and begin to give meaningful retirement savings incentives to small businesses and their employees.

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penses of Self-Employed Individuals, Worker Classification, Taxation of Home Office Expenses, and Electronic Filing," June 4, 1997.

The long and the short of it is, it is good that we are holding this hearing today to highlight a lot of the measures which I support.

I know you are interested in them, as well as Senators Snowe, Bond, and many others. I hope this generates a little bit of momentum so that when we finally sign our tax bill, that we have some of the provisions that we all know are so important to the greatest degree possible.

Senator NICKLES. Senator Baucus, thank you very much. I think we will have some common bipartisan support. I know that Senate Bill 460 on which Senator Bond wishes to testify has 31, maybe 32 co-sponsors, and Senate Bill 570 has 21 co-sponsors, both of which have bipartisan support.

We are also delighted to have Senator Snowe join us as well. Who wishes to go first?

Senator Bond is chairman of the Small Business Committee. Please proceed.

STATEMENT OF HON. CHRISTOPHER S. BOND, A U.S. SENATOR FROM MISSOURI

Senator BOND. Thank you very much, Mr. Chairman and Senator Baucus. In order to save time, I would ask that I be permitted to submit my statement, and also a letter I have sent to the Chairman of the full committee on this measure so you will have the full details, and I can summarize my points.

Senator NICKLES. Without objection.

[The prepared statement and letter of Senator Bond appear in the appendix.]

Senator BOND. I am delighted to hear the very warm reception. I hope that the views expressed by the distinguished chairman and Senator Baucus are echoed throughout the committee, because we are talking about something that is very important when we talk about home-based businesses.

There are over 9 million home-based businesses in this country, and over 14 million individuals earn income through home-based businesses. A majority of home-based businesses are owned by women, and SBA estimates that women are starting over 300,000 new home-based businesses each year.

The Home-Based Business Fairness Act, which I was pleased to introduce on March 18 this year, with Senator Snowe as my lead co-sponsor, now S. 460, currently has 33 co-sponsors.

This bill deals with three priorities identified by small business. The first is 100 percent deductibility of health insurance costs for the self-employed. This was number 15 on the White House Conference list of top recommendations in 1995.

Last year, it was good that we increased the deduction incrementally from the 40 percent today to 80 percent in 2006. That is a very good start. The only problem is, I do not know too many people who can be sure they will not get sick before 2006. I would hope we could go the full way this year, to 100 percent.

Last month we adopted a resolution in the Senate Budget Committee, which I sponsored and found, much to my pleasure, that every single member of the Budget Committee on both sides cosponsored. The resolution calls for a portion of available funds to be set aside for immediate 100 percent deductibility.

Almost a quarter of the self-employed in America today, and that takes in businessmen, farmers, ranchers, day care operators, do not have health insurance, over 5 million self-employed individuals. There are 1.4 million children who do not have health insurance who live in families headed by a small business person.

I think that coverage of these self-employed individuals and their children through full deductibility will enable the private sector to address the health care needs of these individuals rather than setting up an expensive and extensive new governmental plan.

The second part of S. 460 restores the home-office deduction, which was number 20 on the list of top recommendations of the White House Conference.

The Supreme Court in 1993 in the Soliman decision limited the home-office deduction to business owners who see clients in their home and generate income within the home office. Now, that decision excludes service providers like construction contractors, landscaping professionals, computer consultants, sales reps, who, by necessity, perform their services outside of the home.

The bill simply restores the home-office deduction by permitting a home office to include one where the individual performs essential administrative and management activities, such as billing and record-keeping, on a regular basis, provided there is no other place or office to perform them.

Third, and you, Mr. Chairman, and I have worked on this in the past Congress. The number one top headache, as well as recommendation of the White House Conference on Small Business, had to do with the independent contractors.

The IRS currently uses an extremely complex and subjective 20-factor formula to determine whether a worker is an employee or a contractor. As a result, there is a lack of certainty.

Frequent reclassifications involve huge payments of back employment taxes, interest, and penalties. If you do not think it is a problem, the fact is, from 1988 to 1994, the IRS use of the 20-factor test resulted in 11,000 audits, 483,000 worker reclassifications, and $751 million in back taxes, interest, and penalties.

Now, if anybody does not think it is complicated, the IRS put out a training manual for its agents to streamline and simplify the issue. This is the 150-page gem that tells you how simple the 20-factor formula test is. We have got to do better than that, Mr. Chairman.

The bill clarifies the definition of an independent contractor by establishing a safe harbor, which can be met in either of two ways. Number one, a written agreement, economic independence (having the ability to realize income as well as the risk of loss), and work place independence (either using a home office, working at more than one service recipient's facilities, or using your own equipment), or, number two, showing the individual performed services through his or her own corporation, provides his or her own benefits, and there is a written agreement.

These are not new tests. They are based on the existing 20-factor test. What is revolutionary is that they clarify and simplify with the certainty the requirements that small businesses need in order to avoid arbitrary IRS reclassification.

There is also a protection against retroactive reclassification if there is a written contract, the parties have complied with reporting requirements, such as issuing 1099s, and there is a reasonable basis for parties to believe there is an independent contractor relationship. If these criteria are met, , the IRS can only reclassify prospectively, they cannot bankrupt a small business.

The bill, finally, repeals Section 1706 of the 1986 Tax Reform Act. That is the section that was put in to bar knowledge professionals, like computer programmers, who work through placement firms from protection that exists under current law against reclassification.

In the past Congresses we have tried to repeal that section. It had widespread, bipartisan support. Initially it was thought that these people would not report their income, and it turns out they are the ones who are more likely to report it. So, it is not necessary to target them.

We have cost estimates from the Joint Committee on Taxation on the first two parts of the bill: the 100 percent deductibility will cost $7.2 billion over 5 years, obviously adding on to what was done in 1996. The home-office deduction will cost $1.2 billion over 5 years.

There is a question about scoring of the independent contractor provision. Since it is only a classification issue, unless they are counting on gaming the system through penalties, it should cost nothing.

But, in the 104th Congress, our prior version of this provision, S. 1610, was scored to cost $960 million over 5 years. I really do not think the cost will be that much. The savings to small business, and anybody who deals with independent contractors, should be far greater.

Senator NICKLES. Senator Bond, thank you very much. I appreciate your leadership.

We are also delighted to have Senator Snowe with us. Senator Snowe?

STATEMENT OF HON. OLYMPIA J. SNOWE, A U.S. SENATOR FROM MAINE

Senator SNOWE. Yes. Thank you, Mr. Chairman. I am very pleased to be here, and I want to commend you for your leadership in championing small business issues, and for holding this hearing today, and to Senator Baucus as Ranking Member.

I think that it is critically important that we focus, as we look at the reconciliation package, on some of these issues that are important to small business.

I certainly want to congratulate Chairman Bond. As a member of his Small Business Committee, I have witnessed him exhibit leadership on so many of the issues that are important to small business and for the introduction of the Home-Based Business Fairness Act, which I think is very important for small businesses in this country.

I think we all concur on the fact that our Tax Code certainly has been unjust and unfair to small businesses, and the Home0Based Business Fairness Act is an opportunity to correct some of those inequities.

Indeed, small businesses play a key role in our Nation's economy. think that is something that is often overlooked. Even in the 1980's, when we had an expansive recovery, it was small business that basically was responsible for most of the jobs that were created in America.

In fact, last year small business produced 75 percent of the 2.5 million jobs that were created in this country. In my own State of Maine, small businesses represent 97 percent of all the jobs, so they clearly play a very pivotal role.

The Home-Based Business Fairness Act is important. I think that the 100 percent deductibility of health insurance is something that we should move forward on, even though the Congress last year passed an incremental phase-in.

As Senator Bond mentioned, I do not think 80 percent is sufficient. It is not fair that small business is treated differently from companies and corporations who are able to deduct 100 percent. Our approach certainly would go a long way to helping those who are self-employed and uninsured. In fact, it will help 11 percent of that population.

In addition, I held a hearing in Maine that Senator Bond was kind to attend recently on issues important to small business. I had one person who testified who was a small business owner. For 5 years, his family did not have health insurance because he simply could not afford it.

He could not because of the health insurance costs. He owned a home-based business, so he was not able to deduct any of the expenses associated with his business because he worked out of his home. He could not pay the $10,000 in premiums for his family and his children, so they had to go without.

In addition to that, he also operated as a part-time salesman just so that he could try to make ends meet and provide for his own health insurance. I think this is an example of the impact that these inequities in our Tax Code are having on small business owners.

When it comes to the issue of home-based businesses, it is another question of leveling the playing field for small business owners. Those people who operate out of their homes on a legitimate basis, should certainly be entitled to benefit from the Tax Code. Again, it provides the equal treatment for home-based businesses with companies who are able to deduct the full cost of their commercial space.

Senator Bond indicated that there are 14 million people in America who operate home-based businesses. It is the trend. It is the wave of the future. With corporate down-sizing, new technology, flexible work arrangements, we are moving in the direction of more and more people engaging in home-based businesses. In fact, half of the 81,000 small businesses in Maine are home-based.

So, I would hope that we would begin to look at this issue to provide tax benefits in accordance with benefits that are already provided to corporations in America.

Finally, I think the issue of clarifying the definition of independent contractor must be resolved, and I know you, Mr. Chairman, have played a key role in this in the past. There is no rationale

or justification for having inconsistencies with respect to Internal Revenue Service guidelines.

Over the years they have been unclear, they have been ambiguous, and certainly inconsistent. Two identical cases could be interpreted or construed differently based on the interpretations by the Internal Revenue Service.

If that is not bad enough, then you have the retroactive reclassifications that could literally destroy small business who have to pay back taxes, interest and penalties, because the IRS decided, that they do not think that the interpretation was correct. It is like playing Russian roulette. I do not think that is fair to anybody in America.

We should be clear, straightforward, direct, and concise in the application as well as the meaning of our Tax Code, so I would hope that we could clarify that definition so it is appropriate for small businesses to take advantage of it where it is legitimate and proper.

Mr. Chairman, the business author, Peter Drucker, said that, "We are dedicated to the preservation and strengthening of small business, and our tax policy is designated to destroy small business."

I think that we have to do all that we can for the primary job creator in America by improving the Tax Code and making it more equitable and fair to small business. We should be encouraging job creation and the entrepreneurial spirit that has made this a great Nation. So I would hope that you would consider the issues that have been embraced in this legislation. Thank you.

[The prepared statement of Senator Snowe appears in the appendix.]

Senator NICKLES. Senator Snowe and Senator Bond, thank you both for outstanding statements and for your leadership on this issue.

Senator Bond, in your statement you mention a number of small businesses, if the deductibility was increased to 100 percent. In other words, it would be the same as for a corporation. You mentioned that that would increase coverage by an estimated number of people, including the number of kids that are now without insurance. Do you remember those figures?

Senator BOND. Our figures are that 1.4 million children without health insurance today live in families where the bread-winner is a self-employed person. Obviously, we are all trying to make sure that our children are covered by health insurance.

I do not mean to focus just on this aspect because it is a fundamental question of fairness for the small business owner, but I think there is a tremendous public policy good that can be achieved from this because I believe we will make, as Senator Snowe has indicated from the testimony we have heard, a significant impact on the uninsured children who do not have insurance because their parents are farmers, truck drivers, or operate a small business out of the home.

Senator NICKLES. I appreciate your comments.

Senator Baucus, did you have any comments or questions from our colleagues?

Senator BAUCUS. No.

Senator NICKLES. I know both of our colleagues have some further obligations, so I want to thank both of you for your excellent testimony before the committee.

I will ask our next panelist to come up. It will be Donald Lubick, Acting Assistant Secretary of Treasury, Tax Policy, for the Department of Treasury.

Mr. Lubick, welcome.

STATEMENT OF HON. DONALD C. LUBICK, ACTING ASSISTANT SECRETARY, TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. LUBICK. Thank you, Mr. Chairman and Senator Baucus.

I have a prepared statement, with your consent, that will be submitted for the record.

Senator NICKLES. Certainly.

Mr. LUBICK. I will try to be as expeditious as I can in my testimony as well.

Senator NICKLES. Thank you.

Mr. LUBICK. I would like to deal with the four principal issues that have been talked about this morning, delivering some good news, and perhaps some views that represent a slightly different point of view.

But our objective, of course, we share completely with you. This administration is committed to encouraging and helping small business in every way that is possible, consistent with sound tax policy.

Let me start with the home office deduction. We support the general approach of Section 460 as a response to the Solomon case that was decided in the Supreme Court. We think that the proposal will help the tax laws keep pace with changes in the work place.

We have some reservations as to the technical aspects of the drafting of the proposal. We have two suggestions that should be made. One, is to require that the level of services provided in the home be substantial as well as successful to avoid reopening questions that were raised with very substantial litigation aspects before 1976.

Our second suggestion is a drafting one. We think it was inadvertence that this bill would permit, as drafted, the deductibility of commuting expenses by recharacterizing the home as a principal place of business.

We believe that what was intended was that deductions should be allowed for those expenses without necessarily allowing what essentially were commuting expenses. Therefore, we would place the definitional aspect in the language dealing with home office expenses.

With those reservations, we certainly want to work with Congress to accomplish this result and we are supportive of your objective.

Senator NICKLES. Mr. Lubick, before you go further, let me just make sure I understand. On the commuting expenses, you do not want to allow commuting expenses to be deducted as a home office expense.

Mr. LUBICK. Generally speaking, one is not allowed, as a travel expense away from home, the expense of going to the first place of

business. We are dealing with a situation where the home is not, in fact, the primary place of business, otherwise you would not have had the decision in the case. The fact of the matter was, the primary activity was carried on outside the home.

Therefore, if you artificially declare the home to be the principal place of business, you would, I believe inadvertently, permit the immediate deductibility of travel to the first place of work outside the home.

In the case of Dr. Solomon, who was an anesthesiologist, we share in common the fact that we spend a lot of time away from our home putting people to sleep.

Senator NICKLES. We do the same thing in our job.

Mr. LUBICK. In that situation, he went to six different hospitals where he spent almost all of his time. In that case, we would apply the normal rule where one has multiple places of business, that the first commute should not be deductible.

Senator NICKLES. Excuse me. I did not want to interrupt you, and I cannot afford to do that or we will not get to our other panelists. So, please proceed.

Mr. LUBICK. Let me turn, next, to the self-employed health insurance deduction. Again, the administration has strongly supported proposals to facilitate health insurance coverage for all Americans, including the self-employed.

The Health Insurance Portability and Accountability Act of 1996, HIPA, increased the percentage of health insurance premiums from 30 percent in 1996 over a period of years to 80 percent. We believe that HIPA has attained a basic parity with the treatment of the employees versus the self-employed.

Statistics show that, for the most part, employers providing health insurance for their employees require some premium contribution by the employee. As far as the self-employed are concerned, any cost that they pay for their employees are deductible as business expenses.

The only issue, is the cost of insurance that the self-employed provide for themselves, whether that should be deductible or not. The deduction corresponds to the exclusion from income for the employees.

For the most part, obviously different employers have different levels of payment, the 80 percent does achieve parity between the employees and the self-employed. We believe that HIPA has done it quite properly and, therefore, we would not favor extending this further.

Let me turn to another matter, Mr. Chairman, that you referred to, which is electronic filing and payment of taxes. The Treasury is required to collect specific percentages of the depository taxes that businesses are required to pay and deposit periodically through electronic fund transfer.

Our direction was to phase this in over a 6-year period, beginning with the fiscal year 1994. The target was, when fully phased in, that we collect 94 percent of all depository taxes by electronic fund transfers.

The current threshold is persons with annual liabilities of $47 million or more. Beginning July 1, as you alluded to, that threshold

was reduced to $50,000, covering the category of businesses in between.

On Monday, the service announced that it is waiving penalties for the next 6 months for businesses that would become subject to this requirement for the first time on July 1. The delay is responsive to taxpayers who believe they need more time to get into the system and to become comfortable with it.

I would like to report on the substantial progress that has been made toward implementation of the $50,000 threshold. Over 1.1 million of the approximately 1.2 million businesses that are required to begin using the system on July 1 have already enrolled. Another 400,000 businesses that could have continued to use paper coupons up to July 1 have already started to use electronic fund transfers.

As of last week, only 86,000 taxpayers with depository taxes between $50,000 and $47 million were unenrolled. As we speak, that number is continuing to fall.

The waiver of penalties through December 31, 1997 should provide sufficient time to complete that process. The reasons for our previously enacting requirements for electronic fund transfers remain valid: promotion of accuracy and efficiency in processing, significant cost savings to the government, benefit to taxpayers from increased accuracy, reduction in paperwork burden, and availability of a user-friendly tax collection system, you can punch it in on your telephone. Therefore, Mr. Chairman, we would think it is unnecessary to make a change in the threshold.

Now, one final bit of good news. The system has been so effective and so successful, that we have found that by the close of 1998 we will already have attained the 94 percent target. Therefore, we plan to immediately issue a regulation terminating the lowering of the threshold below $50,000.

Instead of going to $20,000 as was scheduled for 1999, we will leave the threshold at $50,000, and those small businesses that wish to come in voluntarily, of course, can do so, but there will be no further requirement beyond that which will take effect fully at the end of this year.

Let me turn, finally, to the issue of worker classification, which has been a perennial issue in Congress since 1978. Senator Baucus, I think both you and I were here when that legislation was passed, which froze the situation as it was in 1978, pending a permanent solution to the classification issue. Twenty years, almost, have elapsed.

We have worked ourselves into a situation where I think we find a somewhat anomalous unevenness among businesses. Most of those that reasonably, but erroneously, classified their workers as independent contractors have been protected; those that correctly classified their workers as employees find themselves frozen the other way.

So, there has been a disparity in treatment because of the absence of a permanent solution that does have an effect upon the competitive positions of businesses that are similarly situated.

I would also like to point out that what we do here in classification for tax purposes may have the intention of dealing only with tax liabilities, but the implications are far broader than that.

The test of employee versus independent contractor applies not only with respect to withholding taxes, it applies in the income tax in determining eligibility for pensions, health insurance coverage, and exclusions.

It applies in many States with respect to worker's compensation eligibility and requirements. It applies with respect to eligibility to receive unemployment benefits, and all kinds of worker protection issues are involved.

I think it is important that when one deals with this issue one realizes that, although each act is self-contained for purposes of the definition, nevertheless, the practical consequence is that you do have the possibility of affecting issues of worker protection far beyond those that deal with the Internal Revenue Service and the collection of taxes.

The Internal Revenue Service has, indeed, taken administratively a number of steps, which I referred to in our prepared statement, to expedite resolution of these cases to minimize penalties.

It has been referred to by Senator Bond that the genesis of this whole Section 530 problem is the retroactive application of penalties in the case of an audit.

If the Internal Revenue Service comes in and finds a misclassification and assesses penalties, let us say, for three back years, the workers whose taxes have not been withheld are presumably untraceable and unable to come up with satisfaction of that liability, and the burden falls on the employer.

It is an additional cost. It is not a question of an adjustment of proper amount of income, it is a dead loss. The inability to respond to that question of retroactivity, I think, is what impelled Congress in 1978 to enact Section 530.

Now, we have found since 1978 radical changes in the structure of employment in this country, and I am assuming that we are going to continue to have radical changes. The employment picture in this country is going to change.

You have referred to the 20-factor test and the complications and difficulties of applying it. One of the problems is that, because of these great differences of forms of employment, the question of who is an employee and what is an employment is necessarily uncertain.

I do not believe it is possible to write a legislative rule that can apply with clear certainty in every case, but we can do one heck of a lot better than we have done. But one of the things I would like to remind you that was enacted in 1978 was a prohibition on guidance. We were prohibited from proceeding to clarify the law.

So we proposed last year, and we continue to propose, three things that we think are significant. One of them is similar to that contained in Senator Bond's bill. Perhaps we were the original author of that, and we would be glad to let him use our copyright on that.

But he has proposed prospectively, that the Service, in cases of reasonable attempts to comply, even if you have not exactly satisfied the standard of 530, that any change can be made prospectively only, without this retroactive application.

We would go further than that. One of the problems is that some persons feel that this decision should be made, not by the IRS hold-

ing a gun to their head with the threat of retroactive assessment, but rather that there be an independent method of review.

We would propose that the Tax Court have the authority to allow an expeditious appeal on this question, and presumably it would use some of its expedited small case procedures, and that the Tax Court would have that same authority to apply the decision on a prospective basis (in the case where the taxpayer has been reasonable, even though it is decided the taxpayer was wrong).

Finally, we would urge you to allow us to issue guidance in this area because, even though we cannot get exact certainty, I believe that we can eliminate the 20-factor test and get down to 4 or 5 key factors and explain them much more easily.

If we were permitted to do so, we would intend, because this is so significant, to do this on a basis of putting out a proposed form of guidance on which taxpayers and the Congress could comment.

The S. 460 approach of adding a safe harbor, we oppose for several reasons. First, we think it is unnecessary. We think if we could give guidance we can do even better than S. 460, because there are a number of questions in S. 460.

Determining what is a profit or loss. While that may appear to be a somewhat mechanical standard, in point of fact, I am sure that if taxpayers arrange their affairs so that there is an ostensible risk of loss, but in reality it does not exist, that the provision would not apply.

I think you are going to generate much litigation and many attempts by employers to try to shift their form of doing business that was not intended by the draftsman of the legislation. I think if we are allowed to give guidance in this area we can set forth rules that will be much simpler and much easier to follow.

We certainly agree that if there is a genuine risk of loss, that that is an indicium that clearly you have an independent business. That is not a characteristic of employees.

The Bond bill puts as a requirement that there be expenses of at least 2 percent of income that are not reimbursed. It seems to us, if there is a genuine risk of loss, that should not make any difference, whether it is 0 or 50 percent of expenses. Risk of loss, to our way of thinking, if it is a genuine risk of loss, clearly entitles you to treatment as independents. So I think that is something that we could put into guidance.

Senator NICKLES. We need to move on pretty quickly.

Mr. LUBICK. All right. I am just about at the end.

As I look at the other factors, again, I think our problem is, as explained in the testimony, that they can be manipulated and the notion of allowing a corporation to be interposed and simply changing the result that way, that, too, we think is an easy escape and manipulable.

So we think the situation can be handled administratively and accomplish all of the results that were intended in the Bond bill without introducing shifting, without incentives to employers to try new methods, without multiplicity of litigation. We agree with you that this is an important problem that should be solved, and we look forward to discussions with you to work these things out.

[The prepared statement of Mr. Lubick appears in the appendix.]

Senator NICKLES. Thank you very much, Mr. Lubick. Is it Lubick? Am I pronouncing it correctly?

Mr. LUBICK. Yes, sir.

Senator NICKLES. Let me just bring up a couple of quick issues with you and see if we have some resolution.

On the independent contractor, you said you were willing to eliminate the retroactive penalty so if you had a reclassification it would not be a retroactive liability.

Mr. LUBICK. That is our proposal, if the conditions of reasonableness are met.

Senator NICKLES. Well, that is a step in the right direction. I am a little concerned. Maybe I should say I welcome your statement concerning that you do not think the rest of this has to be done legislatively, you are saying it can be done by guidance or administratively.

Mr. LUBICK. I think it could be done better, Mr. Chairman, that way, actually, because I think the introduction of a legislative formula is really a chimerical thing. It is not going to work, it is going to lead to more litigation.

Senator NICKLES. Well, let me just say that, administratively, you have not done a very good job.

Mr. LUBICK. We have not been allowed to.

Senator NICKLES. Well, I say you, and I am talking about Treasury, and I am talking about for the last 20 years. You have got a mess. Senator Bond held up the latest IRS proposal, and I think he said it is 150-some pages.

We have got a problem here. The White House Conference on Small Business said this is the number one problem concerning small business, so that means we have got a real problem.

There is a great deal of confusion right now on whether or not someone will qualify as an independent contractor or as an employee, and with the threat of retroactive liability, there is a real problem there.

My point being, I urge you to work with us. I want to achieve the objective. If it requires legislation, which right now I think it does, we will go that route. If it can be done administratively, I will be happy to work with you to see if we cannot come up with some guidelines that will accomplish our objective.

What I do not want to have happen is a lot of work and no results. We want to have some clear-cut, definitive statements where people can decide, whether individual or group, are independent contractors or not. I used to be one, and I can see the confusion. I used to be an employer. I used to hire them. I used to be one myself, and I can see a great deal of confusion. We want to eliminate that confusion.

I also would agree with your statement. You could always dream up another scenario and find somebody in the margin, and it is difficult. But we would like to make it very clear. That is why we had the incorporation of safe harbor.

Let me ask you one question. There is broad support for changing Section 1706 in the Tax Reform Act of 1986 that basically prohibited the safe harbor on technical services, computer programming, and so on. Would you agree with eliminating that?

Mr. LUBICK. Mr. Chairman, I have recused myself from that matter because I spent substantial time in my private practice working on that issue, including before this committee. But, if you will permit me, I will have somebody else in the Treasury send you a written communication answering your question.

Senator NICKLES. Very good.

Mr. LUBICK. In response to your previous question, however, let me say that if you will only untie our hands which have been tied for those 20 years, I think you can judge that we will be able to do a pretty effective job.

Senator NICKLES. Let me move to a couple of other issues. You mentioned on the electronic fund transfer, I thought you said that 1.2 out of 1.2 million.

Mr. LUBICK. It is 1.1 million. I misspoke, I am sorry.

Senator NICKLES. All right. I just thought you had a pretty good average.

Mr. LUBICK. That would be pretty good. I never hit 100 percent.

Senator NICKLES. Yes. Well, that means there is only 100,000 that are not——

Mr. LUBICK. Fewer than that. It was 86,000 when we took a count last week. I do not know what it is down to now, but it is going down as we speak.

Senator NICKLES. Why do I have a feeling that most of those 86,000 are in Oklahoma? [Laughter.]

The reason why I say that, Mr. Lubick, is that either you are underestimating, or every time I have been back since this 10 percent penalty is coming close, I have heard about it at every single meeting. This is not something I generate, because it is not the type of subject you just talk about at every town meeting because it does not affect everybody. But it has come up.

So my guess is, and maybe I am wrong, maybe that 86,000 is right, but I think there is a lot of uncertainty about it. A lot of people do not know about it, a lot of people are not in it, and a lot of people do not like the idea.

You mentioned you wanted this electronic fund transfer system to be user friendly. I want it to be user friendly too, but I want it to be an option. I do not see it being user friendly when you hold a 10 percent penalty at the taxpayer's head and say, you must do this or you are going to be facing a 10 percent penalty.

Now, I am pleased that Treasury has announced a 6-month delay, but I am not sure that at the end of that 6 months you are still not going to have somebody with not a very big business that is going to have payroll in excess of $50,000 that is not going to be ready, not going to be in for whatever reason, and they are still looking at a 10 percent penalty.

Mr. LUBICK. It is not payroll of $50,000, Mr. Chairman.

Senator NICKLES. Payroll taxes.

Mr. LUBICK. It is the tax liability.

Senator NICKLES. I understand.

Mr. LUBICK. So it is a much larger payroll.

Senator NICKLES. Well, it is not that large. It is not that large of a business. So my point being, is that user friendly does not say a 10 percent tax if you do not comply.

Mr. LUBICK. Well, the 10 percent penalty is a penalty that exists today for non-filing of paper coupons.

Senator NICKLES. But you have a 10 percent penalty for noncompliance with electronic filing. In other words, someone——

Mr. LUBICK. No, it is the same penalty, Mr. Chairman. It is for not filing. No matter what the method is, if you do not file there is a penalty.

Senator NICKLES. I think we have a confusion here. I want to make sure that either I am right or you are right. You are telling me that in 1998, if someone continues to file coupons, the old system, does not use electronic filing——

Mr. LUBICK. You are right.

Senator NICKLES [continuing]. But they file on time, there is no 10 percent penalty?

Mr. LUBICK. No, you are right, there would be.

Senator NICKLES. Well, that is what I thought.

Mr. LUBICK. That goes to the method.

Senator NICKLES. Well, that is my point.

Mr. LUBICK. Yes.

Senator NICKLES. The point being, is that I want to make this an option. I want to encourage people to do it, and I want you to be able to encourage people to do it. But I do not like the gun at their head. I think the threshold amount where you drop in one period from a $47 million threshold to $50,000 is too big of a drop.

Mr. LUBICK. Well, that is the sector of businesses that were in one class with respect to the coupon filing. It coincides. They have been treated as a class under the existing system.

Now, with the waiver, if there are only 78,000 businesses left, and we will give special attention to helping people in Oklahoma to make sure that they understand this so that you can devote yourself to some other issues that are more important, but the time we have remaining between July 1, with the fact that we have got this 1.1 million in already, will allow us to focus our attention on education and assistance to those remaining whatever it is, whether it is 50,000, 60,000 by the time we arrive at July 1. I think we can handle that job. If we cannot, we will be back to talk to you.

Senator NICKLES. Well, I expect that we will be talking and I expect that I am going to be looking to increase that threshold up and to put a waiver of that 10 percent penalty at some point. Now, it may be that you will already have your 94 percent. You are already at almost 90 percent, and maybe a little bit above 90 percent. So, my congratulations to you.

But I think a 10 percent penalty just for not moving to the electronic method is, one, it did not come from Congress. Correct me if I am wrong, but that was an IRS enforcement mechanism; is that correct?

Mr. LUBICK. No, Mr. Chairman. I think the statute required us to get people to file electronically.

Senator NICKLES. The statute did not require you to have a 10 percent penalty for noncompliance.

Mr. LUBICK. Well, the penalty is in the statute already. We do not——

Senator NICKLES. No. You are confusing things again. It is 10 percent for not paying withholding taxes, but not a 10 percent penalty for not doing it electronically.

Mr. LUBICK. No.

Senator NICKLES. You have a 10 percent penalty for if you do not do it electronically.

Mr. LUBICK. That is right. It is for nonpayment. But the statute directed us to compel people to get into the electronic system, so in effect it does that same thing.

Senator NICKLES. No. I do not want to rehash this issue. You have already agreed with me once and I do not want you to not agree with me now. You have been there.

Mr. LUBICK. If you have my word I will not go back on it.

Senator NICKLES. I have you on record as saying that there was a 10 percent penalty if you do not comply with electronic fund transfer——

Mr. LUBICK. No.

Senator NICKLES [continuing]. If your threshold is above that amount.

Mr. LUBICK. The penalty is for failure to make a deposit in the manner required by the regulations.

Senator NICKLES. Exactly.

Mr. LUBICK. Yes. And we were required to amend the regulations to put people on electronic fund transfer and to attain a target of 94 percent by the date 6 years out from 1993, I guess it is 1999.

Senator NICKLES. Well, it may well be that you will be there by December of 1997 and we can change this threshold and make it purely optional for small businesses, and maybe that threshold amount would not be $50,000, it might be $1 million. It will be somewhere.

Mr. LUBICK. Well, there is still a problem. This is the present population of businesses, and there will still be new ones coming in. If none of the new ones ever come on and some of the old ones go out, why then you could fall back.

Senator NICKLES. If you do the outstanding job that you said you would—I wrote down user friendly. I like that term, I just have not found it very compatible with IRS very often. If you are successful, this will be an attractive option.

I might tell you, I have encouraged people to do this. I hope that it will work out to be to their mutual benefit to do so. If that is done, not with a 10 percent penalty for going from coupon to electronic, but if it is attractive, efficient, done well enough, then maybe more and more companies will get in it and we will not need the 10 percent additional penalty pointed to them.

Let me pull up one other issue. You mentioned your opposition, I guess—correct me if I am wrong—on the acceleration or moving up of the health insurance for self-employed. I heard your comments to say you think it should stop at 80 percent.

With present law it takes until the year 2006, I believe, to get to 80 percent. Would you be opposed if Congress tried to accelerate and make the 80 percent deductibility for self-insured more immediately, say in the next couple of years?

Mr. LUBICK. No, sir. It is purely a question of financing it.

Senator NICKLES. You do not want it to go at 100, you do not mind if it goes to 80, and you do not mind if we accelerate that, if we can figure out how to do it.

Mr. LUBICK. That is correct.

Senator NICKLES. I just want to make sure that we have that.

I have already covered the commuting expenses. I may have an additional question for that. I have possibly some additional questions. I need to move the other two panels if I am going to conclude by 3:30.

Mr. LUBICK. Sure.

Senator NICKLES. So Mr. Lubick, thank you very much.

Mr. LUBICK. If you will let me know, we will be glad to respond to any questions you have.

Senator NICKLES. I appreciate that. Thank you very much.

Thank you, Mr. Lubick.

I am going to ask our next panel to come together, if they would. We have Stephen Kenda, KENDA Systems, in New Hampshire; Randy Mason, Mason Mechanical Laboratories in Salem, Virginia; Ms. Susan Thomas, Best of Service and Sales International, from Annandale, Virginia.

If there is no objection, I will just call upon our panelists as I have introduced them, and we did that by alphabetical order, if that is all right.

Also, I will insert a statement of Senator Hatch before our committee, and his statement will be inserted immediately following the statement by Senator Baucus.

Mr. Kenda?

STATEMENT OF STEPHEN KENDA, KENDA SYSTEMS, INC., SALEM, NH

Mr. KENDA. Yes, Mr. Chairman. My association, the NACCB, is the largest association representing high-tech staffing firms. Our industry provides highly-skilled computer and engineering professionals to customers who need temporary project support. Our 300-plus member firms generate $4 billion a year in revenue.

Our written testimony addresses four parts of the independent contractor section of 460, but two parts are most critical to us. First, repeal of Section 1706 of the 1986 Tax Reform Act, and second, a safe harbor to prevent the IRS from reclassifying incorporated contractors as employees of firms that retain them. Over half of the high-tech professionals retained by staffing firms are incorporated.

My oral testimony addresses only 1706 repeal, which presents the greatest consensus for action. Complaints you will hear today from other industries about unclear tax laws and arbitrary IRS audits will pale in comparison when you consider the harm 1706 has done to the high-tech staffing industry.

This is because 1706 is a law that applies solely to staffing firms in the technical services industry and bars every single staffing firm from using any of the employment tax safe harbors in Section 530 of the 1978 Revenue Act.

In simple terms, 1706 means that no matter how reasonable a high-tech staffing firm acts, the firm must always persuade the

IRS that its worker classification is correct under the unpredictable common law test.

For example, even if a high-tech staffing firm reasonably relied on a court decision involving our industry or relied on extensive industry practice, neither of these provide a safe harbor from the IRS.

More outrageously, if a high-tech staffing firm wins an IRS employment tax audit without any reclassification of its independent contractors, there is no prior audit safe harbor available and the IRS can later conduct another audit of future years, even though no facts have changed. Congress does not allow this IRS behavior for other industries, yet that is exactly where 1706 has left my industry.

You may believe that these things would never happen, but they have. The IRS investigated my own firm in 1991, costing us thousands of dollars in professional fees, and obviously lost management time.

We gave documents to the IRS and answered many common law employment test questions. We clearly distinguished our independent contractors from our employees. In 1991, the IRS said we had not misclassified anyone. Yet, just a month ago the IRS sent me another letter saying it is coming back. We must once again produce many documents and answer many more questions.

The only difference in our operations from the past, is we use even tighter controls for retaining independent consultants. If I were in any other business, a prior employment tax audit would protect me from a future employment tax audit, but Section 1706 denies me Section 530 protection.

Also due to 1706, the IRS will not recognize a Section 530 safe harbor based on tax advice several years ago from counsel that I had a good basis to use independent consultants.

Finally, due to 1706 an industry practice safe harbor is denied to me, even though repeated industry surveys show that about 80 percent of all high-tech staffing firms use independent contractors just like I do.

In fact, my counsel has handled over 40 IRS employment tax investigations involving thousands of independent computer consultants retained by staffing firms just like mine, and virtually no consultants were reclassified as employees of those firms. Yet because of 1706, none of this matters. How can you justify this?

Mr. Chairman, some say I am fortunate that professional fees and costs for my first IRS encounter were only a few thousand dollars. One of my competitors spent almost $300,000 to win a 4-year IRS battle that almost destroyed his company. Even then, the IRS came back to that firm two more times in the next 4 years, until the IRS finally gave up.

I know of other high-tech staffing firms that received at least two IRS visits and have spent tens of thousands of dollars defending themselves. We all say that we won, but in fact we have lost: lost time, lost money, lost morale.

If you help businesses in other industries that still have Section 530 protection, how can you not also repeal 1706 which denies my any Section 530 relief?

Mr. Chairman, my situation troubles me for another reason. High-tech staffing firms are a cornerstone of our technology-based economy. There simply are not enough high-level computer professionals, and many of the best want to be independent contractors for reasons wholly unrelated to taxes.

I started my business in 1984 as an independent contractor. It gave me the freedom to pursue opportunities, express creativity, and become the fastest-growing, privately-held company in New Hampshire. Yet my business, the independent contractors, and our high-tech industry must grapple with the 1706 burden. It is just not fair.

In closing, Mr. Chairman, the consensus for repealing 1706 is overwhelming. In the last Congress, 52 Senators—22 Democrats, 30 Republicans—jointly asked Chairman Roth for Finance Committee action on 1706 repeal.

In the 103rd Congress, Chairman Roth himself wrote that our industry should receive some kind of statutory alternative to the common law standards like that enjoyed by every other industry. Then Chairman Moynihan said he was committed to resolving the issues at the earliest opportunity.

In the 102nd Congress, the House Government Operations Committee called for 1706 repeal and the Congressional Black Caucus asked for legislation to solve the problems caused by 1706.

If I might have just another 30 seconds, Mr. Chairman.

Senator NICKLES. Yes.

Mr. KENDA. Thank you.

The private sector has echoed Congress' call for repeal. Both the American Tax Policy Institute and the American Bar Association Section on Taxation call for repeal. Likewise, the coalition to repeal 1706 includes a dozen major high-tech associations, including the world's largest engineering association, the IEEE. The National Association of Women Business Owners has joined us.

Mr. Chairman, it is hard to imagine more universal or bipartisan support for any independent contractor issue that has come before Congress in recent history. Ten years have been long enough; let us repeal 1706 in 1997. Thank you.

Senator NICKLES. Mr. Kenda, thank you very much. You have convinced me.

[The prepared statement of Mr. Kenda appears in the appendix.]

Senator NICKLES. Mr. Mason?

STATEMENT OF RANDY MASON, MASON MECHANICAL LABORATORIES, INC., SALEM, VA

Mr. MASON. Thank you, Mr. Chairman. I would like to thank you personally also for Senate bill 570, and for the other members of the committee who have done a lot. It is encouraging to hear the comments today about small business. Being a small business man, that is very close to my heart.

I want to comment on a couple of things that Mr. Lubick said before I get into my written testimony. He mentioned that they were going to end the mandate for between $20,000 and $50,000 because the limits that had been in the bill were met, the 94 percent.

They were only required to meet 58 percent of all Federal tax deposits during this particular enrollment period, so they far overstepped what Congress asked them to do, if that is true that that $50,000 limit brings us to 94 percent. I was unaware of that until I heard that comment.

We would like to say that many of the people who are enrolled in EFTPS small business are not necessarily in support of it; we are mandated by the Federal Government to do that and we are law-abiding citizens. I, myself, my company is enrolled in it. We have not started making payments yet.

But I am definitely not in favor of this system. I believe that small businesses need the freedom to operate without government mandates such as the EFTPS In addition to the fact that we just simply want to operate freely, there are also the costs involved for a small business to enroll.

Part of the reason that Congress implemented this was to raise $3.3 billion in revenues, according to the Congressional Budget report, which offset $2.5 billion in tariff losses because of NAFTA.

It has always been my opinion that you cannot just generate $3.3 billion out of nowhere, it had to come from somewhere. The only place it could come from is small businesses and banks, because of the money being transferred quicker, the interest that was gained on that money.

Small businesses maintain account balances which the banks give them credit for to offset their bank fees. As a result of having the funds transferred out of bank accounts quicker, we lose some of those credits which offset the fees and that will cost us that way.

In addition to that, talking to my bank and setting up with an ACH credit option, I have found that it will cost us approximately $120 per year in additional bank fees just to make these transfers. That is $3.50 per transfer that they are going to require.

In doing this I am not actually dealing directly with my bank, I am dealing with a third-party processor in Cape Coral, Florida. I am in Salem, Virginia, so that is quite a ways from where I am.

Another major concern that small businesses have is that, with the EFTPS option, there is no immediate receipt. Currently, I take the paper coupon and a check to my bank when I make my normal deposits and I receive a receipt directly from the bank at that point.

With this option I will not receive an immediate receipt or proof of payment. I will receive a number which, if I write down correctly, then I will have something to go back with. But I do not have a written proof there, and that concerns me.

I am concerned with what future changes may occur beyond this period, as the IRS could make some changes in the future which may require the funds to be transferred quicker or more directly to the IRS without going through this system.

Another thing that concerns me. I asked my Congressman to write a letter asking the IRS if I could pay the taxes with cash at the bank with the coupon because the law states that U.S. currency is legal tender for taxes.

The IRS wrote back two letters to my Congressman on my behalf saying that, no, once we were enrolled in this process, that we could not use currency or cash to make our tax payments. And I

realize that not many businesses do that, but it the right we have as an American citizen to use currency for taxes, and the fact that we do not use that right does not mean we should relinquish it.

I believe also that the IRS did not take into consideration small business at all when they were setting up these regulations. There is an Executive Order 12866 which deals with significant regulatory action.

And the two definitions of a significant regulatory action is one that will have an annual effect on the economy of $100 million or more, another one is any issue that will raise a novel legal or policy issue.

I believe that what the IRS did raises both those issues. I believe it has more than $100 million annual effect on small business, and it is also the legal issue of whether we can pay taxes with U.S. currency or not.

I would just like to thank you for the opportunity to testify on these points. I know you are trying to get this to move along, so I will end my comments there.

Senator NICKLES. Mr. Mason, thank you very much.

[The prepared statement of Mr. Mason appears in the appendix.]

Senator NICKLES. Our next panelist is Ms. Thomas, from Annandale, Virginia.

STATEMENT OF SUSAN THOMAS, PRESIDENT, BEST OF SERVICE AND SALES INTERNATIONAL, ANNANDALE, VA

Ms. THOMAS. Good afternoon, Senator Nickles. My name is Susan Thomas. I am president of Best of Service and Sales International, a home-based business located in Annandale, Virginia.

I am pleased to testify today on behalf of the National Association for the Self-Employed, the national association representing over 320,000 small business persons and self-employed individuals.

The NASE thanks Chairman Don Nickles and the other members of the Senate Finance Subcommittee on Taxation and IRS Oversight for holding this very important hearing on S. 460 and S. 570.

We commend the sponsors of these bills, Senator Nickles, the other members of this subcommittee, and Senator Bond, for actively pursuing these bills on behalf of small business. We also thank Senator Hatch for his home office proposal.

My company, Best of Service and Sales International, employs three individuals and we market computer equipment, peripheral software, and computer supplies to the Federal Government.

In addition, I have started a new venture called Best Travel Services, where we assist clients in planning overseas vacations and educational and group study tours abroad.

S. 460 includes measures designed to reform the home-office deduction and independent contractor status and it calls for enactment of a full 100 percent health insurance deduction for the self-employed. Also, S. 570 makes the electronic Federal tax payment system voluntary for small business.

The NASE strongly recommends that the Senate Finance Committee include all of these proposals as part of the panel's upcoming mark-up of the 1997 Budget Reconciliation legislation.

I request that the subcommittee include my full written statement as part of the hearing record. In the interest of time, I will principally focus my oral testimony on the need for modernizing the home-office deduction.

I initially started a home-based business several years ago because I was frustrated with, and limited, in a large corporate culture. I originally set up my business in my home upon leaving Wang Laboratories because of the fact that I had very little working capital at the time.

Ironically, it was my intention when I started my business to ultimately move the business out of my home and into commercial office space at a later date.

Today, I would not trade my home-based business for any commercial office location anywhere. I love my home office because of the conveniences that it affords me.

Unfortunately for businesses like mine, the home-office deduction is under attack. While I operate a home-based business, I do not take the home-office tax deduction on my tax return.

Why? Not because the IRS requires businesses that take the deduction to see their clients in their home office, or that they should generate their income there. Those tests are unfair and discriminatory against home-based businesses, even though I actually meet them.

No. The reason I do not take the deduction is the warning that I, and millions of others like me, get from our accountants. Taking the deduction, my accountant told me, is like waving a red flag at the IRS, a flag saying "Audit Me." This is ridiculous.

Congress passes a law to help home-based businesses. The IRS then tries to impose the narrowest possible interpretation on that law, loses two court cases, then takes the issue all the way to the U.S. Supreme Court, as represented by the Solomon case.

After finally convincing the Supreme Court to narrow the deduction, the IRS then audits those who still qualify for it so aggressively that millions of people legitimately entitled to take that deduction are afraid to take it.

Look at the numbers. IRS statistics of income show that 1.5 million people claimed the home-office deduction in 1994. Yet the number of full-time, home-based businesses is variously estimated at between 7 and 14 million.

Why do 80 to 90 percent of home-based businesses not take the deduction, do they not qualify? I believe a great many of them are like me. They do qualify, but are forced to choose between the time and stress of an audit or the modest tax savings of the deduction. I choose to forego the deduction.

The current home-office deduction limitations are unfair and unwise for other reasons, too. All over the country larger businesses are laying off employees. If we want to help these people get on their feet, we should make it easier for them to start a business.

The same goes for people who are forced off the welfare rolls under the 1996 Welfare Reform law. They should be given the opportunity to start up businesses as self-employed people with a minimum of up front costs. Home-based businesses are an obvious way to help facilitate that. Give us the certainty which S. 460 would provide and we will use the home-office deduction.

May I continue 30 more seconds?

Senator NICKLES. Please be quick. We have one more panel.

Ms. THOMAS. Thank you.

Do not allow the IRS to administratively defeat Congress' original purpose with a deduction. Improve the fairness and clarity of the home-office deduction. Not only will more home-based businesses have a better chance to succeed, but more potential home-based businesses will decide to try and that is better for America.

Thank you very much, Mr. Chairman.

Senator NICKLES. Ms. Thomas, thank you.

[The prepared statement of Ms. Thomas appears in the appendix.]

Senator NICKLES. I want to thank all of our panelists for their participation today, and ask that our next panel please come forward.

Our next panel has Debbi-Jo Horton representing DJ Horton & Associates from Rhode Island; Mr. Frederick Oyer, vice president of International Piping Systems from Schiller Park, Illinois; Mr. John Satagaj, president of Small Business Legislative Counsel, Washington, DC; and Deborah Walker, member of the American Institute of Certified Public Accountants from Washington, DC.

We will start in alphabetical order. Ms. Debbi-Jo Horton.

I am going to ask everybody if they would please submit their statements. We will insert those in for the record as given, and if you could summarize those that would be appreciated. Thank you.

STATEMENT OF DEBBI-JO HORTON, DJ HORTON & ASSOCIATES, EAST PROVIDENCE, RI

Ms. HORTON. Thank you, Chairman Nickles.

I am a CPA and an owner of a firm in Rhode Island, and I am also the Taxation Implementation chair for New England for the White House Conference on Small Business. I am also the Taxation chair to the Smaller Business Association of New England, and represent its 1,300 members as well.

Home-based businesses represent one of the fastest-growing sectors of the economy, and more women than men are starting those home-based businesses. In fact, over 300,000 women start home-based businesses each and every year.

Many of them work at home in order to be close to their children. It is a reasonable solution to the dilemma of balancing work and family.

Some micro-borrowers are women. Also, low-income individuals and minorities, and many of them are home-based as well. Many welfare recipients choose starting a home-based business as a vehicle to get off of welfare. Many of these also seek micro-loans in the amount of $2,000 to $10,000 in order to help them start up those businesses.

I, myself, am a home-based business turned to success. I began my firm in a spare bedroom of my home and conducted all of my administrative work from that home office, but I closely resemble Dr. Solomon's case in that I conduct most of my non-administrative work outside my home at clients' offices.

I needed $3,500 to start up and I ended up financing my venture by borrowing $2,000 from a money store at 2 percent of interest per

month, and the balance obtained on credit cards. I was able to pay off those debts quickly, but would have been able to pay them off even faster had I been able to deduct a home-office deduction.

I also counsel many start-up home-based businesses that struggle to make ends meet because of the unfair tax burden that they face because they choose to work from their homes. Granted, it is their choice, but a choice they feel they do not have because of their commitment to their family. They need the second income, yet they wish to have their children close to them and have one parent at home when they return home from school.

My point in all of this is that, if these home-office deductions were allowed, many of these micro-loans would not be needed. I am told that the cost to make a micro-loan and administrative cost to the SBA is over $3,500. It is also an equal amount to the nonprofit that partners with them.

As a single mother of two children, I can personally attest to the need for the 100 percent deductibility for health insurance. My ex-husbands are supposed to cover their children on their corporate-paid health insurance, but, because of changes in jobs and periods of unemployment, at one point or another both of my children would be uninsured. In fact, my daughter, because of her father's unemployment and change of jobs, would be uncovered more often than she would be covered.

I have been self-employed for more than 8 years now and I have paid for continuous coverage of health insurance for my children because I did not want them to be uninsured. The President and Congress have debated the need for health insurance coverage for uninsured children, 1.4 million of those being uninsured children of self-employed.

Welfare provides coverage to many of those who have little or no income. As I mentioned before, many welfare recipients are opening a small business as a solution to come off welfare. How about giving them the ability to pay for their own health insurance as well?

Finally, the definition of independent contractor must be clarified. The uncertainty of worker classification is a major threat to the business community and this has been debated intensely over the last 2 years. It is about time to draw it to a close.

In establishing new safe harbors, a joint committee was informally established that included not only government participation, but small business participation as well.

May I continue?

Senator NICKLES. Please, quickly.

Ms. HORTON. Yes.

We, the tax chairs, would urge that the Senate and the Finance Committee include the elements of S. 460 in the budget agreement which this committee currently is taking under consideration.

I would like to thank you for holding these hearings and inviting us to testify.

Senator NICKLES. Ms. Horton, I thank you very much. I compliment you on your success in your home-based business.

[The prepared statement of Ms. Horton appears in the appendix.]

Senator NICKLES. Mr. Oyer?

STATEMENT OF FREDERICK OYER, VICE PRESIDENT, INTERNATIONAL PIPING SYSTEMS, INC., SCHILLER PARK, IL

Mr. OYER. Good afternoon, Chairman Nickles. I, as you have requested, would ask that you simply accept our written statement as part of the record.

Senator NICKLES. I will do that for all of the witnesses. Thank you.

Mr. OYER. I would like to make another deal with you, if I could. I am willing to yield my time to Mother Teresa in return for a meeting with you on Monday afternoon.

Coincidentally, I do not often travel from Chicago, but I will be back here on Monday and I will yield that time, should you be available between 4:00 and 6:00 p.m., or a senior member of your staff.

I am passionate about independent contractor legislation and what you might be doing, and continuing to do, to the construction industry. I think we need more time on that, and I would hope very much that you would ask questions. This probably is not quite the right forum, since we are down to four minutes before Mother comes.

Senator NICKLES. You have got a deal.

Mr. OYER. Thank you, sir.

Senator NICKLES. Mother Teresa is calling. But I will be happy to visit with you a little bit more.

[The prepared statement of Mr. Oyer appears in the appendix.]

Senator NICKLES. Mr. Satagaj.

STATEMENT OF JOHN SATAGAJ, PRESIDENT, SMALL BUSINESS LEGISLATIVE COUNSEL, WASHINGTON, DC

Mr. SATAGAJ. Thank you, Mr. Chairman.

Let me cut to the chase. We heard more times than I can remember just already this afternoon about the Treasury's desire to have the ability to write the rules.

As you and I both know, if we are giving a terrible, miserable speech to small business and they are all staring at you and miserable and you want to get them happy, just say, by the way, the IRS would like to write the rules again. I mean, that takes care of that pretty quickly.

Senator NICKLES. That would do it.

Mr. SATAGAJ. I think it is about time they got off that case.

Second, Secretary Lubick talked about some of the standards in your legislation. Your first safe harbor has three points in it. It has a point covering financial control of a business, the second covers behavioral control, and the third covers intent of the parties.

Well, lo and behold, if you look at the IRS training manual, it boils it down to three items: financial control, behavioral control, and intent of the parties.

Secretary Lubick said about the fact that you have a standard that says the ability to realize a profit or loss, that it was very difficult to prove this. The IRS manual states, "The ability to realize a profit or incur a loss is probably the strongest evidence that a worker controls the business aspects of a service rendered." That is their own manual.

The factors already considered: significant investment, unreimbursed expenses, and making services available and method of payment are all relevant in this regard.

Well, guess what your standard on financial control says? It says, realize a profit and loss, unreimbursed expenses, agree to perform the services. Three out of four. You did not get significant investment.

You know what the Treasury says? Not all financial control facts need to be present to realize a profit or loss. For example, a worker can be paid on a straight commission basis, make business decisions, your point, B–3. Unreimbursed expenses, your point, B–2.

Have the ability to realize a profit or loss, even if the worker does not have a significant investment. Guess what? The one you left out, they left out too. Son of a gun.

On the subject of your second safe harbor. You hear time and again from businesses, great, we have this, but give me one I can comply with, something that is straightforward and mechanical, I know it and I do it.

You say, incorporate, no benefits, a written agreement. IRS manual. Guess what it says? If you incorporate, you have a written agreement and you do not offer benefits, there is a great deal of evidence that you are, in fact, an independent contractor.

A lot of people say, look, everybody in the world can incorporate, no big deal. You all do it. It is a lot of work to become incorporated. There is a lot that goes with that, with the State requirements, the Federal requirements. It is a big deal.

I am sure you have run into plenty of independent contractors who have told the businesses they do business with, man, I do not want any more of that stuff. I do not need any more of the government in my life. I do not want to incorporate. That is number one.

Number two, as I said, it is complicated. Number three, there are some significant tax responsibilities that go with being incorporated: estimated tax payments, and a real biggie, you have got to file a W–2 for anybody in that business that is an employee.

If you are a one-person corporation, owner/employee that provides services, you have to provide a W–2. Talk about bringing more people into the system. Your proposal actually brings more in. So those people who say we are taking them out, no way.

Finally, to those who say, well, some big manufacturer out there is going to tell the whole work force you are incorporated today. Well, I represent business. That is my business. I am a lawyer practicing law and do a lot of work in this area.

I can tell you, there are plenty of lawyers on the other side who would love to have that case for all those folks to bring some kind of a marvelous class action suit or whatever against that employer, saying, holy smokes, look what he did to coerce all these people. It is just not going to happen, because I am going to tell my client you are nuts if you go out there and tell everybody you are going to incorporate them tomorrow to do that.

Finally, there are a lot of things that the IRS has available now as a tool to deal with any sham situations. We can handle those situations that are there.

So I think what you have done is a great job in taking what the IRS itself has said in this manual and have boiled it down to the

essential, clear elements. You have skipped a step where the IRS said, we could do this job, we could reduce it down. Well, you did it already and it is a great job.

Thank you, Mr. Chairman.

Senator NICKLES. Thank you very much.

[The prepared statement of Mr. Satagaj appears in the appendix.]

Senator NICKLES. Ms. Walker?

STATEMENT OF DEBORAH WALKER, MEMBER, AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS TAX EXECUTIVE COMMITTEE, WASHINGTON, DC

Ms. WALKER. Good afternoon. My name is Debbie Walker. I am past chair of the AICPA Executive Committee for the Tax Division.

The AICPA appreciates the opportunity to comment on S. 460. What I would like to do is shorten this testimony, since I am aware that you are very short on time.

First of all, we support the increase for health insurance deduction for self-employed individuals from the premise that self-employed people should be treated the same way as employees.

In addition, we support the home-office provisions of S. 460 as providing some needed relief to many people who operate outside their home, or in their homes as a home office.

Let me get right to the worker classification rules, because we have addressed this and focused on this for many years, most intently for the last 3 or 4 years, working with your staff, in some cases.

We believe the independent contractor clarification is better than existing law, however, we recommend two changes. First of all, in the legislation you do not include any specific provisions of what the written contract should cover.

We would like to see included in the legislation preferably, or certainly in the legislative history, details of what that contract should cover, things such as the service provider is not being provided fringe benefits, is not being treated as an employee, is responsible for their own taxes, is responsible for their own business license, is responsible for maintaining books and records, things such as that which any independent contractor should be doing.

The second provision, I am afraid we are going to disagree a little bit here, is the alternative safe harbor which allows a safe harbor if the business is conducted through a corporation or an LLC, we believe should be dropped.

We recognize, in fact, that if individuals perform their business through a corporate form, that that is one characteristic that can help in determining that we have an independent contractor relationship. However, we do not believe that that should be a safe harbor, because we believe that perhaps that is too much of an opportunity for abuse and too much of a possibility of coercion.

I understand what was said and we, in fact, probably believe that there would not be too much coercion, but we are not confident enough to leave it off the table and leave the opportunity available.

That concludes what we have to say on S. 460. We commend you for your advocacy, and thank you for solving the problem.

[The prepared statement of Ms. Walker appears in the appendix.]

Senator NICKLES. I want to thank all of our panelists. I apologize. I went maybe a little longer than I should have with Treasury, but we had a little disagreement on a few issues that I wanted to hash out.

I appreciate the cooperation that we have had from all of our participants today. I think we do have a couple of good pieces of legislation, and we will try to move as much of those as possible this session, and some of it pretty quickly.

So, this hearing is timely. We want to do some positive things for small business, and I think clarification of independent contractor, the self-employment health deduction, and home office clarification would be giant steps in the right direction, and I thank you for your participation.

With that, the committee will adjourn. We will keep the record open for additional comments from colleagues for another day. Thank you.

[Whereupon, at 3:35 p.m., the hearing was concluded.]

APPENDIX

ADDITIONAL MATERIAL SUBMITTED FOR THE RECORD

PREPARED STATEMENT OF HON. CHRISTOPHER S. BOND

Mr. Chairman and members of the Subcommittee, it is my pleasure to be here today, and I appreciate your invitation to testify before the Subcommittee on two important bills for small business in this country: S. 460, the Home-Based Business Fairness Act of 1997, and S. 570, reforming the Electronic Federal Tax Payment System. These bills address four of the top concerns that I have heard from the small business community over that past several years as the Chairman of the Committee on Small Business.

The Home-Based Business Fairness Act of 1997

In March of this year, I introduced the Home-Based Business Fairness Act of 1997 with my colleagues Senators Snowe and Nickles. Let me say at the outset that I am very grateful for their efforts in developing this legislation, and I am pleased to report that the bill now has 33 co-sponsors, including several members of this Subcommittee. In addition, a companion to S. 460 has been introduced in the House, and that bill (H.R. 1145) enjoys solid bipartisan support. This legislation is designed to address three of the most significant tax issues facing small businesses, especially those operated from the home.

Home-based businesses are a significant and often overlooked part of this country's economy. Some people may be surprised to learn that more than nine million men and women in this country now operate home-based businesses, and more than 14 million individuals earn income through home-based businesses. Even more impressive is the fact that a majority of these enterprises are owned by women, and the Small Business Administration estimates that women in this country are starting more than 300,000 new home-based businesses each year.

There are a number of reasons for the explosive growth of home-based businesses. Recent innovations in computer and communication technology have made the "virtual" office a reality and allow many Americans to compete in marketplaces that a few years ago required huge investments in equipment and personnel. In addition, many men and women in this country turn to home-based business in an effort to spend more time with their children. By working at home, these families can bring in two incomes, while avoiding the added time and expense of day-care and commuting. Corporate down-sizing, too, contributes to the growth in this sector as many skilled individuals convert their knowledge and experience from corporate life into successful enterprises operated from their homes.

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The rewards of owning a home-based business are also numerous. The added independence and self-reliance of having your own business provide not only economic rewards but also personal satisfaction. You are the boss: you set your own hours, develop your own business plans, and choose your customers and clients. In many ways, home-based businesses provide the greatest avenue for the entrepreneurial spirit, which has long been the driving force behind the success of this country.

But with these rewards come a number of obstacles, not the least of which are regulations and burdens imposed by the Federal government. In fact, the tax laws, and in particular the IRS, are frequently cited as the most significant problems for home-based businesses today. Changes in tax policy must be considered by this Congress to ensure that our laws do not stall the growth and development of this successful sector of our economy.

The Home-Based Business Fairness Act of 1997 responds to this call for help from the small businesses in this country in three ways.

Deductibility of Health-Insurance Costs for the Self-Employed

First, the bill addresses the deductibility of health-insurance costs for the self-employed. During the 104th Congress, we made significant progress in this area. Initially, we made the deduction permanent after years of uncertainty. Then, last summer, we passed legislation that will increase the deduction for these health-care costs to 80% incrementally by 2006. While I fully supported that increase, the self-employed cannot wait 10 years for partial deductibility when their large corporate competitors can fully deduct such costs today.

With the self-employed currently able to deduct only 40% of their health-insurance costs, it comes as no surprise that nearly a quarter of the self-employed, many of whom operate home-based businesses, do not have health insurance. In fact, 5.1 million self-employed individuals do not have health insurance. Even more alarming is the fact that within these five million households headed by a self-employed person are more than a million children who are not covered by health insurance.

In order to make it easier for home-based business owners and their families to have health insurance, we must level this playing field. S. 460 will increase the deductibility of health insurance for the self-employed to 100% beginning this year. A full deduction will make health insurance more affordable to home-based business owners and help them and their families get the health insurance coverage that they need and deserve.

In addition, the budget resolution recently adopted by the Senate provides a unique opportunity to include full deductibility of health insurance for the self-employed in the reconciliation legislation that the Finance Committee will be drafting in the coming weeks. During the markup of the budget resolution, I introduced a Sense of the Senate amendment that calls for a portion of the available funds to be set aside for this provision and urges that it be made effective immediately. I was pleased that my amendment received overwhelming support

from both sides of the aisle and passed on a unanimous voice vote. I believe that we can make a significant step toward improving health care by ensuring that the self-employed are better able to afford health insurance. In addition, with the bipartisan goal of providing health-insurance coverage for children, we should not miss this opportunity to help bring such security to more than a million children living in households headed by the self-employed.

Home-Office Deduction

A second provision of the Home-Based Business Fairness Act will restore the home-office deduction and further level the playing field for home-based businesses. After the Supreme Court's 1993 *Soliman* decision, the only home-based businesses that can deduct the costs associated with their home office are those that see their clients in the home and that generate their income within the home office. That narrow interpretation of the law denies the home-office deduction to service providers like construction contractors, landscaping professionals, and sales representatives, who must by necessity perform their services outside of the home.

It is patently unfair to prevent these individuals from deducting their utility costs, property taxes, and other expenses related to the home office, when they could do so if they rented an office separate from the home. I thank my colleague from Utah, Senator Hatch, for his willingness to allow us to work together on this issue and for his co-sponsorship of the bill. My bill incorporates the legislation that Senator Hatch introduced earlier this year and will permit a home office to include one where the individual performs his or her essential administrative and management activities such as billing and record keeping. In order to qualify for the deduction, the bill requires that the business owner perform these activities on a regular, on-going, and non-incidental basis and have no other office in which to perform them.

The restoration of the home-office deduction for home-based businesses not only puts them on an equal footing with their larger competitors, but also frees important capital that can be used to expand the business. In many cases, the amount that a home-based business owner saves as a result of this deduction will be about the same as the funds that he or she must otherwise seek from a bank or other lending institution. The home-office deduction allows small businesses to keep more of their hard earned money, and most small business owners would rather meet their short-term capital needs by reinvesting their earnings in their businesses than by taking out additional high-interest debt.

Mr. Chairman, for too long home-based businesses have borne the inequality created by the *Soliman* decision. Even more troubling is the fact that many home-based businesses that would arguably meet the current criteria for the deduction never claim it out of fear that merely checking the "home office" box on their Federal tax return will result in an IRS audit. With rarely any employees, a home-based business owner can hardly afford the time away from his or her business endeavors to fight an audit, let alone afford the cost of hiring an accountant or lawyer to take on the case. It is time for us to eliminate these obstacles and clear the way for the continued success of these important entrepreneurs.

Clarification of Independent-Contractor Status

The final element of the Home-Based Business Fairness Act is relief for entrepreneurs seeking to be treated as independent contractors and for businesses needing to hire independent contractors. As the Chairman of the Small Business Committee, I have heard from countless small business owners who are caught in the environment of fear and confusion that now surround the classification of workers. This situation is stifling the entrepreneurial spirit of many small business owners who find that they do not have the flexibility to conduct their businesses in a manner that makes the best economic sense and that serves their personal and family goals.

The root of this problem is found in the IRS' test for determining whether a worker is an independent contractor or an employee. Over the past three decades, the IRS has relied on a 20-factor test based on the common law to make this determination. On first blush, a 20-factor test sounds like a reasonable approach: if a taxpayer demonstrates a majority of the factors, he or she is an independent contractor. Not surprisingly, the IRS' test is not that simple. It is a complex set of extremely subjective criteria with no clear weight assigned to any of the factors. As a result, a small business taxpayer is not able to predict which of the 20 factors will be most important to a particular IRS agent, and finding a certain number of these factors in any given case does not guarantee the outcome.

To make matters worse, the IRS' determination inevitably occurs two or three years after the parties have determined in good faith that they have an independent-contractor relationship. And the consequences can be devastating. The business recipient of the services is forced to reclassify the independent contractor as an employee and must pay the payroll taxes the IRS says should have been collected in the prior years. Interest and penalties are also added on. The result for many small businesses is a tax bill that bankrupts the company. And that's not the end of the story. The IRS then goes after the service provider, who is now classified as an employee, and disallows a portion of his business expenses — again resulting in additional taxes, interest and penalties.

Each of us in Congress recognizes that the IRS is charged with the duty of collecting Federal revenues and enforcing the tax laws. The problem in this case is that the IRS is using a procedure that is patently unfair and is doing so on an increasingly frequent basis. Between 1988 and 1994, the IRS' use of the 20-factor test resulted in some 11,000 audits, 483,000 worker reclassifications, and $751 million in back taxes and penalties. These facts make me wonder whether the IRS is using this test as a *de facto* source of enhanced revenue collection when the classification decision does not alter the aggregate tax liability to the Federal government at all.

For its part, the IRS released its revised worker-classification training manual earlier this year. The Commissioner's accompanying memo, describes the manual as an "attempt to identify, simplify, and clarify the relevant facts that should be evaluated in order to accurately determine worker classification . . . ." There can be no more compelling reason for immediate action on this issue. The revised manual is over 150 pages — even longer than the original draft. If it takes this many pages to teach revenue agents how to "simplify and clarify" this small

business tax issue, I think we can be fairly sure how simple and clear it is going to seem to taxpayers who try to figure it out on their own.

The Home-Based Business Fairness Act removes the need for so many pages of instruction on the 20-factor test by establishing a clear safe harbor based on objective criteria. Under these criteria, if there is a written agreement between the parties, and if an individual demonstrates economic independence and independence with respect to the workplace, he will be treated as an independent contractor rather than an employee. And the service recipient will not be treated as an employer. In addition, individuals who perform services through their own corporations will also qualify for the safe harbor as long as there is a written agreement and the individuals provide for their own benefits.

These two tests for the safe harbor are not revolutionary. The first draws on the IRS' current classification criteria, and the second is based on the body of case law that holds that workers who perform services through a corporation are not employees of the service recipient. Even the IRS has acknowledged this latter point in its training manual. What is revolutionary about the bill are the clarity and certainty that the safe harbor brings to the thousands of individuals and businesses caught in this classification trap.

The safe harbor is simple, straightforward, and final. To take advantage of it, payments above $600 per year to an individual service provider must be reported to the IRS, just as is required under current law. This will help ensure that taxes properly due to the Treasury will continue to be collected.

Mr. Chairman, the IRS contends that there are millions of independent contractors who should be classified as employees, which costs the Federal government billions of dollars a year. This assertion is plainly incorrect. Classification of a worker has no cost to the government. What costs the government are taxpayers who do not pay their taxes. My bill has two requirements that I believe will improve compliance among independent contractors using the safe harbor. First, there must be a written agreement between the parties — this will help independent contractors know from the beginning that they are responsible for their own tax payments. Second, the safe harbor will not apply if the service recipient does not comply with the reporting requirements and issue 1099s to individuals who perform services.

The bill also provides relief for businesses and independent contractors when the IRS determines that a worker was misclassified. Under the bill, if the business and the independent contractor have a written agreement, if the applicable reporting requirements were met, and if there was a reasonable basis for the parties to believe that the worker is an independent contractor, then any IRS reclassification upheld in court will only apply prospectively. This provision gives important peace of mind to small businesses that act in good faith by removing the unpredictable threat of retroactive reclassification and substantial interest and penalties.

A final provision of this legislation repeals section 1706 of the 1986 Tax Reform Act, which effectively barred an entire group of independent contractors from the protection available

in section 530 of the Revenue Act of 1978. When section 1706 was enacted, its proponents argued that technical service workers — such as engineers, designers, and computer programmers — were less compliant in paying their taxes. Later examination of this issue by the Treasury Department found that technical service workers are in fact more likely to pay their taxes than most other types of independent contractors. This revelation underscores the need to repeal section 1706 and level the playing field for individuals in these professions. In the 104th Congress, proposals to repeal section 1706 enjoyed wide bipartisan support in the Senate, and it is my hope that the 105th Congress will finally act on this proposal to restore equality for these professionals.

The importance of adding clarity to the independent-contractor situation is underscored by the fact that the delegates to the 1995 White House Conference on Small Business voted to designate it as their top priority. At that conference, then-IRS Commissioner Richardson noted that either classification — independent contractor or employee — can be a valid and appropriate business choice as long as the individual pays his or her taxes. This conclusion was later affirmed in the IRS' new worker-classification training manual. It is time that the law reflects this conclusion and allows small businesses to hire employees or independent contractors as their business needs demand, without the fear and uncertainty that now prevails.

The Home-Based Business Fairness Act is a common-sense measure that will provide tax fairness for the increasing number of individuals who operate their businesses from home and contribute so significantly to the strength of our economy. These business owners have waited far too long.

I am pleased to inform this Subcommittee that I have received dozens of letters from small businesses and their advocacy groups from across the industry spectrum indicating their strong support for this legislation and the tax relief it provides. I understand that a number of the small business groups that support S. 460 will be testifying here today, and I expect that you will hear in greater detail about the pressing need for the three legislative provisions in the bill.

Electronic Federal Tax Payment System

Let me turn now to S. 570, which you, Mr. Chairman, introduced in April of this year, and of which I am pleased to be an original co-sponsor. This legislation addresses a problem that I am sure many of the members of this Subcommittee have heard a great deal about in recent weeks — the Electronic Federal Tax Payment System or EFTPS. Originating in 1993, this system was designed to accelerate the Federal government's collection of tax deposits. While it does not change the due date for tax deposits or impose new taxes, it does create a new Federal mandate on small businesses to pay their taxes electronically.

The legislation establishing EFTPS directed the IRS to collect an increasing *percentage* of tax deposits electronically over a 5-year period instead of through the current coupon system. To implement EFTPS, the IRS translated those percentages into *dollar* thresholds, which many contend cover far more businesses than is necessary to meet the relevant collection percentage.

For the first two years of the system, businesses with $47 million in payroll taxes were required to make their tax deposits electronically. Beginning this year, that threshold falls dramatically. As a result, businesses with $50,000 in payroll taxes, which represents about 10 to 15 employees, will have to pay their taxes electronically. The IRS selected this drastically low threshold not to meet the percentages required by the legislation, but for its administrative ease — this threshold corresponds with existing rules governing the due date for tax deposits by businesses with more than $50,000 in payroll taxes. To make matters worse, the IRS' regulations provide that beginning in 1999, businesses with as little as $20,000 in payroll taxes will be required to use EFTPS.

The alarmingly low thresholds, however, are only part of the problem. The IRS has continually ignored the possibility of establishing a small business exemption from EFTPS, which is permitted under the 1993 legislation. As a result, beginning on July 1 of this year, 1.2 million small businesses will be required to use EFTPS, and that number is expected to increase substantially when the $20,000 threshold takes effect just over 18 months from now.

Regrettably, the IRS has missed another opportunity with EFTPS to demonstrate that "service" is not just a word in its name. EFTPS is a system built on banking systems and technology that have been in use of many years now, processing thousands of transactions with a high degree of accuracy. In addition, EFTPS has been developed and is administered by two well respected financial institutions in this country — NationsBank and First National Bank of Chicago. From the information that I have received about the system from these two "Treasury Financial Agents," many small businesses may find that it is an efficient way to pay their taxes without much of the paperwork and administrative hassles involved in the current coupon system.

The IRS, however, has failed to communicate these facts effectively to small business or to provide a small business exemption under which small firms could be encouraged to use the system voluntarily, thereby discovering its benefits for themselves. Instead, beginning last year, the IRS sent out thousands of letters with the headline that the taxpayer "MUST ENROLL AND DEPOSIT ELECTRONICALLY." From small business' perspective, EFTPS is nothing more than another government mandate added onto the myriad regulatory and paperwork burdens that they already must face, especially when it comes to paying taxes.

The result has been widespread fear and confusion within the small business community. In addition, the level of misunderstanding about the system is staggering. As the Chairman of the Committee on Small Business, I have heard many business owners express such misunderstandings as: the IRS will have unrestricted access to their bank account so the tax deposit can be withdrawn electronically; they will have to deposit their taxes earlier under EFTPS; they can no longer use their local bank to deposit their taxes; they cannot afford the sophisticated computer equipment required to use the system; and the list goes on. These misperceptions underscore the abysmal job that the IRS has done in explaining the system, let alone demonstrating to these small enterprises that it may be beneficial to their businesses.

Moreover, the IRS has fanned the fears of these businesses by repeatedly threatening in its communications that failure to comply will result in a 10% penalty on the amount of the deposit.

Over the past several weeks there have been congressional efforts to address the potential damage that penalties will have on the 1.2 million small businesses that must begin using the system on July 1. While I believe a permanent solution must be implemented, I appreciate the efforts that the Finance Committee has undertaken to secure a moratorium on penalties for up to a year while we consider the legislation to make EFTPS voluntary for small business. I am pleased that the letters that we have sent to the Treasury Department and the IRS have finally been answered and the IRS has agreed to waive penalties for six months. In the short run, this will at least allay the fear that inadvertent errors or problems with the system will leave small firms paying the price.

Over the long term, however, we are left with more than a million law abiding small business owners who must comply with a law that they do not understand and that they see as just another Washington mandate. S. 570 addresses this situation in a straightforward, permanent way. First it eliminates the mismatch between the percentages under the 1993 legislation and the dollar thresholds in the IRS regulations. Under the bill, the threshold will remain at $47 million this year, and then gradually decrease to $5 million. As a result, most small businesses will not have EFTPS forced upon them.

Second, and of equal importance, the bill calls on the IRS to do what it should have done in the first place, develop a program that encourages small businesses to use the system voluntarily. In April, the IRS indicated that more than 100,000 businesses meeting the $50,000 threshold were already using the system on a voluntary basis, and I am confident that the number has increased in the last two months. Under the voluntary participation program envisioned by S. 570, I would hope that the IRS will turn to these existing small business participants as role models who can provide first-hand examples of the ease and benefits of EFTPS for small enterprises.

It is unfortunate that the IRS' reputation has made taxpayers skeptical of most IRS announcements, especially when they appear to contain good news. This legislation gives the IRS an opportunity to change that reputation. By working with those it is charged with serving, the IRS can demonstrate the advantages of EFTPS, just as the IRS has used positive public opinion to expand usage of its TeleFile system. I sincerely doubt that TeleFile would have been as successful if the IRS had sent out letters to eligible taxpayers *directing* them to file their tax returns by phone.

Mr. Chairman, I congratulate your efforts to find a legislative solution to the EFTPS problem, and I look forward to working with you and your colleagues on the Finance Committee to see that it is enacted into law. Thank you again for the opportunity to testify before your Subcommittee on these important issues for small business. I would be pleased to answer any questions that you or members of the Subcommittee may have.

United States Senate
COMMITTEE ON SMALL BUSINESS
WASHINGTON, DC 20510-6350

June 3, 1997

The Honorable William V. Roth, Jr.
Chairman
Committee on Finance
219 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Roth:

As you draft legislation to implement the recent budget accord, we request that you give careful consideration to the three elements included in S. 460, the Home-Based Business Fairness Act. We believe that these provisions, in addition to the leadership's tax cuts, will significantly assist small businesses as they continue to contribute so importantly to our national economy.

The budget resolution recently adopted by the Senate provides a unique opportunity to include 100% deductibility of health insurance for the self-employed in the legislation that your Committee will consider this summer. Support for this provision is exemplified by the Sense of the Senate amendment, which was unanimously approved by the Budget Committee, calling for a portion of the available funds to be set aside for full deductibility of health insurance for the self-employed. S. 460 increases this deduction to 100% immediately and will make health-insurance more affordable for more than five million self-employed individuals. More importantly, it helps expand health-insurance coverage to more than a million children, thereby responding to a top bipartisan goal of this Congress.

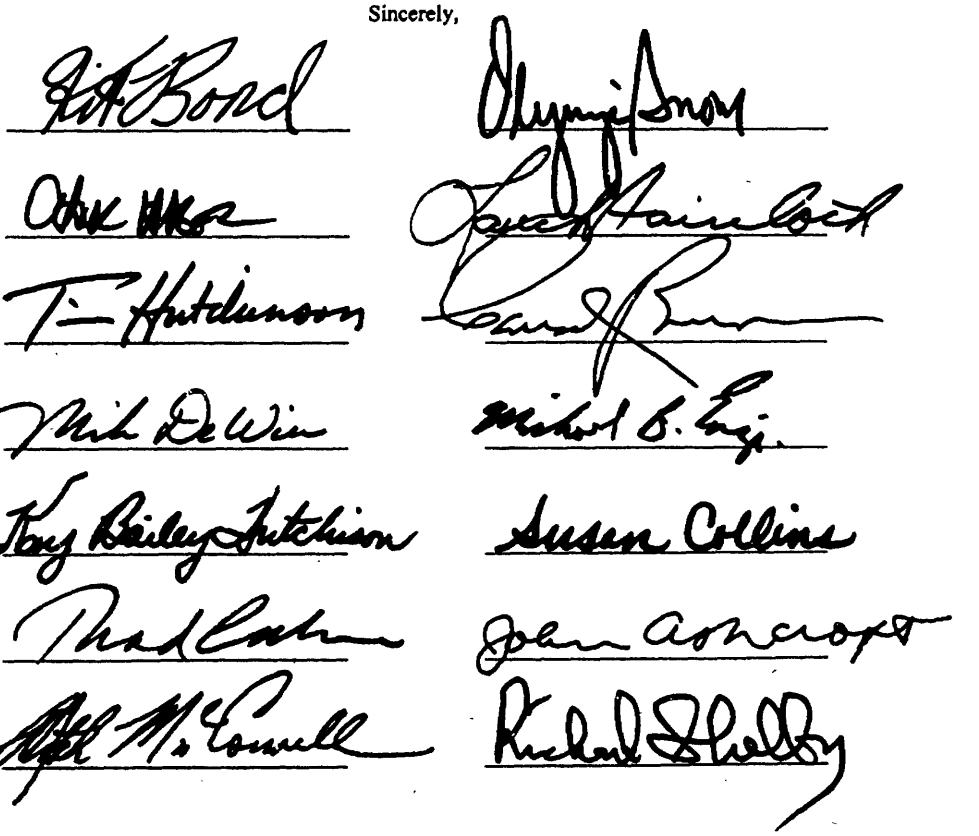
We understand that funds will be limited for additional tax provisions that your Committee can include in the tax legislation. We believe that the other two sections of S. 460, dealing with the home-office deduction and worker classification, are critically important to small business and can be accomplished at a modest cost.

With more and more Americans working from home due to corporate downsizing and child-care concerns, the restoration of the home-office deduction has become increasingly important. This is especially true for those home-based business owners who use their home office to conduct essential day-to-day administrative and management activities but by necessity must provide their services outside of the home. In addition, for many small enterprises, the dollars they save through the home-office deduction provide important short-term capital and reduce their need for bank loans or other outside financing.

Finally, clarification of the status of independent contractors is a top concern for many small businesses and was the number one recommendation of the recent White House Conference on Small Business. The Home-Based Business Fairness Act contains an important safe harbor for independent contractors based on clear, objective criteria. In addition, it provides protection against retroactive reclassifications of workers by the Internal Revenue Service, which all too often results in liabilities for back taxes, interest and penalties that can threaten the continued existence of a small firm in many cases. We urge you to include this provision in the tax legislation in an effort to provide certainty for small businesses making worker-classification decisions and to recognize the changing nature of business relationships in our economy.

Thank you for your consideration of these important small business issues. We appreciate your leadership on legislation to implement the recent budget accord, and we look forward to working with you to see that it is signed into law.

Sincerely,



Pat Roberts

Jesse Helms

Richard Shelby

Robert C. Smith

John Warner

Dan Quayle

Frank H. Murkowski

Thad Cochran

Letter to The Honorable William V. Roth, Jr.
Chairman, Committee on Finance
June 3, 1997

Regarding S. 460, the Home-Based Business Fairness Act of 1997

List of Signatories

Christopher S. Bond
Chuck Hagel
Tim Hutchinson
Mike DeWine
Kay Bailey Hutchison
Thad Cochran
Mitch McConnell
Pat Roberts
Rod Grams
John W. Warner
Frank H. Murkowski
Olympia J. Snowe
Lauch Faircloth
Conrad Burns
Michael B. Enzi
Susan M. Collins
John Ashcroft
Richard C. Shelby
Jesse Helms
Robert F. Bennett
Don Nickles
Dan Coats

STATEMENT OF SEN. ORRIN G. HATCH
BEFORE THE
SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT

JUNE 5, 1997

Mr. Chairman, I applaud you on having this hearing today. The small businesses of America are over-taxed and over-regulated. Congress must do something to bring them some relief. One of the most important things we can do for small business is give them reasonable access to the home office deduction. The "Home Office Deduction Act of 1997" , S. 406, that I have introduced will do just that. This bill will clarify the definition of what is a "principal place of business" for purposes of Section 280A of the Internal Revenue Code, which allows a deduction for an office in the home. I am pleased that Senator Bond has included identical language in his bill, S. 460. I am proud to join him as a cosponsor.

The 1993 Supreme Court decision in Commissioner v. Soliman effectively closed the door to legitimate home office deductions for hundreds of thousands of taxpayers. Moreover, the decision unfairly penalizes many small businesses simply because they operate from a home rather than from a store front, office building, or industrial park.

The Soliman case significantly narrowed the availability of this deduction by requiring that the home office be the principal business location of the taxpayer. This requirement has proven to be impossible to meet for many taxpayers with legitimate home office expenses.

Many small businesses use their home as an office to receive telephone messages, keep business records, plan advertising campaigns, store supplies, and fill out federal tax forms. A number of these business owners generate their income in the home of customers and not in their home office. Under the Soliman decision, these businesses would not qualify for the deduction because their office is not considered to be the principle place of business. In fact, having a full-time employee in the office who keeps the books and sets up appointments would still not result in a home office deduction for the business. This restriction is unfair to small business and needs to be changed.

The Home Office Deduction Act of 1997 is designed to restore the deduction for home office expenses to pre-Soliman law. The bill allows a home office to meet the definition of a "principal place of business" if it is the location where the essential administrative or management activities are conducted on a regular and systematic basis by the taxpayer. To avoid possible abuses, the bill requires that the taxpayer have no other location for the performance of these essential administrative or management activities.

Mr. Chairman, today's job market is rapidly changing. New technologies have been developed and continually improved that allow instant communication around the once expansive globe. More and more business owners are finding it more convenient to work out of their homes or have their employees work out of their homes. In this new age, redefining the deduction for home office expenses is vital. It is necessary that our tax policy not discriminate against home businesses simply because a taxpayer makes the choice, often based on economic or family considerations, to operate out of the home.

Mr. Chairman, these hearings are of vital importance to many small businesses across the nation. I ask that the committee listen closely to the testimony of these representatives and consider how vital small business is to our economy. The Soliman decision reduced the effectiveness and fairness of the home office deduction and it must be reversed. This legislation has strong bipartisan support in Congress and is supported by many business organizations.

DJ HORTON & ASSOCIATES
Financial Accounting Consulting & Taxation Services

DEBBI-JO HORTON, CPA

Testimony of Debbi-Jo Horton, CPA
New England Regional Taxation Implementation Chair to
the 1995 White House Conference on Small Business
and
Taxation Chair to the Smaller Business Association of New England
Before the Subcommittee on Taxation and IRS Oversight
of the
Senate Committee on Finance
June 5, 1997

Honorable Chairman Nichols and Members of the Committee, I am Debbi-Jo Horton, a CPA and owner of an CPA firm in East Providence, Rhode Island. I am the New England Regional Taxation Implementation Chair to the 1995 White House Conference on Small Business and the Taxation Chair for the Smaller Business Association of New England and represent their 1300 members.

As I testify on S460 I would like to speak on each portion of the bill separately, beginning with the home office deduction. Nearly everyone agrees that home based businesses represent one of the fastest growing sectors of the economy and that more women than men are starting these home based businesses. In fact over 300,000 women start home based businesses each and every year.

Many have chosen to start their own business, at home, in order to be close to their children. It is a reasonable solution to the dilemma of balancing work and family. Often these new entrepreneurs need to buy or rent a bigger home or put on an addition to their current home. Under current laws they would more than likely not be able to deduct any portion of this increase in rent/mortgage and utilities. It would appear they are being punished for choosing to be home with their family.

Many of these new businesses seek microloans to finance their start up capital to buy equipment, supplies, and sometime to pay for the renovations needed to be made to their home office. Lets look for a moment at the cost of these microloans.

Microborrowers include women, low-income individuals, minorities, business owners in areas suffering from localized economic downturn and other individuals possessing the capability to operate successful small businesses. Many are home-based. The microborrower can be located in any environment. Many are low-income and/or welfare recipients who have the desire to transform their lives. Self-employment projects are clearly a route off welfare. In many cases, micro-businesses provide employment for individuals other than just the business owner.

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Many of these microloans are sought for between $2,000-$10,000. An example of this would be Beth Greenlee who wanted to develop her part-time interior decorating business into a full-time venture. She needed to borrow $8,000 to expand out of her home and into a retail store in the state of Washington. She obtained a microloan and opened here store in May of 1995 drawing dozens of customers from the region. She became very successful and after 18 months of operation, she made a thorough assessment of her business only to find that her greatest success was still in the interior decorating side of her business not in her merchandise sales (although it too was moderately profitable). This analysis led her to the conclusion that she could increase her profitability if she eliminated her storefront and managed her business FROM HER HOME OFFICE. Imagine how much more dollars it would actually put in her pocket if she could take a deduction for that home office and not have to pay self employment taxes on that, nor would she have needed that $8,000 in the first place.

I myself am an example of a home-based business. I began my firm in a spare bedroom of my home. I conducted all of my administrative work in my home office, but closely resembled Dr. Solomon's case in that I conducted most of my work outside the home office. I needed $2,000 to purchase some used computer equipment and another $1,500 for desks, supplies, etc. I could not find financing. I ended up financing my venture by borrowing the $2,000 from a money store at 2% interest per month, putting my auto up for collateral. The balance was obtained from credit cards. I was able to pay off those debts in 18 months, but could have done so much sooner if I did not have to put away so much in order to pay my self-employment taxes.

My firm grew rapidly and I now rent more than 1100 square feet of commercial office space and employ 3 other people, looking to hire another shortly. I counsel many start-up home-based businesses that struggle to make ends meet because of the unfair tax burden they face because they chose to work from their homes. It is their choice certainly, but many feel that they do not have a choice because of their commitment to their family. They need the second income, yet they wish to give their children the love and security of having at least one of their parents home when they arrive home from school.

My point in all of this is that if these home office deductions were allowed, many of these microloans would not be needed. Why? Because the amount of tax savings (regular income taxes AND self-employment taxes) would sufficiently cover the needed cash. No loan needed and no interest payment to make.

As reported in the November 1, 1996 Report On The Microloan Demonstration Program put out by the U.S. Small Business Administration the total SBA funded Microloans made were 5,284. This represented a total dollar amount lent of $52,080,602. for an average of $9,856 loan.

The breakdown by state is as follows:

State	Average loan amount
Alabama	$10,000
Arkansas	6,450
Arizona	6,363
California	13,277

Colorado	12,497
Connecticut	17,492
DC	15,443
Delaware	13,214
Florida	16,660
Georgia	11,195
Hawaii	4,478
Iowa	7,317
Idaho	12,341
Illinois	11,716
Indiana	13,812
Kansas	10,574
Kentucky	14,199
Louisiana	15,107
Maine	11,919
Maryland	14,694
Massachusetts	10,444
Michigan	12,444
Minnesota	7,823
Missouri	15,303
Mississippi	8,790
Montana	11,038
Nebraska	9,260
New Hampshire	6,522
New Jersey	14,379
New Mexico	2,435
Nevada	9,539
New York	14,468
North Carolina	7,106
North Dakota	13,192
Ohio	9,021
Oklahoma	15,129
Oregon	17,050
Pennsylvania	14,261
Puerto Rico	9,653
South Carolina	17,586
South Dakota	8,609
Tennessee	7,430
Texas	11,335
Utah	18,625
Virginia	10,118
Vermont	13,868
Washington	9,097
Wisconsin	10,299
West Virginia	13,633

100% Deductibility of Health Insurance Premiums for the Self-Employed

The fact that self employed persons are allowed to deduct only a small portion of their health insurance premiums from their income is unacceptable. A deduction of 100% of these medical premiums must be allowed to determine the net profit of the company. This would allow the benefit of the deduction for purposes of income, FICA, and Medicare taxes. This allowance should be available to the self-employed, partners, and shareholders of an S Corporation.

The effect of this is complicated for self employed persons doing business in states that piggyback US gross income for the state tax calculation. There is then no benefit to a 100% deduction unless it is part of computing the Schedule C net income or the pro-rata share of partnership, S Corporation, or LLC income.

If a self-employed person hires employees, they are allowed to deduct 100% of their employee's health insurance payments and the employer's portion of FICA and Medicare payments from his/her self employment income and not their own. If you operate as anything other than a C Corporation, you are not allowed these deductions. Why?

As a single mother of two children from two previous marriages I can attest to the need for 100% deductibility. Both of my ex-husbands are supposed to cover their child on their health insurance. Both have changed jobs and have not covered their child at one point or another. One of my husbands have changed jobs so frequently that because of waiting periods and periods of unemployment my daughter would be left without coverage more often than she would have coverage.

Both ex-husbands are employees of corporations and pay very little if anything towards that coverage. I have owned my own business and have been self-employed for more than 8 years. I have paid for continuous coverage for myself and my children with most of that premium being nondeductible because I did not want my children to be uninsured. The President and Congress have debated the need for health insurance coverage for uninsured children. How about starting with something you already have. I would be able to pay for more of my employee's coverage if I would be able to deduct 100% of my own premiums. I would be able to afford to purchase better coverage for my family and my employees' families.

It doesn't usually make sense to start to reinvent the wheel when you have something in place currently that just needs refining and expansion. I agree that their are many families that have little or no insurance, but lets look at some of the facts. Welfare provides coverage to many of those who have little or no income from a job. And as I mentioned before many welfare recipients are finding opening a small business as a solution to coming off welfare, now lets give them the ability to afford their health care for themselves and their families.

The 100% deduction of health care premiums ranked #15 in the final 60 recommendations of the White House Conference on Small Business. C Corporations are allowed to deduct this

expense in it's entirety. Congress has not asked them to give up 60% of their deduction, nor is it anticipated. Small business asks that they be treated in an equitable fashion. This sort of inequity places a severe financial burden on the small business owner.

And finally, the definition of an independent contractor must be clarified. The uncertainty of worker classification is a major threat to the business community. We have debated the need for this intensely over the last 2 years, lets draw this to a close. I believe it is safe to say that we all agree that:

a) The 20 factor test is too subjective. The test relies on a "facts and circumstances" approach. There are no factors that will default a worker to the employee or independent contractor category. Further there is no guideline as to how many answers cause a classification. Thus the classification is in the eyes of the beholder. There must be a safe harbor test which will provide surety for both the business and the worker. This is especially true because misclassification can result in termination of the business and the business owner and others being personally liable for "imputed" payroll taxes.

b) Safe harbor provisions should be established which would protect the hiring business from the burdensome penalties currently being assessed by the IRS.

c) The IRS should eliminate back taxes for misclassification when Form 1099's are filed and there is no evidence of fraud.

In establishing these new safe harbor tests a joint committee was informally established that included not only government representatives but also representatives for "small business". This was evident in the hearings that were held and the many meetings and discussions that resulted from those hearings. The intent was to provide tests which will be: easy to understand, consistent and fair, while still insuring that all income earned by workers is reported. I believe this bill provides just that.

For anyone that has not been part of the discussions of the last two years, the meat of the problem can be summed up like this:

Many small businesses are either independent contractors or the users of the services of independent contractors. Frequently they are both. During the 1990's the number of independent contractors has increased dramatically. Many businesses have "down sized" and many of the former employees are now consultants. Often for their former employers.

Many problems arise when the IRS reclassifies independent contractors as employees. The subjectivity of the IRS's 20 factor test and resulting determination of the IRS can bankrupt a small business. The ramifications of reclassification are costly and often the reclassification is unfair and unreasonable. Isn't it unreasonable to the worker and a business who have agreed as to the worker's classification that the IRS can, and does, attack the classification resulting in a great cost in time and money for the business?

If the IRS demonstrates the worker should have been treated as an employee rather than an independent contractor, as agreed by the worker and business, the business can be required to pay all the payroll taxes that would have been paid if the worker had been an employee, plus interest. The IRS can also assess various forms of penalties for failure to file or pay. It is not unusual for the interest and penalties to far exceed the amount of taxes. But it does not stop there. Personal liability exists for "responsible persons". This means that not only can the business owner be held personally liable for these amounts, but other persons can as well. The IRS can and has required controllers of closely held businesses with no direct or indirect ownership to personally pay these amounts.

This is only the beginning,...reclassification can affect qualified pension plans and other benefit plans because all of the nondiscrimination tests must be recalculated. If the worker is reclassified as an employee they could qualify as part of a businesses qualified pension plan. This in turn could effect payments the worker had made to their own retirement plans.

As an organization that represents smaller businesses we are looking to make it easier for businesses to comply with the complex rules and regulations that are our tax system. The area of independent contractor/employee is currently a very complicated area. It is also one that has great risk for business and business owners. We strongly support providing safe harbors that would allow for business and workers to have certainty regarding worker classification .

Women represent the largest and fastest growing sectors of the small business community. Women account for a majority of the start up small businesses in this country, and a majority of them are independent contractors. This means that more women are entering the arena as independent contractors than ever before. The National Association of Women Business Owners views the independent contractor issue as their top concern. The Business and Professional Women's Federation/USA has also seen an increase in membership of women business owners. The independent contractor issue has been a topic of concern to their members and was included as one of the topics at their National Conference July, 1995.

I'd like to thank Senator Nichols for holding this hearing and allowing me the opportunity to provide testimony for the Finance Committee's subcommittee on Taxation and IRS Oversight this 5th day of June, 1997.

Before the
U. S. Senate Committee on Finance
Subcommittee on Taxation and IRS Oversight
Hearing on Small Business Taxation Proposals
June 5, 1997

TESTIMONY OF
STEPHEN KENDA, PRESIDENT OF KENDA SYSTEMS, INC. (SALEM, NEW HAMPSHIRE) AND
PAST PRESIDENT, NATIONAL ASSOCIATION OF COMPUTER CONSULTANT BUSINESSES
ACCOMPANIED BY
HARVEY SHULMAN, ESQ. OF GINSBURG, FELDMAN & BRESS (WASHINGTON, D.C.) AND
GENERAL COUNSEL, NATIONAL ASSOCIATION OF COMPUTER CONSULTANT BUSINESSES

Mr. Chairman, NACCB is the largest association representing high-tech staffing firms that specialize in providing highly-skilled computer and engineering professionals to customers in need of temporary technical support. We have over 300 member firms, with about 750 offices that generate around $4 billion in revenues.

Our attached written comments address 4 parts of the "independent contractor" section of S. 460: first, repeal of Section 1706 of the 1986 Tax Reform Act, second, a safe harbor for "incorporated" contractors, third, a safe harbor for contractors who meet 4 key common law factors, fourth, a statutory rule on "control".

My oral testimony addresses only Section 1706 repeal, which presents the most compelling case and greatest consensus for action. Congress's general concerns about unclear laws, and arbitrary and expensive IRS audits, must be magnitudes greater when it comes to Section 1706. Every complaint you hear today from other industries must be multiplied when you consider what Section 1706 has done to the high-tech staffing industry.

For those who do not know, Section 1706 is a law that applies solely to staffing firms in the technical services industry. Section 1706 bars every staffing firm from relying upon any of the employment tax safe harbors in Section 530 of the 1978 Revenue Act. In simple terms, this means that no matter how reasonable a high-tech staffing firm acts in classifying a worker, the firm must always persuade the IRS that its classification is correct under the ancient and unpredictable common law test. For example, if a high-tech staffing firm reasonably relied on a court decision involving this industry, that court decision provides no safe harbor. Nor does the extensive use of independent contractors in our industry provide any safe harbor. And, most outrageously, if a high-tech staffing firm wins an IRS employment tax investigation without any reclassification of its independent contractors, there is no "prior audit" safe harbor available and the IRS can later conduct another audit of future years

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even though no facts have changed. Congress does not tolerate these results for other industries, yet that is exactly where Section 1706 has left my industry.

You may say that some of these things would never happen, but they have. The IRS investigated my own firm in 1991, costing us thousands in professional fees. We gave documents to the IRS and answered many common law employment test questions. We distinguished our independent computer consultants from our employees. In 1991 the IRS said we had not misclassified anyone.

Yet a few weeks ago the IRS sent me another letter saying it wants to again review our use of independent contractors. We must produce many documents and answer more questions, though we operate no differently than in the past, except for having even tighter standards for using independent consultants.

If I were in any other business, a prior employment tax audit would protect me from another IRS audit. But Section 1706 denies me Section 530 protection. Also because of Section 1706, the IRS will not allow me to claim a Section 530 safe harbor based on advice several years ago from my experienced tax counsel who reviewed my operations and contracts and advised that I had a good basis to use independent consultants. Finally, due to Section 1706, an industry practice safe harbor is denied to me even though repeated industry surveys show that about 80% of all computer consulting staffing firms use independent contractors just like I do. In fact, my counsel handled over 40 IRS employment tax investigations involving thousands of independent computer consultants hired by staffing firms just like mine -- and virtually none of those consultants were reclassified as employees of those firms. Yet because of Section 1706, none of this matters. How can you justify this?

Mr. Chairman, some say I am lucky because legal and accounting fees and costs for my first IRS encounter were only a few thousand dollars. One of my competitors spent almost $300,000 to win a four year battle at the IRS on this issue -- a battle that almost destroyed it. Even then, the IRS came back to that firm two more times in the next four years to explore the issue again, until the IRS finally gave up. I know of other high-tech staffing firms that received at least two IRS visits and have spent literally tens of thousands of dollars. We all say that we "won", but in fact we have lost -- time, money and morale get drained. If you want to help businesses in other industries that still have Section 530 protection, how can you not also repeal Section 1706 which continues to excludes me from any Section 530 relief?

Mr. Chairman, my situation amazes me for another reason. High-tech staffing firms are the backbone of our technology-based economy. There aren't enough high-level computer and engineering professionals, and many of the best want to be independent contractors for reasons unrelated to taxes. They pride themselves on having adopted a business name and, in most cases, a business structure that identifies them as small businesses; they want to

remain apart from the corporate world's set wage scales, limited raises, rigid vacation and leave policies, ongoing monitoring and yearly reviews; they want to accept work on a specific project or for a specific period, free from detailed control and involuntary reassignments to new projects, new managers, or new locations; they want to be able to market themselves to others, while still working through a staffing firm and its customer, without feeling disloyal; and they are willing to take the risk of loss by not being paid if their work is substandard, or to re-do substandard work without additional pay. Yet, despite such reasons, in every hiring situation in our industry we must grapple with how the IRS will apply the common law employment test that Section 1706 leaves us with. This is not fair.

Mr. Chairman, the consensus for repealing Section 1706 is overwhelming.

- In the 104th Congress, 52 Senators -- 22 Democrats and 30 Republicans -- jointly asked Chairman Roth for Finance Committee action on Section 1706 repeal.

- In the 103rd Congress, Chairman Roth himself wrote to then-Chairman Moynihan and stated that "the technical services industry should receive relief from the unintended consequences of Section 1706 so that this industry receives some kind of statutory alternative to the common law standards like that enjoyed by every other industry." Then-Chairman Moynihan also stated that he recognized the "unintended consequences" of Section 1706 and he was "committed to resolving the issue at the earliest opportunity."

- In the 102nd Congress, the House Government Operations Committee, after receiving extensive input on IRS enforcement of Section 1706, found "no basis" for the law and called for its repeal. That same year the Congressional Black Caucus, noting the "enormous financial impact" of IRS audits on small businesses in the high-tech industry, asked for legislative action to solve the "problems caused by Section 1706."

The private sector has echoed these Congressional calls for repeal. The non-partisan, prestigious American Tax Policy Institute urged repeal of Section 1706 in 1994. And in 1996 the American Bar Association, Section on Taxation called for repeal. Likewise, over a dozen major associations in the high-tech industry, including the world's largest engineering association, the Institute of Electrical and Electronic Engineers, and the National Association of Women Business Owners have joined in the Coalition to Repeal Section 1706.

Mr. Chairman, as you can see, it is hard to imagine more universal or bipartisan support for any independent contractor issue that has come before Congress in recent history. Ten years has been long enough to wait. Let's repeal Section 1706 in 1997.

Before the
U. S. Senate Committee on Finance
Subcommittee on Taxation and IRS Oversight
Hearing on Small Business Taxation Proposals
June 5, 1997

TESTIMONY OF
STEPHEN KENDA, PRESIDENT OF KENDA SYSTEMS, INC. (SALEM, NEW HAMPSHIRE) AND
PAST PRESIDENT, NATIONAL ASSOCIATION OF COMPUTER CONSULTANT BUSINESSES
ACCOMPANIED BY
HARVEY SHULMAN, ESQ. OF GINSBURG, FELDMAN & BRESS (WASHINGTON, D.C.) AND
GENERAL COUNSEL, NATIONAL ASSOCIATION OF COMPUTER CONSULTANT BUSINESSES

The National Association of Computer Consultant Businesses ("NACCB") hereby comments on S. 460. Our comments are in 4 parts:

I. GENERAL BACKGROUND
II. COMMENTS ON REPEAL OF SECTION 1706 OF 1986 TAX REFORM ACT
III. TECHNICAL COMMENTS ON NEW SAFE HARBOR PROVISIONS IN §3511
IV. TECHNICAL COMMENTS ON "CONTROL" PROVISION

I. GENERAL BACKGROUND.

NACCB supports the goals of S. 460 that would increase the deductibility of health insurance premiums paid by self-employed workers, clarify the term "principal place of business" for purposes of establishing a home office, and provide new "safe harbor" protections for the use of independent contractors, accompanied by the repeal of Section 1706 of the 1986 Tax Reform Act. However, these comments are limited to Section 4 of S. 460.

Section 4 of S. 460 includes 6 major provisions. The provision of primary importance to NACCB firms is the repeal of Section 1706, which is contained in Section 4(c) of S. 460. Our comments will address the Section 1706 provision first. Next we will address the two safe harbor provisions in Section 4(a) of S. 460: the safe harbor based upon the existence of a business entity in the form of a corporation or a limited liability company and the safe harbor based upon the establishment of a worker's economic independence and workplace independence. Finally, we will address the provision in Section 4(b) of S. 460 which states that compliance with statutory or regulatory standards shall not be treated as evidence of control under the common law. This testimony does not address two other provisions in S. 460 -- placement of the burden of proof on the IRS after a taxpayer makes a prima facie case of independent contractor status, and the requirement that reclassifications of workers must be made prospectively if the taxpayer has acted reasonably and in good faith. However, we strongly support those provisions.

II. SECTION 1706 OF THE 1986 TAX REFORM ACT MUST BE REPEALED.

From a tax fairness and equity standpoint, perhaps the most important part of S. 460 is the provision that would repeal Section

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1706 of the 1986 Tax Reform Act -- also known as Section 530(d) of the 1978 Revenue Act. In fact, NACCB believes that it would be unconscionable to improve the safe harbors available to all businesses without first repealing Section 1706 which disqualifies our industry from the most basic safe harbors in Section 530.

It is well known that Section 530 was enacted in 1978 in response to concerns the IRS application of the centuries-old common law employment test was unpredictable and punitive to taxpayers. Section 530 provided a safe harbor alternative to the common law test by requiring the IRS to respect a business's treatment of a worker as an independent contractor if the business had a "reasonable basis" for its treatment, did not inconsistently treat workers as employees and independent contractors, and had filed appropriate reporting Forms 1099 with the IRS.

As part of the 1986 Tax Reform Act, Section 1706 repealed the Section 530 safe harbor for only the technical services industry, and it did so in a most insidious manner. In particular, it focused only on so-called "three-party" situations in the technical services industry in which a worker (the first party) uses the services of a broker (the second, or intermediate, party) to locate consulting opportunities with a client or customer (the third party). Section 1706 took away all Section 530 relief from the intermediate party, the broker. In fact, customers who contract directly with consultants in so called "two-party" situations still have Section 530 relief; and, even in the "three-party" situations, the customers also retain Section 530 relief -- only the broker has been targeted.

As a result of Section 1706, the technical services industry is the only industry in this country where the employment tax liabilities of certain firms are determined under only one test, the 20-factor common law employment test. In every other industry, -- whether in "three-party" or "two-party" situations -- every firm has its employment tax obligations determined under two alternative tests: either the 20-factor common law employment test or a back-up, alternative employment tax safe haven such as Section 530. If a worker is determined to be self-employed under either alternative, then the worker -- and not the firm -- must pay the employment taxes.

In order to understand the compelling reasons for repealing Section 1706, it is important to understand how that provision was enacted. Section 1706 originated as a non-controversial "revenue offset" measure that was estimated to raise $12 million per year; it was never analyzed in detail and it was never discussed in any hearings. As a proposed "revenue offset" measure, it was also somewhat of an "experiment" in reaction to claims that the Section 530 safe haven was "too liberal" and had led to tax noncompliance which sometimes resulted in unfair competitive advantages to certain firms and workers -- claims which, it should be noted, would apply to every industry if they were true.

Unfortunately, the "experiment" that became Section 1706 has created a nightmare for the technical services industry by placing it in the very same vulnerable situation that all firms faced in the 1970s and that first led to enactment of the Section 530 back-up, alternative employment tax safe haven. As a result, Congress received thousands of complaints that the Section 1706 "experiment" had failed. In 1987 over 125 members of the House -- including a

bipartisan majority of the Ways and Means Committee, led by then-Representative Judd Gregg and Representative Dick Gephardt -- called for a two year moratorium on Section 1706 while it could be studied. The Small Business Administrative, Office of Advocacy also joined the call for a moratorium or repeal. The proposed moratorium was not pursued, but in 1988 Congress passed Section 6072 of TAMRA to require the Treasury Department to study the impact of Section 1706.

The Treasury Department Study, released in March 1991, is the most comprehensive and unbiased analysis of Section 1706. The Treasury Department Study contains new information, not available when Section 1706 was enacted, which confirms that discrimination against the technical services industry cannot be justified -- and legislative relief is necessary.

First, the Study concluded that although the technical services industry had been the only industry singled out for loss of the Section 530 back-up, alternative employment tax safe haven, the discrimination had been imposed against an industry in which there is actually better tax compliance in comparison to many other industries. When Congress enacted Section 1706, it did not know this fact!

Second, the Study found that especially because of its application to only so-called "three-party situations" in the technical services industry" -- and the exemption of "two-party" situations -- Section 1706 is "difficult to justify on equity or other policy grounds."

Third, the Study confirmed that application of the "20-factor common law [employment] test can be difficult, in particular in the multi-party situations affected by Section 1706" (emphasis added). Indeed, the Study quoted an Assistant Treasury Secretary who admitted that this test "may also produce inappropriate results" and "does not yield clear, consistent, or satisfactory answers".

Fourth, the Study dispelled the notion that the government loses tax revenues when technical services workers perform services as independent contractors instead of as employees. The Study found that when workers in any industry perform services as independent contractors, some may underreport their incomes or overstate their business expenses. Yet the Study concluded that for the technical services industry, "Misclassification of employees as independent contractors increases tax revenues, however, and tends to offset the revenue loss from undercompliance by individuals, because direct [taxable cash] compensation to independent contractors is substituted for tax-favored employee fringe benefits." (emphasis added).

Following up the Treasury Study, calls for Section 1706 repeal increased:

- In November 1992 the House Government Operations Committee, after a detailed study and hearings, recommended in House Report No. 102-1060, p. 15, that "the limited exception from Section 530 protection for certain technical service workers, commonly referred to as Section 1706, should be repealed."

- In 1992 the Congressional Black Caucus noted the "enormous financial impact" of IRS audits in the high-tech industry, especially

on women and minority owned businesses, and it called for legislation to solve "the problems caused by Section 1706."

- In 1993 and 1994, sixty-three Senators (29 Democrats, 34 Republicans) wrote individual letters to then-Finance Committee Chairman Moynihan and asked for action on Section 1706. Now-Chairman Roth himself wrote to then-Chairman Moynihan that "the technical services industry should receive relief from the unintended consequences of Section 1706 so that this industry receives some kind of statutory alternative to the common law standards like that enjoyed by every other industry." Then-Chairman Moynihan agreed that there were "unintended consequences" and "committed to resolving the issue at the earliest opportunity."

- In 1994, the non-partisan prestigious American Tax Policy Institute concluded that "the original basis for [Section 1706] enactment has been refuted" and urged its repeal: "There is no justification to support the exclusion of three party technical service workers. Their exclusion merely serves to complicate the law."

- In 1995 a majority of the Senate sent a joint letter to Chairman Roth asking for action on Section 1706 repeal.

- In 1996, the American Bar Association, Section on Taxation testified before the House Ways and Means Committee that "Section 1706 ... should be repealed, so that the safe harbor provisions will apply in the case of technical services personnel. There is little rationale for the singling out of technical services personnel for a special rule, and the definition of [such] personnel is too ambiguous to apply in today's service-oriented economy."

In short, after the Treasury Study and the consensus that has emerged to repeal Section 1706, there is no longer any justification for continuing the tax discrimination created by Section 1706. If the technical services industry is to be denied all Section 530 relief, then so must every other industry; if "three-party" relationships in our industry are to be denied Section 530 protection, then so must "two-party" situations -- and no one is proposing those drastic alternatives.[1/]

[1/] The discrimination against our industry is sufficient basis alone to repeal Section 1706. However, after the Treasury Study it cannot be said that classification of workers as independent contractors actually results in revenue losses -- especially as tax compliance will increase with better reporting systems.

In addition, certain changes made to Section 530 in the Small Business Job Protection Act of 1996, P.L. 101-188, have further undermined the already specious claim that firms which have used both employees and independent contractors cannot compete on a "level playing field" with firms that have used only independent contractors. That argument was based on the assertion that the IRS will deny Section 530 relief to the former firms while granting Section 530 relief to the latter firms on the ground that the latter firms have treated "substantially similar" workers in an "inconsistent" manner. Yet, P.L. 104-188 clarified that workers do not hold "substantially similar positions" simply because they

(continued...)

We wish to note that in urging repeal of Section 1706, we are joined by the Coalition for Section 1706 Repeal, which includes the Black Data Processing Associates; the American Consulting Engineers Council; the Institute of Electrical and Electronics Engineers; the National Association of Women Business Owners; the Independent Computer Consultants Association; the American Engineering Association and many others. Moreover, the leading editorial voice in the computer industry, Computerworld magazine, also joined the call for repeal in its editorial "Repeal 1706" which stated in part:

> Singling out technical workers who use brokers isn't fair and never was. Why should one set of rules apply to contract programmers and another to, say, contract janitors?
>
> *** *** ***
>
> [L]et's stop tarring and feathering one select group.... [T]his in itself is reason for the repeal.

NACCB believes that enough has been said and studied on this issue in the past 10 years. Now is the time to repeal Section 1706.

III. TECHNICAL COMMENTS ON NEW SAFE HARBOR PROVISIONS IN §3511.

In general, the statutory language in proposed Section 3511 is a major improvement to current law. However, there are a few places where modifications to statutory language are necessary, especially in connection with the safe harbor for independent contractors who claim to be incorporated or limited liability companies. In addition, the legislative history developed at these hearings and in Committee Reports will be useful.

A. Safe Harbor Based on Business Structure

For NACCB, the most important safe harbor under proposed §3511 is based on showing that a worker operates through a "business structure" -- a corporation or a limited liability company ("LLC") -- and does not receive benefits from a service recipient.

i. Codification of Existing Law

NACCB strongly supports a safe harbor provision to protect incorporated and LLC contractors. It is important to emphasize as to corporations this safe harbor provision does not change existing law. Instead, this provision merely codifies the IRS position set forth at page 2-23 of the publication entitled Independent Contractor or Employee? Training Materials, Training 3320-102, TPDS 84238I (Rev. 10-96) (hereafter "Training Materials"). The Training Materials, in turn, reflect a body of case law authority that has developed to recognize that a contractor who incorporates and becomes an employee of his or her own corporation is not to be treated as an

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[1/](...continued)
perform the same type of work, but rather that the full relationship between the firm and its workers must be considered. See also Lambert's Nursery and Landscaping, Inc. v. U.S., 894 F.2d 154 (5th Cir. 1990). Hence, without losing Section 530 protection firms may use both independent contractors and employees to perform the same type of work as long as they reasonably treat each group of workers differently.

employee of that corporation's clients or customers. See Idaho Ambucare Center, Inc. v. United States, 57 F.3d 752 (9th Cir. 1995).

ii. Application of Safe Harbor to Professionals

We have heard suggestions that the "business structure" safe harbor should be limited to certain types of service providers, such as professionals, whose incorporation is not uncommon and who tend to be well-educated, well-paid, and highly skilled. Whether or not the statute is limited, the legislative history should specifically mention the appropriateness of this safe harbor for professionals.

Although for decades professionals have properly offered their services as independent contractors even when they were not incorporated or LLCs, see, e.g., Metcalf v. Mitchell, 269 U.S. 384 (1926) (engineer); Azad v. United States, 388 F.2d 74 (8th Cir. 1968) (doctor); deTorres v. Commissioner, 65 TCM 2381 (1993) (engineer); Youngs v. Commissioner, 69 TCM 2032 (1995) (accountant); Training Materials at 2-13 citing Treas. Reg. §31.3121(d)-1(c)(2), it is not uncommon for professionals to incorporate for many non-tax purposes related to limiting liability for work performed, keeping personal assets beyond the reach of creditors, establishing a business name or presence, attracting capital, and many other non-tax reasons. See, e.g., Idaho Ambucare Center, Inc. v. United States, 57 F.3d 752 (9th Cir. 1995)(doctor formed a professional corporation).

Almost 30 years ago the IRS ruled it would "treat organizations of doctors, lawyers and other professional people organized under state professional association acts as corporations for tax purposes." Rev. Rul. 70-101, 1970-1 C.B. 278. However, the IRS did not limit its ruling to only those professionals who incorporated under special statutes that cover professionals. It further stated, "if a corporation is organized and operated as a professional service business under the general business corporation statute of its state, it will generally be recognized as a corporation." Id. at 280.

Of course, over the years the types of professionals have increased and Congress has responded to recognize them. Beyond traditional professions like law and medicine, other professions now include all types of engineering, as well as computer systems analysis and programming. Just last year in the Small Business Job Protection Act of 1996 "(SBJPA"), Congress amended the Internal Revenue Code provision on benefits provided to "leased employees" under §414(n). The Conference Report provided examples of how this amendment applied to "professionals" and, in so doing, provided examples of "professionals" as follows: "attorneys, accountants, actuaries, doctors, computer programmers, systems analysts, and engineers". Senate Report No. 104-281 at 1568. In another part of the SBJPA, Congress amended the Fair Labor Standards Act to require the Department of Labor to classify as "professionals" exempt from time-and-one-half overtime rates "computer systems analysts, computer programmers, software engineers, or other similarly skilled workers." 29 U.S.C. §206(a)(17). And while some professionals may or must have a degree in their field, e.g., doctors, the Department of Labor has recognized that in other professions a degree in that discipline need not exist, e.g., computer sciences. See 29 C.F.R. §541.302(c). ("While such [computer professionals] commonly have a bachelor's or higher degree, no particular academic degree is required ..., nor are there any requirements for licensure or certification ...."). See

also Morgan-Chandler v. The Consortium of Maryland, Inc., 132 CCH Labor Cases ¶33,454 (Md. 1996)(technical writer is a professional).

Finally, in late 1996, for purposes of the employment tax laws, the IRS itself stated that "highly trained professionals" include "doctors, accountants, lawyers, engineers, or computer specialists". Training Materials at page 2-13.

Accordingly, if Congress narrows the "business structure" safe harbor in S. 460, it should clearly include "professionals" in a modified safe harbor. And whether the safe harbor is narrowed or remains as is, the legislative history should explain that it is not uncommon for "professionals" -- which includes computer programmers, systems analysts, engineers (software, hardware, network, etc.) and similarly skilled professionals -- to incorporate.

iii. Modifying Statutory Language on "Benefits"

The "business structure" safe harbor requires the service provider not receive from the service recipient any "benefits that are provided to employees of the service recipient." This statutory language should be modified to refer only to "benefits that are provided under this title and not otherwise required by law".

In many instances, contractors are allowed to park in a service recipient's parking lot, to use a service recipient's telephone or other equipment, etc. In the broad sense, these privileges could be viewed as "benefits", though S. 460 should not disqualify a service provider who receives such benefits from this safe harbor.

Similarly, some service recipients may be required by state laws to provide certain types of "benefits" to workers who otherwise qualify as independent contractors under federal law. Two examples that come to mind immediately are worker's compensation coverage and state unemployment insurance for workers who are considered employees under state law, but not under federal tax law. A service recipient should not lose protection under this safe harbor because it is complying with a state law to provide such types of "benefits".

Both of the above concerns can be addressed if the statutory language is modified to refer to only benefits provided "under this title and not otherwise required by law", i.e., tax-favored benefits such as health insurance and pension plans.

iv. Modifying Statutory Language to Protect Service Recipients Where Service Provider Fails to Comply

a. The "business structure" safe harbor applies only if the service provider "conducts business as a properly constituted corporation or limited liability company under applicable State laws". It is critical that the legislative history provide specific guidance on when a business is or is not "properly constituted". Corporations, for example, must maintain by-laws, retain a registered agent, issue stock, have annual meetings of board of directors and shareholders, file annual reports, file corporate and employment tax returns with the IRS, keep corporate books and records, and so on. Failure to hold an annual meeting or to file an annual report on time should not destroy the safe harbor. The legislative history should make it clear that if a corporation or LLC

substantially complies with these requirements, or is recognized as valid under state law, then the IRS should not be able to find that the entity is not "properly constituted". On the other hand, it may be fair to disqualify the service provider from this safe harbor if it does not file tax returns with the IRS as a business entity (Forms 1120, 940, 941, W-2, etc.).

b. Most importantly, the service recipient cannot know, as a practical matter, when a service provider's business is "properly constituted". The service recipient does not have access to the corporate service provider's tax filings, its books and records, its by-laws and the like. The service recipient should be allowed to rely upon prima facie evidence that the business entity is properly constituted. Section 4(a) of S. 460 should be modified by adding under subsection (f) of proposed §3511 SPECIAL RULES the following new paragraph (4):

(4) ADDITIONAL RULES FOR CORPORATION AND LIMITED LIABILITY COMPANY SERVICE PROVIDERS. -- The following rules apply to claims for relief under Subsection (e) in any taxable year.

(A) If a corporation or limited liability company has failed to file all income and employment tax returns required to be filed under this title or has failed to comply with any applicable requirement in section 6041 of this title in regard to any service claimed to be covered by this section, then such entity shall not be entitled to safe harbor relief under this section.

(B) If a service recipient or payor --

(i) obtains a written statement from a service provider that states it is a corporation or limited liability company, provides the state (or, in the case of a foreign entity, the country) and year of incorporation or formation, provides a mailing address, and includes an Employer Identification Number, and

(ii) makes all payments for the performance of the services claimed to be covered by this section to the corporation or limited liability company pursuant to a written contract with such entity,

then the service recipient or payor shall be deemed to have satisfied the requirement in paragraph (1) of subsection (e) necessary for it to be entitled to safe harbor relief under this section.

B. Safe Harbor Based on Economic and Workplace Independence

The second safe harbor under proposed §3511 is based on showing both a worker's economic independence and a worker's workplace independence (of course, a written contract must also exist and proper IRS reporting requirements must be followed). Section 3511 lists 3 factors that demonstrate a worker has economic independence, and all 3 must be satisfied. It lists 4 factors that demonstrate workplace independence, only 1 of which must be satisfied.

This safe harbor can work well for many service providers. Yet, for the reasons stated below the economic/workplace independence safe harbor will be problematic for many "knowledge professionals" like

computer and engineering professionals, physicians, accountants and others who choose to -- or must -- perform most of their work "in the field" on the premises of their clients and customers. As explained below and along with a statement that this safe harbor is to be interpreted liberally (like Section 530), these professionals would come within this safe harbor, but the alternative "business structure" safe harbor is more important to many professionals. This being said, we turn to some technical details of this safe harbor.

i. Comparison of S. 460 and S. 1610

Preliminarily, we want to emphasize this economic/workplace independence safe harbor is much more narrow than the safe harbor proposed in the bill that Senators Bond and Nickles offered in the last Congress, S. 1610. S. 1610 had a number of provisions which many workers could have more easily satisfied to become independent contractors. Many workers who are now clearly employees under the common law test could have been treated as independent contractors under S. 1610. But we do not see that result at all for the economic/workplace independence safe harbor in S. 460. Rather, this new safe harbor, if applied properly, should generally result in the same answer to the question of whether a worker is an employee or an independent contractor as would be the case under the common law. It would not allow employers to simply start treating their employees as independent contractors.

The main benefit of the economic/workplace independence safe harbor in S. 460 is not that it provides a different result from the common law in most cases, but rather that it provides a clear, short, simple test that focuses on some of the more determinative common law factors which can be further explained in legislative history.

ii. Ability to Realize a Profit or Loss

Whether a worker has the "ability to realize a profit or loss" is one of the traditional common law factors incorporated into §3511. This factor should be relatively simple to apply in light of the recent IRS Training Materials and related rulings that clarify its application.

a. The Training Materials at page 2-21 identify certain factors as relevant to determine whether a profit or loss can be realized: significant investment, unreimbursed expenses, making services available, and method of payment. Of course, these factors are not exclusive, as other relevant factors have been identified to include whether the contractual arrangement provides that satisfactory performance is a precondition for payment to the worker[2]; whether the worker has warranted the work will be done in

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[2] Under the Fair Labor Standards Act and state wage and hour laws, employees must be paid for their time performing services for their employers, even if the work is substandard. Hence, guaranteed payment of a worker's compensation is strong evidence of employment status because the worker cannot suffer a loss from substandard work. On the other hand, independent contractors do not have to be paid for (continued...)

a "workmanlike manner", or according to "industry standards", or has otherwise agreed to accept liability for defective work[3]; and whether the services establish or detract from the worker's business reputation rather than the reputation of the worker's client or customer.[4]

b. The Training Materials at pages 2-21 and 2-31 are also helpful in applying this factor because they make it clear that not all of the above factors are necessary to establish a profit or loss. For example, as the IRS emphasized at page 2-16 of the Training Materials, a significant investment is not required: "It should be stressed, however, that a significant investment is not necessary for independent contractor status. Some types of work simply do not require large expenditures."

iii. Unreimbursed Business Expenses

a. This is another valid factor which should be relatively simple to apply. At page 2-18 of the Training Materials, the IRS has already identified certain relevant expenses: rent and utilities, tools and equipment, training (which should include continuing education for professionals), advertising, payments to business managers and agents (including brokers), wages and salaries of assistants, licensing/certification/professional dues, insurance, postage and delivery, repairs and maintenance, supplies, travel, leasing of equipment, depreciation, and inventory/ cost of goods sold.

b. It is also appropriate that §3511(h) provides the business expenses incurred to "run" the "business side" (e.g., administrative side) of the worker's business (and not just expenses to provide the actual services) are relevant. For example, a physician or a computer programmer may have equipment used exclusively to keep track of invoices and collections; to access software that is instructional in nature (e.g., it reports on new

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[2](...continued)
substandard work and their nonpayment -- or payment only upon condition that they "repair" their faulty work -- demonstrates that they may suffer a risk of loss. This is particularly true for professionals, even if they are paid on an hourly basis. See Training Materials at page 2-26 ("a business's ability to refuse payment for unsatisfactory work continues to be a characteristic of an independent contractor relationship").

[3] Various state statutes defining who is an independent contractor provide for consideration of such warranties or liability. See, e.g., Oregon Revised Statutes Annotated §670.600 (states that the worker "assumes financial responsibility for defective workmanship or service not provided as evidenced by the ownership of performance bonds, warranties, errors and omission insurance or liability insurance....").

[4] The IRS Manual - Administration, Exhibit 5(10)00-4 states that whether the worker's business reputation is affected is relevant to the profit or loss factor.

medical procedures or new network engineering developments); to produce marketing materials; and to access the Internet to contact other physicians and computer programmers about new ideas for resolving tough problems. Although this equipment may not be used on the physician's patients or be connected to the client network that the programmer is working on, it is used to "run" the "business side" of the business and the costs associated with it are properly made relevant under §3511.

iv. Performance of Services for a Particular Amount of Time or to Complete a Specific Result or Task

a. This is another valid factor that the Training Materials at page 2-27 recognize as relevant: "If a business engages a worker with the expectation that the relationship will continue indefinitely, rather than for a specific project or period, this is generally considered evidence of their intent to create an employment relationship." Stated conversely, as §3511 does, a contract to perform services for a specific amount of time or to complete a certain task or project (or phase thereof) is strong evidence of independent contractor status. Thus, for example, it is common for a self-employed attorney to agree to complete a case or to draft a will for a client. It is also common for a self-employed computer programmer or technical writer to agree to provide services under a six-month purchase order up to a certain dollar (and/or hour) limit, or to agree to complete certain milestones in a software development process.

b. The Training Materials at page 2-27 also make it clear that renewals of such arrangements do not convert a discrete relationship into an indefinite one. For example, although some independent contractors may not agree to work until project completion because the amount of time involved may be difficult to predict, they may agree to work on the project for one year. If, at the end of the year, the project is uncompleted and the contractor agrees to extend for another six months, or agrees twice to extend for another 60 days each time (total of 120 days), that arrangement is consistent with this factor. In some cases, where clients or customers have typically issued "purchase orders" for services only on a quarterly or semi-annually basis, to cover that 3 or 6 month period, that arrangement would also meet this factor.

v. Principal Place of Business

Many physicians, computer programmers and analysts, "field" sales representatives and other independent contractors maintain home offices where they perform essential billing, collection, marketing, continuing education, and other requirements. Where appropriate use is made of such home offices, they would qualify as a "principal place of business". However, even though S. 460 defines "principal place of business" in §3511(h)(6), it is important to note that this definition is independent of whether the service provider may take a tax deduction for depreciation of that home office or travel from it to client sites.

vi. Primarily Providing Service at Single Recipient

a. This factor should work well in practice, though care must be taken in its application. Although the other factors under the workplace independence provision of §3511 are relatively simple to apply, unless this factor is interpreted properly it will unfairly prejudice those service providers who are "knowledge professionals" -- e.g., computer programmers, physicians, pharmacists -- who must, of necessity, perform most of their services on the premises of the service recipient. That is where the computer network, or hospital emergency room or pharmacy is located. Even the IRS has stated at page 2-30 in its Training Materials that "In many cases, services can be provided at only one location." Of course, related administrative aspects of providing the services (e.g., billing, collection, marketing, continuing education), which would also be considered under this factor, do occur away from the service recipient's premises. For these reasons, and because §3511 is providing a safe harbor to taxpayers, this factor should be interpreted generously.

b. The statutory language states that a service provider must "not primarily provide the service at a single service recipient's facilities". The most logical meaning of this provision is that in considering the total amount of time spent by the service provider in performing services and associated administrative tasks for all of its clients or customers, a majority of that time (i.e., "primarily") must not have been spent at one service provider's facilities.

c. This provision properly provides service recipients the flexibility they need in using a "timeframe" to measure the performance of their services. For example, a service provider who does not meet this factor in any one calendar year will still be able to have his or her services reviewed for a longer period that includes earlier years. Thus, a service provider would meet this factor if he or she spends 55% of the time in one year working at one location, but over the past 3 years has spent only 20% of time at that location, with no other service recipient location taking more than 20% of time. In other words, proper interpretation of this factor will allow the service provider to demonstrate his or her workplace independence.

vii. Fair Market Value for Rent of Facilities

This is a relevant factor.

viii. Primarily Using Non-Service Provider Equipment

See "vi" above with regard to issues on how to interpret the word "primarily".

IV. IRS CONSIDERATION OF EVIDENCE OF "CONTROL"

Section 4(b) of S. 460 states that the IRS may not consider "compliance with statutory or regulatory standards" as "evidence of control". We support this provision, but urge that it be changed to read as follows:

> For purposes of determining whether an individual is an employee under the Internal Revenue Code of 1986 (26 U.S.C. 1 et seq.), compliance with statutory, ~~or~~ regulatory, industry or professional standards shall not be treated as evidence of the right to control.

First, the statutory language should refer to "evidence of the right to control". The IRS has repeatedly emphasized the common law test is a "right to control" test"; actual control need not exist for the worker to be deemed an employee.

Second, in many cases the agreement with an independent contractor calls upon him or her to perform services that meet "industry or professional" standards, which may be established by non-governmental authorities. The fact the contractor must meet standards that are not set by the service recipient, but are set by unrelated entities, should not be used as evidence of a right to control. Such standards are no different than those imposed by statute or regulation.

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In conclusion, NACCB strongly supports the goals of S. 460, particularly as to its independent contractor provisions. The few modifications to statutory language suggested above are, however, essential in our view to meeting those goals.

FOR RELEASE UPON DELIVERY
Expected at 2:00 p.m. EDT
June 5, 1997

STATEMENT OF
DONALD C. LUBICK
ACTING ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT
COMMITTEE ON FINANCE
UNITED STATES SENATE

Mr. Chairman and Members of the Subcommittee:

I am pleased to present the views of the Department of the Treasury on issues in S. 460 and S. 570 relating to the deductibility of health insurance premiums for the self-employed, the deduction of home office expenses, worker classification, and the Electronic Federal Tax Payment System (EFTPS), with a focus on their impact on small businesses.

DEDUCTION FOR HEALTH INSURANCE COSTS OF SELF-EMPLOYED INDIVIDUALS

Under current law, contributions by employers to accident and health insurance for employees and their families are deductible and are excluded from employees' income. Self-employed individuals generally are entitled to a deduction in computing adjusted gross income for a percentage of the health insurance premiums paid for themselves and their spouse and dependents.[1] With the Administration's support, the Health Insurance Portability and Accountability Act of 1996 (HIPAA) increased this percentage from 30 percent in 1996 to 40 percent in 1997, and the percentage is scheduled to increase in stages to 80 percent in 2006. The Administration has strongly supported proposals to facilitate health insurance coverage for all Americans, including the self-employed.

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[1]The deduction is not available for any month in which the self-employed individual is eligible for employer-subsidized health coverage of an employer of either the self-employed individual or his or her spouse.

The proposal in Section 2 of S. 460 is ostensibly aimed at providing parity between the tax treatment of health insurance costs for employees and for self-employed individuals. However, it is typical for employers to pay for only a portion of their employees' (or retirees') health care costs. In many situations, the remainder of the cost is paid by employees and former employees in the form of after-tax contributions.[2] Thus, the increase to an 80 percent deduction that the Administration supported in HIPAA will come closer to providing rough parity between employees over their careers and self-employed individuals than a 100 percent deduction for self-employed individuals. We believe that HIPAA addresses this issue in an appropriate manner.

DEDUCTIBILITY OF HOME OFFICE EXPENSES

With respect to the home office deduction, we are supportive of the general approach taken in S. 460. The proposed reforms will help the tax law keep pace with changes that have occurred in the workplace. We believe, however, that certain technical modifications are necessary (1) to ensure that de minimis management activities would not qualify taxpayers for the home office deduction, and (2) to prevent the bill from affecting the nondeductibility of commuting expenses.

Under current law, a home office deduction is generally allowed with respect to the use of a taxpayer's residence only in limited circumstances, including where a portion of the home is exclusively used on a regular basis as the taxpayer's "principal place of business." In Commissioner v. Soliman, the Supreme Court disallowed a home office deduction to an anesthesiologist who practiced at several hospitals, but performed his administrative activities in a home office because he was not provided office space by the hospitals. The Court held that the home office was not his principal place of business, because his primary services were performed at the hospitals.

In response to the Soliman case, several bills (including S. 460) have been introduced that would allow a home office deduction to taxpayers who manage their business affairs from their home. For example, S. 460 would treat a home office as a "principal place of business" if (i) the office is exclusively used by the taxpayer to conduct "essential" administrative or management activities on a "regular and systematic" basis, and (ii) the taxpayer has no other location to conduct these essential administrative or management activities. Thus, under the bill, a home office deduction would be allowed under circumstances where the taxpayer's home is not in fact the taxpayer's principal place of business.

While we generally agree with the bill's approach to the home office deduction, we believe that certain changes should be made. In particular, the current rules were enacted by Congress in 1976 to reduce the substantial amount of litigation over the circumstances under which a taxpayer who worked in his or her home could deduct as a business expense a portion of the costs associated with maintaining the home. We should avoid turning back the clock and creating a level of ambiguity

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[2]For example, the cost of COBRA continuation coverage or other coverage for former employees is payable on an after-tax basis by the former employee or his or her dependent, and federal employees pay a portion of their health insurance costs on an after-tax basis.

that would result in more disputes between taxpayers and the IRS. To address this concern, we believe that the services being performed in the home office must be both "substantial and essential." This would avoid allowing a home office deduction where only a de minimis amount of administrative or management activities are conducted.

We are also concerned that the bill would affect more than home office deductions. Because the bill is drafted in a manner that changes what qualifies as a "principal place of business," it would appear also to permit deductions for currently nondeductible commuting expenses. We believe the effects of the proposal should be limited to allowing home office expenses and thus certain drafting changes should be made to the bill.

In summary, we generally support the home office provisions in S. 460 and would be pleased to work with Congress to address the concerns we have raised.

WORKER CLASSIFICATION

We are opposed to the independent contractor provisions in S. 460, primarily because of our concern that the provisions could result in a loss of important worker protections due to widespread and disruptive shifting of employees to independent contractor status.

Background

The classification of workers as employees or independent contractors is a significant and complex issue. Whether workers are classified as employees or as independent contractors is significant for both Federal income tax purposes and Federal employment tax (i.e., Social Security, Medicare, Federal unemployment insurance and withholding) purposes. Legislative changes in the standard for determining whether a worker is an employee or an independent contractor also affect fundamental issues under the existing legal system such as protection of workers' safety, health and pensions.

Income, Social Security and Medicare taxes on employees are collected mainly by employers through the withholding system, whereas the same taxes on independent contractors are collected mainly through self-assessment under the estimated tax system. Independent contractors can offset income by deductions for business expenses that generally are not as readily available to employees (except to the extent that the employee itemizes deductions, and business expenses and other miscellaneous itemized deductions exceed 2 percent of adjusted gross income). In contrast, certain fringe benefits provided by a business to employees are eligible for greater tax preferences than are available to independent contractors. While independent contractors can adopt tax-qualified self-employed retirement plans that can be similar to employer-sponsored plans for employees, other benefits are only available or more cheaply available through an employer (such as group health insurance, workers' compensation insurance, and unemployment insurance).

The classification of workers as employees or independent contractors also is significant under

a variety of Federal and State labor and worker protection laws that cover only employees, such as unemployment insurance, workers' compensation, wage and hour requirements, and family and medical leave requirements. While different definitions may apply to worker classification under different laws, because of the distinctly different purposes they serve and the defining case law, the interpretations under one law may influence, legally or practically, the interpretations under other laws. For these reasons, it is important that any legislation altering the status of workers be carefully considered to determine its potential impact on worker protections.

For purposes of the Internal Revenue Code, most workers are classified as employees or independent contractors based on the traditional common-law test for determining the employer-employee relationship.[3] This test focuses on whether the employer has the right to control not only the result of the worker's services but also the means by which the worker accomplishes that result.

The common-law control test by its nature depends on the specific facts and circumstances of each situation. In an effort to administer this facts and circumstances standard better, the Internal Revenue Service (IRS) derived from the case law a variety of factors that courts considered, with more or less weight being accorded to particular factors depending on the context. In most cases, the classification of a worker under the common-law standard is clear. However, because the control test is inherently a factual determination, there are cases in which the correct status of a worker is less obvious.[4] The uncertainty in these cases has been perpetuated by the long-standing statutory moratorium on the issuance of public guidance through regulations or revenue rulings regarding the proper classification of workers for employment tax purposes.

Current tax law does not consistently favor status as either an employee or an independent contractor.[5] However, in particular circumstances, one or the other of the classifications may be

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[3]The Internal Revenue Code (Code) does contain special rules for classifying certain categories of workers. Briefly, these include mandatory independent contractor classification of certain licensed real estate agents, direct sellers, and sitting-service placement agents (sections 3506 and 3508 of the Code); and mandatory employee classification of corporate officers and certain agent-or commission-drivers, life insurance salesmen, home workers, and traveling salesmen (section 3121(d) of the Code).

[4]Cases in which there is intentional misclassification of an employee as an independent contractor should be distinguished from the classification issue generally. In these cases, there is no real question as to whether the workers are employees or independent contractors. Rather, the parties involved may use misclassification as a guise to avoid the costs of Federal and State mandates designed to protect employees or as a method to avoid full reporting of income and to evade taxes.

[5]Prior to 1984, compensation earned by independent contractors was subject to lower rates for Social Security and Medicare taxes than wage income. This disparity was believed to create an incentive for misclassification. The differences were actually less significant than they

advantageous to a service provider, the service recipient, or both. A company's costs may, for example, be lower if its workers are classified as independent contractors rather than employees to the extent the company can pay independent contractors less than the sum of the cash compensation, the costs of the company's portion of Social Security and Medicare taxes, unemployment insurance, workers' compensation, other fringe benefits that the company incurs for employees, and the overhead costs of withholding and recordkeeping. In effect that would require shifting such burdens to the workers without correspondingly adjusting the worker's compensation.

In addition, the income and employment tax provisions of the Code may favor classification as an independent contractor where a worker has significant unreimbursed business expenses. This is primarily because independent contractors face significantly fewer restrictions on their ability to deduct trade or business expenses than employees, as noted earlier.[6] Conversely, employee status may be advantageous for workers with few business expenses who benefit from the tax advantages accorded to fringe benefits, especially those that cost less, or are only obtainable, through an employer, such as employer-provided group health insurance, workers' compensation insurance, or unemployment insurance.

Workers who are classified as independent contractors may also have greater opportunities than employees to avoid full compliance with the tax laws. Independent contractors may find it easier to omit some of their income on their tax returns without detection, although underreporting of income becomes more difficult when an independent contractor's gross income is reported to the IRS on information returns. Moreover, even independent contractors who report 100 percent of income have greater opportunities to overstate deductible business expenses. (In addition, independent contractors can claim their deductible business expenses in full because they are not subject to the requirements that they itemize deductions and that their business expenses and other miscellaneous itemized deductions exceed 2 percent of adjusted gross income.) Clearly, some taxpayers have made use of these opportunities, resulting in noncompliance.

Legislative History

Since the late 1970s, Congress and the Department of the Treasury have considered numerous proposals aimed at resolving issues associated with the classification of workers as employees or independent contractors. Recent proposals have focused primarily on reducing uncertainty,

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appeared, however. Although tax rates were lower for self-employment income than for wages, an independent contractor could not deduct self-employment taxes while an employer could deduct its portion of Social Security and Medicare taxes in computing its taxable income for income tax purposes.

[6]Also, the estimated tax system used to collect income, Social Security, and Medicare taxes from independent contractors largely avoids the overwithholding that can result when an employee incurs large business expenses, has net income that fluctuates during the year, or is employed for only part of a year.

simplifying the rules, and reducing the potential penalties for misclassification. In addition, there have been proposals that include attempts to change Section 530 of the Revenue Act of 1978, which includes a moratorium on issuance of administrative guidance. This moratorium has increased uncertainty, particularly given the changes in the American workplace and development of new service relationships that are inherent in a dynamic economy.

Section 530. In response to a number of large retroactive employment tax assessments in the 1970s, Congress provided certain employers with general statutory relief from IRS reclassification of workers from independent contractors to employees. Section 530 of the Revenue Act of 1978 prohibits the IRS from correcting erroneous classifications of workers as independent contractors for employment tax (but not for income tax) purposes, including prospective corrections, as long as the employer has a reasonable basis for its treatment of the workers as independent contractors. A reasonable basis includes reliance on (i) judicial precedent, published rulings, letter rulings or technical advice memoranda; (ii) a past IRS audit (although prior to changes effective after 1996, not necessarily an employment tax audit) in which there was no assessment attributable to the employment tax treatment of the worker or of workers holding substantially similar positions; (iii) a long-standing recognized practice of a significant segment of the industry in which the worker was engaged; or (iv) any other reasonable basis for the employer's treatment of the worker.

The relief provided by section 530 is not available unless the employer consistently treats the worker, and any other worker holding a substantially similar position, as an independent contractor (sometimes referred to as the "substantive consistency" test) and complies with the statutory requirements for payments to independent contractors. For example, section 530 relief is not available if the employer has failed to comply with the information reporting requirements associated with its treatment of the worker as an independent contractor.

Section 530 applies solely for purposes of the employment tax provisions of the Code. It has no legal effect on an employer's treatment of a worker as an employee for income tax purposes. Further, it does not affect the worker's own tax treatment for any purpose. Consequently, section 530 can result in the receipt by the Social Security system of less than the appropriate amount of employment taxes for some workers. This is because these workers are simultaneously treated as employees for their own tax purposes, and thus are subject only to the employee share of Social Security and Medicare taxes, and are treated as independent contractors by their employers, which pay no employment taxes with respect to these workers. As a result, an amount equal to the employer portion of Social Security and Medicare taxes is not paid. Section 530 also has no impact on determinations of employment status for other purposes, such as eligibility for pension and health benefits and workers' compensation and unemployment insurance.

Section 530 was enacted as a one-year "stopgap" measure until Congress could devise a less contentious standard for classifying workers. It was extended several times and finally extended indefinitely in 1982.

Section 3509. In the Tax Equity and Fiscal Responsibility Act of 1982, Congress added

section 3509 to the Code in order to mitigate employers' liabilities for retroactive employment tax assessments where section 530 relief was not available. Section 3509 generally limits an employer's liability for failure to withhold income, Social Security, and Medicare taxes on payments made to an employee whom it has misclassified as an independent contractor.

Under section 3509, an employer is liable for 1.5 percent of the wages paid to the employee, in lieu of the income taxes that were not withheld, plus 20 percent of the employee's portion of the Social Security and Medicare taxes on those wages. If the employer has not complied with the information reporting requirements associated with the treatment of the worker as an independent contractor, however, these percentages are doubled to 3.0 and 40 percent, respectively. In addition, the employer's liability under section 3509 cannot be reduced by any self-employment or income taxes paid by the misclassified worker. Section 3509 also does not relieve the employer of its liability for 100 percent of the employer portion of Social Security and Medicare taxes. The relief provided by section 3509 is not available if the employer has intentionally disregarded the withholding requirements with respect to the employee.

The rules of section 3509 were developed in an attempt to place an employer and the Federal Government in approximately the same financial position, on average, in which they would have been if the amount of taxes actually paid by the misclassified employees had been determined and used to abate the employer's liabilities, without the need actually to determine those amounts. Thus, section 3509 has no effect on an employer's own liability for Federal or State unemployment insurance taxes or the employer portion of Social Security or Medicare taxes. Also, in return for limiting the employer's liability for failure to withhold employee taxes, section 3509 prohibits the employer from reducing its own liability by recovering any tax determined under the section from the employee, and, as discussed above, gives it no credit for any taxes ultimately paid by the employee.[7]

Section 1706. In the mid-1980s, some employers in the technical services industry complained that the relief granted under section 530 created an unfair advantage for certain of their competitors. They noted that section 530 affects different taxpayers differently, depending on whether they satisfy the statutory conditions for relief. In particular, employers that have consistently misclassified their employees as independent contractors are entitled to relief under section 530, while other employers in the same industry (that, for example, have sometimes taken more conservative positions on classification issues) are not entitled to relief because they cannot satisfy the consistency requirements of section 530. The crux of the employers' complaints was that certain taxpayers in the industry achieved unfair cost savings by having consistently treated and continuing to treat the service providers as independent contractors.

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[7]Under section 3509, as under prior law, the full amount of the misclassified worker's gross compensation is subject to tax, even though, if the worker had always been treated as an employee, the employer would presumably have negotiated to reduce wages to reflect the employer's liability for its portion of Social Security and Medicare taxes, unemployment insurance, and any fringe benefits provided by the employer at its option.

As a result of these complaints, in section 1706 of the Tax Reform Act of 1986, Congress excluded from the ambit of section 530 taxpayers that broker the services of engineers, designers, drafters, computer programmers, systems analysts and "other similarly skilled workers engaged in a similar line of work," effective for payments made after December 31, 1986. Section 1706 applies exclusively to multi-party situations, i.e., those involving (i) technical services workers, (ii) a business that uses the workers, and (iii) a firm that supplies the workers to the business. The effect of section 1706 is to deny section 530 relief solely to the firm that supplies the workers. Section 1706 did not affect the application of section 3509 to such cases.

Small Business Job Protection Act of 1996 - Changes to Section 530. As part of the Small Business Job Protection Act of 1996 (the Small Business Act), Congress clarified and modified the application of section 530, enacting provisions that codified certain IRS positions and practices and changed others. Section 1122 of the Small Business Act provided that: (1) the IRS must provide notice of the availability of section 530 relief at the beginning of a worker classification audit (the IRS issued Publication 1976 for use in satisfying this requirement in October 1996, IR-96-44); (2) beginning for audits commenced after December 31, 1996, the prior audit safe harbor applies only if the audit included an examination for employment tax purposes regarding worker classification; (3) a "significant segment" of the taxpayer's industry does not require the practice by more than 25 percent of the industry; (4) an industry practice need not have continued for more than 10 years in order for the practice to be considered long-standing; (5) a practice will not fail to be treated as long-standing merely because the practice began after 1978; (6) a worker does not have to be otherwise classified as an employee in order for section 530 to apply; (7) the fact that a taxpayer changes the treatment of workers from independent contractors to employees for employment tax purposes does not affect the applicability of section 530 for prior periods (adopting an IRS position stated in Rev. Proc. 85-18); and (8) the determination as to whether an individual holds a position substantially similar to a position held by another individual includes consideration of the relationship between the taxpayer and such individuals.

In addition, the Small Business Act modified the burden of proof in section 530 cases by providing that if a taxpayer establishes a prima facie case that it was reasonable not to treat a worker as an employee, the burden of proof shifts to the IRS with respect to such treatment. In order for the shift in burden of proof to occur, the taxpayer must fully cooperate with reasonable requests by the IRS for information relevant to the taxpayer's treatment of the worker. The shift in burden of proof does not apply for purposes of determining whether the taxpayer had any other reasonable basis for treating the worker as an independent contractor.

Recent Administrative Initiatives

Last year, the IRS announced several administrative initiatives to improve the current situation in the worker classification area. These initiatives respond to concerns expressed by taxpayers, particularly small businesses.

Training and Training Material for IRS Examiners. The IRS developed new training materials

for IRS examiners. The training materials are intended to ensure that examiners make legally correct determinations about whether workers are properly classified as employees or independent contractors under the common-law standard. The materials emphasize to examiners that they must approach the issue of worker classification in a fair and impartial manner, and remind examiners that either worker classification -- independent contractor or employee -- can be a valid and appropriate business choice. These new training materials also demonstrate how the application of the common-law standard has evolved to reflect the changing nature of business relationships. Recognizing the importance of the worker classification issue, and the need to make the training material as clear and as useful as possible, the Service took the unusual step of requesting public comments on the draft of the training documents. Between the original proposed draft and the final version, over 60 sets of comments were received. These comments resulted in significant revisions. The usefulness of the training materials, not only to examiners but also to the public, is illustrated by the fact that the Web site containing these materials has received thousands of "hits" since the materials were finalized in October of 1996.

The IRS training document also addresses in detail the application of section 530 of the Revenue Act of 1978. It makes clear to examiners that section 530 should be actively considered during an examination and that section 530 should be addressed before exploring worker status. In fact, the materials state that examiners are required to explore the applicability of section 530 even if not raised by the taxpayer, in order to correctly determine the taxpayer's tax liability.

During 1996, the IRS undertook intensive retraining of its examiners in the area of worker classification, holding 34 separate classes and investing more than 22,000 person hours in the endeavor. Over 750 specialists in employment tax and related areas received training in these two-day courses. A follow-up video conference also was conducted. In addition, in November, the IRS conducted a three-hour video program for general revenue agents on the worker classification issue. The amount of time devoted to training and the detail in materials provided to employment tax specialists reflects an IRS commitment to ensure that these specialists correctly and fairly classify workers and are informed of the availability of Section 530 and the special rules applicable to classes of statutory employees, statutory non-employees and other special classes of workers, as well as the appropriate application -- in a wide variety of industries and business practices -- of the common-law standard for determining whether a worker is an employee.

This does not mean that businesses need to analyze and undergo this type of training to determine whether their workers are employees or independent contractors. Rather it shows a commitment to provide examiners with the background, training, and experience needed to understand the law, with all of its exceptions and special procedures, and to understand the variety of business practices to which the law is applied. A business owner needs to focus only on application of the law to its business, not on understanding the entire spectrum of business relationships and statutory categories presented to the employment tax specialist. Moreover, the IRS and Treasury have provided summary materials for use by small business. For example, a one-page description of Section 530 is provided to businesses, who can use this to gain a practical understanding of section 530 requirements, instead of reading the detailed background, legal support,

and exercises provided to educate employment tax specialists in this area. The training materials (including the opportunity provided for taxpayers and all other interested parties to comment on a draft of the materials) and the IRS training program based on the new materials are intended to promote both consistency and additional clarity concerning IRS application of the common-law classification standard.

Classification Settlement Program. Another significant initiative taken by the IRS is a classification settlement program that allows businesses to resolve worker classification cases earlier in the examination process, reduce taxpayer costs, and ensure the proper application of the provisions of section 530. The classification settlement program is based on the following key principles: Reclassification of workers who have correctly been treated as independent contractors must be avoided. Worker classification issues should be resolved quickly, and as early in the administrative process as possible. Worker classification issues should be resolved uniformly throughout the country. Resolution of worker classification issues should take into account a taxpayer's past compliance with section 530, as well as the common-law standard. The IRS's compliance programs should encourage correct classification and correct reporting of payments to workers.

Under the classification settlement program, businesses that have misclassified their workers as independent contractors, have filed Form 1099 information returns, but have failed to meet the other requirements for relief under section 530, can settle the matter with IRS examiners by reclassifying their workers prospectively and paying only limited tax assessments.[8] This eliminates the risk that tax assessments could be applied for multiple years.

Participation by businesses in the settlement program is entirely voluntary, and businesses declining to participate retain all rights that exist under the IRS's current procedures. The program is intended to approximate the aggregate results that would be obtained under current law if businesses accepting the offers had instead exercised their right to administrative or judicial appeal. This program appears to have successfully reduced the burdens involved in resolving worker classification settlements, as the rate of acceptance of settlement offers during the quarter ending March 31, 1997 was 81.86 percent. The program is in the second year of a test period that runs through March 6, 1998. At the end of the test period, the program will be evaluated to determine whether it should be continued on a more permanent basis.

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[8]Under the program, if the business meets the section 530 reporting consistency requirement but the business either clearly does not meet the section 530 substantive consistency requirement or clearly cannot meet the section 530 reasonable basis test, the assessment is limited to one year of employment tax liability (as limited by Code section 3509). If the reporting consistency requirement is met and the business has a colorable argument that it meets the substantive consistency requirement and the reasonable basis test, the assessment is limited to 25 percent of one year's income tax withholding, Social Security and Medicare tax liability for the year (as limited by Code section 3509), plus the Federal unemployment insurance tax liability for the year.

Early Referral to Appeals. In addition, in March 1996, the IRS announced procedures for allowing businesses, at their option, to resolve employment tax issues more quickly by appealing these issues to the IRS Appeals function even while the development of other issues raised during an examination is still in progress. In May this appeals procedure was extended for a second year (Ann. 97-52, 1997-21 IRB 22).

These are significant administrative initiatives; they respond to concerns about worker classification expressed by small businesses and other taxpayers and they materially improve the climate for decisions on worker classification. These initiatives should be allowed to go forward without disruption. The Administration has also proposed legislative changes, described below, to lessen the stakes involved in misclassification by eliminating past employment tax liability in certain cases where taxpayers have a reasonable argument that they meet the requirements of Section 530 and by providing easier access to an independent determination by the Tax Court. These proposals also will materially improve the current situation for taxpayers and the IRS.

Administration's Legislative Proposals Relating to Section 530 and Tax Court Jurisdiction

Perhaps the greatest problem for business in the worker classification area is not the possibility that an employer treating its employees as independent contractors will be required to reclassify them as employees for the future, but the risk of substantial employment tax liability and penalties for previous years, even if the employer had a reasonable argument for its classification decision or the belief that it was entitled to section 530 protection.

To address this problem, last year we proposed that Congress permit businesses that misclassify workers as independent contractors and fail to meet the requirements of section 530 to reclassify their workers prospectively with no employment tax liability for prior years, provided that they satisfy certain conditions.[9] To qualify for this relief, the business would have to meet the section 530 reporting consistency condition and have a reasonable argument that it meets the section 530 substantive consistency and reasonable basis requirements. This proposal is intended to provide relief to taxpayers who fall just short of meeting those section 530 requirements. Of course, as under current law, if workers are correctly classified as independent contractors, or if the taxpayer meets section 530, then the business would not be required to reclassify the workers as employees. This proposal was included in the Administration's Tax Simplification Proposals, presented by Secretary Rubin on April 14 of this year.

Further, under the proposal, a taxpayer that believes the IRS has erred in its case would be given an expanded opportunity to obtain an independent review of the IRS decision. United States Tax Court jurisdiction would be enlarged to cover worker classification determinations for employment tax purposes. Of course, the Tax Court would have the authority described above to determine whether misclassified workers should be reclassified on a prospective basis only.

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[9]This suggested legislative change builds on and codifies the relief provided under the IRS's Classification Settlement Program, described above.

Access to the Tax Court would permit disputes to be resolved more quickly and at lower cost than in Federal District Court. Simplified procedures that might be adapted for small business cases would be available in some circumstances. Tax Court judges have considerable experience in resolving tax cases involving similar issues, and many small cases are currently resolved without requiring the business to retain counsel. We believe that the expanded Tax Court jurisdiction would provide a business with increased access to an independent judicial resolution if the business believed its determination, rather than the IRS position, was correct.

These legislative proposals -- to eliminate past employment tax liability in certain cases where taxpayers fall just short of meeting section 530, and to increase a small business's access to an independent, third-party determination -- should further help taxpayers and the IRS to resolve worker classification problems in a fair and cost-effective manner. We believe that, in combination with the administrative steps described earlier, they would provide significant relief to small businesses from the most serious problems relating to worker classification.

In addition, we believe that it may be possible to improve understanding of the common-law classification standard through revenue rulings or other guidance. The recently revised IRS training materials take an important step in this direction by emphasizing that the true common-law test for purposes of the Internal Revenue Code is the right to "direct and control" and that the "20 factors" that are often referred to in connection with this test are relevant only insofar as they provide evidence bearing on whether the test is satisfied.

At present, section 530 precludes the issuance of revenue rulings or guidance. We think that it would be helpful to taxpayers, and ensure uniform national treatment, if relief is provided from this prohibition. This would permit issuance of guidance that could help taxpayers focus on a few factors that are most relevant to their particular situations. We would be pleased to explore with Congress the possibility of amending section 530 at least to the extent necessary to permit publication of such guidance. Providing such guidance could reduce uncertainty, and move toward greater simplification, without shifting the historic balance between classification of workers as employees or independent contractors in a way that threatens worker protections that are based on classification.

The guidance could build on one or more key factors, but it needs to allow flexibility for interpretation consistent with the differing and evolving factual settings in which the standard would be applied. For example, administrative guidance could build on the concept that a key factor in determining whether it is appropriate to classify a worker as an independent contractor is whether the worker has a real possibility of profit and bears a genuine risk of economic loss.

We would intend that such guidance would first be issued in proposed form in order to provide an opportunity for public and Congressional comment and review as to the standards developed. While such guidance could not prescribe a purely mechanical test that would apply in all circumstances, it could simplify the process and reduce uncertainty, without resulting in the widespread and possibly unsettling shifting of current worker classifications that would follow inevitably from some of the legislative proposals that have been introduced in the past.

S. 460

You have asked for our views on the independent contractor provisions of S. 460. We are opposed to these provisions in S. 460 for the reasons stated below. In general, we are concerned that the safe harbor proposed under S. 460 could result in widespread and disruptive shifting of employees to independent contractor status, causing loss of important worker protections, including employer-provided pension and health coverage. We also have grave doubts about other aspects of the proposal, especially whether a purely mechanical standard can ever be devised to deal appropriately with the wide variety of worker relationships and occupations that characterize the complex and dynamic American workplace.

In addition, we believe that now is not the time to overlay yet another piecemeal change to the substantive legislation governing worker classification. Just last year, several changes were made to section 530. Also, new training of employment tax examiners, new training materials, and a process permitting early referral to appeals appear to be successfully reducing burdens in this area. Our procedural legislative proposals relating to section 530 and Tax Court jurisdiction would appropriately lower the stakes concerning worker classification determinations, without risking disruptive shifting of employees to independent contractor status. Moreover, permitting us to issue administrative guidance could also help simplify the process and reduce uncertainty.

Evaluating legislative proposals. Worker classification is a difficult and long-standing issue that has far-reaching implications. Fundamental legal and business issues, including issues beyond the collection of income and employment taxes, may be affected by legislative changes altering the standard for determining whether a worker is an employee or an independent contractor.

Under current law, worker classification in the Internal Revenue Code directly affects income, Social Security and Medicare taxes. However, it also affects other issues such as the availability of employer-provided pensions and group health insurance. For example, under current law, tax-qualified retirement plans sponsored by a business are permitted to cover only the business's employees. Legislation that resulted in the conversion of employees into independent contractors for Federal tax purposes would reduce the number of people eligible to save for retirement in tax-qualified employer-provided pension, 401(k), and other retirement plans. These reclassified workers would be free to establish their own tax-favored retirement plans. However, employer-sponsored plans have proven to be a particularly effective means of promoting retirement savings for workers, especially for middle- and lower-income workers who might be less likely to save outside the workplace, in part because of automatic employer contributions, employee savings through payroll deduction, employer matching contributions, employer education programs, and economies of scale. Maintaining and further increasing worker savings are important policy goals for both the Administration and the Congress. In addition, converting employees into independent contractors could result in fewer people receiving the benefits of lower-cost group health coverage through their employers.

In evaluating any proposed legislation, it is also important to consider whether a new statutory

standard under Federal tax law would lead, legally or practically, to loss of employee retirement or health benefits or coverage under other Federal and State laws, such as the laws that provide unemployment insurance, workers' compensation, minimum wage and maximum hour protections, workplace health and safety standards, and family and medical leave protections to workers who are classified as employees. This might occur, for example, if businesses that reclassified workers as independent contractors under a new Federal employment tax standard also incorrectly treated those workers as independent contractors for purposes of other laws that are based on employee status. Broader reclassification under these other statutory provisions could also result from subsequent efforts, in the interest of simplification, to eliminate inconsistencies between the classification standards under those State and Federal non-tax laws and a new Federal employment tax classification standard by conforming them to the new standard. Also, the determination under the tax laws can be decisive in practice, because of the inability of states to audit once a determination is made for tax purposes. These potentially sweeping implications should be explored carefully and thoroughly before enactment of any new statutory classification standard for Federal tax purposes.

As a general matter, experience suggests that it is difficult to legislate one simple, purely mechanical definition or safe harbor that applies appropriately to the many varied existing worker relationships and occupations. All verbal formulations are subject to problems of manipulability or may be unclear when applied to these differing relationships and occupations. Moreover, specific statutory rules, by contrast to regulations and rulings, are not easily adapted to the changes that are constantly taking place in an area as complex and dynamic as the American work place. There will always be people who operate with new forms of employment not envisioned before. Further, different businesses will choose to structure their relationships with workers in different ways.

Evaluating S. 460. We have very serious concerns about the safe harbor and burden of proof provisions of this bill. First, we are concerned that the new safe harbor could, and would over time, result in widespread and unsettling shifting of employees to independent contractor status, causing tax and other legal disruptions and loss of important worker protections, including employer provided pension and health coverage. This concern is heightened because the bill would apply to worker classification for income tax as well as employment tax purposes.

Second, we are concerned that the addition of this new statutory safe harbor will increase rather than decrease burdens and complexity for businesses and the IRS. Businesses that have uncertainties regarding worker status would potentially need to perform as many as three analyses: under the new safe harbor, under Section 530, and under the existing common law rules. Adding new layers and standards can result in greater administrative burdens on small business administration and on the system generally.

In addition, we are concerned that further expansion of the kinds of cases in which the burden of proof is shifted to the IRS could undermine the voluntary compliance system and result in the loss of worker benefits and protections based on inadequate evidence.

Any changes in the worker classification area must be made with care to ensure that they do

not result in wholesale reclassification of great numbers of workers and concomitant loss of important worker benefits and protections.

We share the sponsors' goal of providing a mechanism for businesses that reasonably believed their workers were independent contractors, and filed Form 1099s for these workers, to classify their workers without imposition of employment tax liability for past years, but we have serious concerns about elements of the prospective reclassification proposal contained in S. 460, particularly its extension beyond employment taxes to income taxes.

Risk of shifting worker status. In an effort to achieve mechanical simplicity in this area, S. 460 would prescribe "safe harbor" criteria for classification as an independent contractor that could result in large-scale shifting of workers from employee to independent contractor status.

The proposed safe harbor includes several requirements that must be met for a service provider to be treated as an independent contractor. These elements of the safe harbor generally are subject to risk of manipulation or can easily be satisfied by many workers who would historically be treated as employees under the common law test and under common sense views of appropriate worker classification. The requirement that an employee have unreimbursed expenses of at least 2 percent of AGI suffers from several inherent problems. Many employees may have unreimbursed expenses of at least this amount; the appropriate percentage may depend on the circumstances involved; it is unclear why results should differ based on non-work related adjustments to income (such as alimony, IRA contributions, or earnings of a spouse); it is unclear how expenses would be allocated among contracts or work projects; it is unclear how the standard would apply when the 2 percent threshold is determined after the end of a calendar year, the standard is subject to manipulation by service recipients who can easily require employees to pay expenses and adjust their compensation to reflect the additional costs incurred; and it is unclear why this standard is necessary, given that unreimbursed expenses would be taken into account under the profit or loss requirement discussed below. The requirement that the service provider agree to perform services for a particular amount of time, or complete a specific result or task, can easily be satisfied by providing a worker with a contract for a specified period, such as month-to-month or pay-period-to pay-period.

The alternative requirements relating to principal place of business, provision of services, and use of facilities are also easily satisfied or manipulated. The service provider can use his or her home as a principal place of business, or can be charged fair market rent for use of the service recipient's facilities, or can use equipment not supplied by the service recipient but have his or her compensation increased to reflect these costs. The requirement that the worker not primarily provide the service at a single service recipient's facilities will be readily satisfied by many repair, maintenance, and delivery workers who may be employees, or by employees in other occupations that, by their nature, involve the performance of services at more than one location. The requirement that the worker and service recipient enter into a written agreement concerning worker classification also would fail to prevent inappropriate recharacterization of employee status, particularly where workers have less bargaining power than the business.

The legislation also includes a verbally simple requirement that the service provider have "the ability to realize a profit or loss". We agree that the potentiality of suffering a genuine economic loss would be, in cases where it occurs, a, perhaps the, key element in determining the proper classification of a worker. In applying this standard, the ability to realize a loss must be a requisite component of the test. For this potential loss standard to have meaning and not be a sham, the risk of loss must be real. Moreover, the potential to realize a profit must also have genuine economic substance; certainly, contingent compensation is not itself an indicator of independent contractor status.

As indicated above, we believe that administrative guidance could address how this standard would be applied (if section 530 were amended to permit the issuance of such guidance), and because of the need to allow for flexibility in interpretation consistent with the different factual settings involved, administrative guidance would be the appropriate forum in which to address this standard. We would have serious concerns about use of such an imprecise standard as a statutory safe harbor. We anticipate that to prescribe this standard by statute rather than to permit it to be addressed through administrative guidance (where the subtleties and limitations could be addressed) might encourage employers to treat it as a mechanical standard that could be satisfied in form rather than in substance. Employers might then attempt to manipulate the requirement by recharacterizing worker status without altering the underlying relationship between the worker and the employer.

It is not difficult for an employer to structure an artificial arrangement that would superficially appear to meet a requirement that an individual be able to realize a profit or loss to be considered an independent contractor, yet would lack economic substance. For example, an employer could require the employee to purchase or rent certain tools and supplies used in generating the employer's product, but could protect the employee from loss by directly compensating the employee through a commensurate pay increase. This could permit an employee to appear to "realize a profit or loss" without changing the nature of the employer-employee relationship or the tasks that the employee would undertake. While we would view all these arrangements as insufficient to constitute the ability to realize a profit or loss, we are concerned that absent clearer limitations or guidance, taxpayers would take such positions in practice.

Two examples illustrate the basis for these concerns about the safe harbor in S. 460. Assume that an employer has employees who are janitors and wishes to shift them from the status of employees to independent contractors, even though the business hired and trained them and provided detailed rules and directions on how offices should be cleaned. Assume further that the business attempts to manipulate the profit and loss requirement by stating that it will only pay the worker if the worker completes the work in accordance with industry standards of cleanliness, but the employer has no intention of refusing to pay on this basis. The other requirements of S. 460 may easily be satisfied even if the worker would appear to be an employee of the employer under the common law standards, and a common sense view. For example, the employer could tell its janitors that in the future they would be required to provide their own mops, cleaning fluids, sponges, gloves, garbage bags, and vacuums (and arrange for them to rent the vacuums or larger machinery), when offering to hire them under the new terms, increasing the rate of compensation to reflect these expenses. For

workers with low wages or sufficient adjustments to income (such as alimony), expenses such as these should be sufficient to constitute at least 2 percent of AGI (only $240 for someone with $12,000 AGI attributable to the employment). The janitors could be required to work on a month-to-month basis in order to satisfy the requirement that the worker agree to perform services for a particular amount of time. The janitors would be operating primarily with equipment not supplied by the service recipient and might well work at a variety of sites. The employer could also require all janitors to sign a service agreement indicating that the janitor would not be treated as an employee with respect to janitorial services for Federal income tax purposes. Accordingly, under the safe harbor these janitors could be treated as independent contractors.

Similar arrangements could be made with the secretaries of the employer. The secretaries could be charged fair market rent for use of their office space, or rent their desk, computer and phone (based on rental rates for such equipment), in order to meet the requirements that unreimbursed expenses equal at least 2 percent of AGI, and that the worker pay a fair market rent for use of the service recipient's facilities. Employers might attempt to meet the profit or loss requirement by including in the personnel manual a statement that secretaries are compensated only if their work meets industry standards, even if the employer has no intention of refusing to pay on this basis. The employer could also insist that the secretaries execute a contract stating that the secretary would not be treated as an employee for Federal income tax purposes with respect to provision of secretarial services. The workers in both of these examples would be classified as employees under the common law standard and under a common sense definition of employee, but would be treated as independent contractors under the safe harbor.

S. 460 would also provide an alternative safe harbor for workers to be treated as independent contractors if services are performed pursuant to a written contract that provides the worker will not be treated as an employee for Federal tax purposes, the worker conducts services as a corporation or limited liability company, and the worker does not receive from the service recipient or payor benefits that are provided to employees of the service recipient. We have serious concerns that this provision could also encourage widespread shifting of employees to independent contractor status.

Increasing complexity by adding safe harbor to two other tiers of determinations. S. 460 would impose a one-way safe harbor on top of the current rules. Any employer that did not meet the safe harbor would still need to operate under the existing regime. Having a multiplicity of different tests and standards creates burdens for small businesses. By overlaying a new safe harbor on the existing laws, the bill would require that employers learn and apply three different regimes: the safe harbor rules, Section 530, and the common law standards. Instead of overlaying yet another set of legal standards on top of existing rules, we believe it would be preferable to explore ways to simplify and focus the current legal standards through the issuance of administrative guidance. For these reasons, we question the value of legislating the proposed safe harbor.

Partial shifting of burden of proof. Under current law, in civil tax litigation, the burden of proof generally lies with the taxpayer. In Tax Court, the Commissioner's notice of deficiency is presumed to be correct, and the taxpayer must prove it is incorrect. In the refund context, the

challenged assessment is presumed to be correct, and the taxpayer must prove his or her entitlement to, as well as the amount of, a refund. The Government generally bears the burden of proof in civil tax cases only where it asserts fraud. The Small Business Act modified the burden of proof in section 530 cases by providing that if a taxpayer "establishes a prima facie case that it was reasonable" not to treat a worker as an employee, the burden of proof with respect to the determination under Section 530 shifts to the IRS, if the taxpayer "fully cooperates" with "reasonable requests" for information.

S. 460 expands application of the shifted burden of proof to cases involving income taxes as well as employment taxes, and with respect to the service provider as well as the service recipient. This change would dramatically increase the scope and number of cases in which burden shifting could occur. This expansion could seriously undermine tax enforcement and compliance and could result in the loss of benefits to workers.

Proposals to shift the burden of proof in tax cases have uniformly been condemned by knowledgeable tax practitioners as a drastic change that could cripple the voluntary compliance system. Any shift of the burden of proof, even a partial one, could make it more difficult for the IRS to examine taxpayers adequately and collect the correct amount of tax. It must be remembered that the taxpayer always has control of the facts and can maintain the documentation necessary to substantiate tax consequences. Indeed, this is the rationale for placing the burden of proof on taxpayers in the first place.

S. 460 gives the taxpayer the benefit of the shifted burden if the taxpayer has "fully cooperated" with "reasonable requests" by the IRS. Whether a taxpayer has "fully cooperated," and whether an IRS request is "reasonable," are factual questions that are likely to spawn their own controversies and give rise to anomalous results. For instance, if the taxpayer has failed to maintain supporting data, or if the data are not technically under the taxpayer's "control" (even if the taxpayer has the same or better access to it than the IRS), the taxpayer might nevertheless argue that it has fully cooperated and that the burden of proof shifts to the IRS.

Similarly, the "prima facie case" threshold would result in bifurcating the evidentiary issues into an initial, "prima facie" case portion and an ultimate finding as to the merits of the dispute. Thus the proposal could lead to more, not less, litigation, with the attendant costs and delays for taxpayers.

Prospective reclassification without imposition of employment tax liability for prior years. As discussed in the description of the Administration's legislative proposals relating to section 530, we propose to permit employers to reclassify workers prospectively with no employment tax liability for prior years, provided that the business met the section 530 reporting consistency condition, and had a reasonable argument that it meets the other section 530 requirements. This proposal is intended to provide relief to taxpayers who fall just short of meeting the section 530 substantive consistency and reasonable basis requirements. S. 460 also provides for prospective reclassification without imposition of tax liability for prior years, if the service recipient or payor entered into a written contract with the service provider that the service provider would not be treated as an employee for Federal income tax purposes, and if the service provider demonstrates a reasonable basis for

determining that the service provider is not an employee and that this determination was made in good faith.

We have several concerns with the proposal in S. 460 as drafted. First, the proposal applies not only to past liability for employment taxes, but with respect to all determinations of worker status for income tax purposes. We are concerned that employers thereby could be excused from providing pension and health benefits to employees who would otherwise be covered. Second, our proposal, consistent with Section 530, requires employers to treat all similarly situated workers the same way. S. 460 would grant employers the special relief even if they pick and choose among workers, treating similarly situated workers differently.

Conclusion

Worker classification is a difficult and complex issue that has far-reaching implications. Legislative changes that would result in the reclassification of workers from employee to independent contractor status could affect a variety of protections for these workers. Because of these concerns, we oppose the independent contractor provisions of S. 460. It is important to explore these potential consequences thoroughly before enacting any new statutory classification standard for Federal tax purposes. At the same time, we believe that Congress in the short run should consider proposals to eliminate retroactive employment tax liabilities in certain cases where an employer has a reasonable argument that it meets the requirements of section 530, and to permit taxpayers to resolve disputes with IRS in a simpler and more cost-effective manner.

EFTPS

You have also asked for our views on S. 570, a bill to exempt certain small businesses from the mandatory electronic fund transfer system. As background to this discussion, we would like to bring to your attention some recent developments in this area, of which you may already be aware.

On Monday, the IRS announced that it would not impose penalties through December 31, 1997, on businesses that become subject to the Electronic Federal Tax Payment System (EFTPS) on July 1, 1997, but fail to use EFTPS. These businesses will still be required to make timely deposits, using either paper coupons or EFTPS.

Under current law, businesses that had more than $50,000 of federal payroll tax deposits in 1995 are required to begin making deposits through EFTPS on July 1, 1997.[10] The six-month waiver

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[10]The $50,000 threshold was originally scheduled to go into effect on January 1, 1997. In 1996, however, Congress became concerned that many of the businesses scheduled to begin electronic payments on that date were either not aware of or confused about their obligations. To address this concern, the Small Business Job Protection Act of 1996 provided that this class of taxpayers is not required to begin using EFTPS until July 1, 1997. (The IRS had shared this concern and had announced, before this delay was enacted, that it would not impose penalties on

of penalties announced by the IRS will provide additional time for these businesses to convert to the new electronic payment system. The IRS will use this additional time to continue its outreach efforts to small businesses. Businesses will be encouraged to get acquainted with EFTPS and to make payments under the new system. They can use this period to learn more about making electronic payments and to make the switch to the new system comfortably and confidently. Successful use of the new system will show businesses that they are correctly enrolled and that their payments can be processed without error. Businesses that encounter problems will be able to make deposits by paper coupon, giving them time to get help and make adjustments without facing a penalty.

We want to stress, however, that the IRS and the small business community have already made substantial progress in converting to the new electronic payment system. Over 1.1 million of the approximately 1.2 million businesses that are required to begin using EFTPS on July 1 have already enrolled in the system. Another 400,000 businesses that could have continued to use paper coupons have enrolled in EFTPS voluntarily. Moreover, approximately 300,000 businesses have voluntarily begun making electronic payments through the new system in advance of the July 1 effective date. Since EFTPS became operational, the Treasury Department has received over $100 billion of electronic payments through the new system.

Turning to the current statutory and regulatory provisions, businesses are required to withhold income taxes and FICA taxes from wages paid to their employees. Businesses also are liable for their portion of FICA taxes, excise taxes, and estimated payments of their corporate income tax liability. Under section 6302 of the Code, the Treasury Department has generally required that these taxes be deposited with banks and other financial agents of the United States. Prior to 1994, all of these depository taxes could be remitted through deposits with a bank or other financial agent using a paper coupon.

In 1993, section 6302(h) was added to require the Treasury Department to develop and implement an electronic fund transfer system for the collection of these taxes. The Treasury Department has developed EFTPS in response to this requirement.

Section 6302(h) requires the Treasury Department to collect specified percentages of the depository taxes through electronic fund transfer. This requirement was phased in over a six-year period, beginning with fiscal year 1994. For fiscal year 1997, 58.3 percent of payroll taxes and 60 percent of all other depository taxes are required to be collected through electronic fund transfer. When fully phased in (in fiscal year 1999), 94 percent of all depository taxes are required to be collected by electronic fund transfer. The regulations implementing this requirement provide that taxpayers are required to use EFTPS if their annual payroll tax deposits exceed a specified threshold. The regulatory requirement is also phased in. For calendar years 1995 and 1996, the thresholds were $78 million and $47 million, respectively. For calendar years 1997 and 1998, the threshold is $50,000.

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these businesses before July 1, 1997.)

Under the regulations the threshold is currently scheduled to fall again, to $20,000, in 1999. However, because participation in EFTPS has surpassed expectations, we will reach the target imposed by section 6302(h) for 1999 and subsequent years without the need to further reduce the threshold. Accordingly, I am pleased to announce that we intend to amend the regulations within the next month to make the $50,000 threshold permanent. Thus, businesses below the $50,000 threshold will not be required to use EFTPS in the future.

S. 570

S. 570 would modify the phase-in rules of section 6302(h). Instead of requiring the collection of specified percentages of depository taxes through electronic fund transfer, a business would be required to use electronic fund transfer for a calendar year only if its depository taxes for the second preceding calendar year exceeded a specified threshold. This is essentially the same approach as that of the current regulations, but the thresholds are generally much higher. For calendar year 1997, the threshold is $47 million.[11] The threshold drops to $30 million in 1998, to $20 million in 1999, to $10 million in 2000, and to $5 million in 2001 and subsequent years.

The Treasury Department believes this change is unnecessary. As noted above, the IRS and the small business community have already made substantial progress toward implementation of a $50,000 threshold. As of June 2, all but 86,000 of the 1.2 million businesses above the $50,000 threshold have already enrolled in EFTPS. The waiver of penalties through December 31, 1997, should provide sufficient time to complete the enrollment process. Moreover, we continue to agree with the views expressed by Congress when it enacted section 6302(h). The report accompanying the legislation listed the following advantages of an electronic fund transfer system:

> Use of an electronic fund transfer system for the collection of tax will promote accuracy and efficiency in processing, and consequently, is expected to result in significant cost savings to the Government. Taxpayers will benefit from increased accuracy, reduction in paperwork burden, and availability of a user-friendly tax collection system.[12]

We also note that 300,000 small businesses have effectively endorsed these views by voluntarily making electronic payments through EFTPS. These businesses have realized the advantages of the new system. EFTPS eliminates most of the paperwork in the old paper

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[11]For the period January 1 through June 30, 1997, this threshold may be lower for certain taxpayers than the threshold currently in effect. As a result of the delay provided in the Small Business Job Protection Act of 1996, the regulatory threshold for 1996 remains in effect through June 30, 1997. Although this threshold is also $47 million, only payroll tax deposits count against the threshold. Under S. 570, all depository taxes are taken into account in determining whether the threshold is exceeded.

[12]S. REP. NO. 189, 103d Cong., 1st Sess. 61 (1993).

coupon system. With EFTPS, deposits may be made quickly and conveniently by telephone or personal computer. EFTPS does away with the need to write out a check, fill out a coupon, and walk or drive to the bank to make the deposit.

While we expect substantial voluntary participation in EFTPS to continue even if S. 570 is enacted, the increased thresholds of S. 570 will inevitably result in some revenue loss. We question whether this loss is justified in view of the many other important tax policy objectives that the Administration and Congress are attempting to accomplish in this year's budget legislation.

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The Treasury Department appreciates the opportunity to discuss these issues with the Members of this Subcommittee and we would be pleased to explore these issues further.

Mr. Chairman, this concludes my formal statement. I will be pleased to answer any questions that you or other Members may wish to ask.

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NFIB
National Federation of Independent Business

TESTIMONY OF
RANDY MASON
OWNER AND GENERAL MANAGER
MASON MECHANICAL LABORATORIES, INC.

Before: Subcommittee on Taxation and Internal Revenue Service Oversight

Committee on Finance

U.S. Senate

Date: June 4, 1997

Subject: EFTPS and Government Mandates

Thank you for the opportunity to voice the concerns of myself and many other small business owners across America. My name is Randy Mason. I am part owner and general manager of Mason Mechanical Laboratories, Inc., a small, family owned business in Salem, Virginia. I am here today on behalf of myself and the National Federation of Independent Business (NFIB). NFIB is the nation's largest small business advocacy organization representing 600,000 small business owners in all fifty states. Our membership reflects the general business profile in that we have the same representation of retail, service, manufacturing and construction businesses that make up the nation's small business community. The typical NFIB member employs five people, and has gross revenues of $350,000 annually. NFIB sets its policy positions and priorities based on regular surveys of its membership.

Over the past twenty years I have seen a number of government regulations and mandates affect our business. Almost one year ago, on June 10, 1996, I learned of another federal mandate, the Electronic Federal Tax Payment System (EFTPS). My bookkeeper showed me a copy of IRS publication 1693 (rev. 5-96) with an article entitled "ELECTRONIC FEDERAL TAX PAYMENTS-IT'S THE LAW." My bookkeeper informed me that we would fall under this mandate beginning January 1, 1997. In the past I have done what most small business owners do when faced with another government mandate, complain and comply. This time I decided to take a stand against what I feel is a unnecessary, unwise and burdensome mandate on small businesses in America. We are here today because many other small business owners feel this way and have spoken out against EFTPS. Following are the concerns I have with EFTPS specifically, and government mandates, in general.

1. Small business owners are being constantly subjected to new regulations from federal, state, and local governments. Often these new regulations are a result of legislation which is passed without ever considering what effect it will have on businesses. This is exactly what happened in the case of the EFTPS mandate which was a part of the NAFTA Agreement. Congress included the implementation of EFTPS to offset a loss of tariff revenues. In effect, what Congress did was shift a $3.3 billion tax burden from foreign tariff revenues to U.S. small businesses and banks. Rather than phase in an electronic tax payment system by offering incentives to businesses and allowing them to join the system voluntarily, Congress required the IRS to collect 94 percent of federal tax deposits electronically by January 1, 1999, when the phase-in is completed.

Small businesses have been forced to act as tax collection agencies for the federal

government since the Current Tax Payment Act of 1943. For 53 years we have done this with no compensation for the time required to calculate withholding taxes, FICA, etc. Now we are being told not just how much tax to pay, and when to pay it, but also how to pay it. It is time for the federal government to concentrate on making itself more efficient, and stop forcing experiments on small business.

2. The cost to small businesses will be considerably more than the Members of Congress realized when they passed NAFTA. According to the Congressional Research Service report 96-703 E (August 8, 1996), "The Joint Commission on Taxation estimated that the provision (Electronics Fund Transfer) would increase revenues by $3.3 billion over the 5 years, 1994-1998." As I understand it, these revenues would be the interest gained as a result of the funds being transferred earlier out of the business accounts and banks, and into the treasury accounts. This amounts to $3.3 billion that U.S. businesses and banks are losing. Businesses depend on the average daily balance in their bank accounts to gain credits which offset the fees banks charge for their services.

In addition to these losses, banks will be charging a transaction fee to make the electronic transfers. My bank has informed me of two options. The least expensive option would cost our business approximately $600.00 per year in fees. If each of the 1.2 million small businesses being affected this year pay only the lesser fee, this would amount to an annual cost of $144 million.

3. The EFTPS provides no immediate written proof of payment to a small business. Under the current coupon system, we take our federal tax deposits to the bank at the same time we take

our regular account deposits. When we make those deposits, we receive an immediate receipt with the date and time of deposit, which we keep as proof of timely payment. If the IRS has any question about our timely payments, they will require proof.

4. I am concerned with the future changes that may occur if the EFTPS is fully implemented. Even though there is no direct access to business accounts in the ACH credit option under the current regulations; once the system is in place, what is to keep a future Congress from deciding that they could raise an additional $3.3 billion in revenues by directly accessing business accounts and allowing the IRS to initiate the transfers? This may seem outrageous now, but in another 10 years or in a time of fiscal crisis, there will be a strong temptation to move in that direction. We have an historical model of taxation and collection of taxation in this country dating from the Sixteenth Amendment in 1913 which would certainly point in that direction.

5. There is a law (31 USC Sec. 5103) which states "United States coins and currency (including federal reserve notes and circulating notes of federal reserve banks and national banks) are legal tender for all debts, public charges, taxes, and dues." According to a letter sent to my Congressman, Mr. Goodlatte, from the IRS (Feb. 21, 1997), the IRS states "once a taxpayer is required to pay electronically, cash will no longer be an acceptable form of payment for tax deposit payments." This raises a novel legal issue and also raises a lot of questions.

A. Can the federal government choose for whom currency will be legal tender and for whom it will not?

B. Can the federal government make currency legal tender for all of the transactions

except taxes?

C. Will the federal government in order to bring these two laws into agreement:

I. Repeal mandatory EFTPS?

II. Remove legal tender status of U.S. currency?

6. The U.S. Department of the Treasury states: [Federal Register: September 30, 1996 (volume 61, number 190, page 51180)] "The regulations are not a significant regulatory action as defined in Executive Order 12866. Accordingly a regulatory assessment is not required. It is hereby certified that this revision will not have a significant economic impact on a substantial number of small entities. Therefore a regulatory flexibility analysis is not required."

However, Executive Order 12866 states; " 'significant regulatory action' means any regulatory action that is likely to result in a rule that may:

(1) Have an annual effect on the economy of $100 million or more, or adversely affect in a material way the economy, a sector of the economy, productivity, competition, jobs, the environment, public health or safety, or state, local, or tribal governments or communities;

(2) Create a serious inconsistency or otherwise interfere with an action taken or planned by another agency;

(3) Materially alter the budgetary impact of entitlements, grants, user fees, or loan programs or the rights and obligations of recipients thereof, or

(4) Raise novel legal or policy issues arising out of legal mandates, the president's priorities, or the principles set forth in this Executive Order."

This regulation (mandatory EFTPS) definitely falls under the definition of a "significant regulatory action" according to definitions (1) and (4). Yet the IRS chose to ignore the impact

that this regulation would have. These regulations and many others should be much more carefully reviewed, not only by the agencies that write them, but also by the people who will be affected by them.

In conclusion; NAFTA was introduced in the House on November 4, 1993, and passed on November 17, 1993. Two weeks seems much too short a time for a massive bill with so many questionable provisions among which is mandatory EFTPS. Congress needs to correct this mistake by making EFTPS voluntary at every level of business. S. 570 is a step in that direction. We are pleased with this week's announcement by the IRS to suspend penalties for the first 6 months of EFTPS' enactment. However, we still believe a better solution is to make the program voluntary, and support the immediate enactment of S. 570. In less than four weeks over a million small business owners will be forced to comply with EFTPS if Congress doesn't act quickly. If two weeks was long enough to get NAFTA through, then it is not too late to get S. 570 out of committee and onto the floor for a vote.

Thank you again for allowing me to voice my concerns on behalf of the NFIB and its 600,000 small business owner members.

NECA

MECHANICAL • ELECTRICAL • SHEET METAL ALLIANCE

THE U.S. SENATE FINANCE COMMITTEE SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT HEARING ON HOME-BASED BUSINESS FAIRNESS ACT OF 1997

Statement of the Mechanical/Electrical/Sheet Metal Alliance
Presented by Frederick S. Oyer
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June 5, 1997

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THE U.S. SENATE FINANCE COMMITTEE
SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT
HEARING ON HOME-BASED BUSINESS FAIRNESS ACT OF 1997

Statement of the Mechanical/Electrical/Sheet Metal Alliance
June 5, 1997

The Mechanical Electrical Sheet Metal Alliance is a coalition of three national construction industry employer trade associations. They are the Mechanical Contractors Association of America (MCAA), the National Electrical Contractors Association (NECA), and the Sheet Metal and Air Conditioning Contractors' National Association (SMACNA). The Alliance represents more than 9,900 construction contracting firms nationwide that employ more than 540,000 trades workers with state-of-the-art technical training and skills and abilities. Alliance contractors hold a growing market share of more than 60 percent of the nation's non-residential construction activity.

Alliance contractors annually train over 90,000 apprentices and journey persons in career upgrade training at a cost exceeding $175 million. These construction firms and their local associations sponsor over 1,000 local training programs staffed by approximately 5,600 instructors utilizing equipment and facilities owned by the training programs valued at more than $500 million. Virtually all this high-skill career training is privately financed through collective bargaining structures, and surpasses any privately or publicly financed vocational and trade education system in the country in both scope and effectiveness.

Support stringent classification standards

The Alliance supports, without reservation, efforts to stem the workforce degradation that is directly the result of misclassification of employees as independent contractors. Similarly, the Alliance supports efforts to narrow the excuses from liability for misclassification to remove incentives for abuse. Moreover, the Alliance supports attempts to assure full payment of taxes by independent contractors.

Even with this unqualified support for legislative and regulatory reform objectives, the Alliance does not support the legislative proposals under consideration today (S. 460/S. 473). Tightening the requirements for 1099 filing is beneficial. However, the Alliance is concerned that the classification criteria set out in the proposal, when applied to the highly trained, highly mobile skilled construction workforce, would jeopardize the entire structure of training, health and welfare, pension, and other workforce development and retention benefits that are based on ***hours of covered employment.*** Rarely is the independent contractor classification appropriate for the demands of non-residential construction. By any measure a crew of craft workers on the job are not "independent." Under present law, the lower cost of performing as a misclassified independent contractor is subsidizing unfair competition.

Protect industry workforce development structures

We acknowledge the tremendous change in workforce patterns in this country in recent years, and agree that individual responsibility for career development can be beneficial for individuals in all types of careers - production and administrative and professional occupations as well. However, we also note that not all trends in work flexibility are necessarily beneficial. Much of the growth of the contingent workforce, and the concomitant growth of independent contractor status, leads to a tenuous attachment to employment and the economy - often with fewer benefits - which in turn accounts for a high level of underemployment in the economy overall.

In the organized sector of the industry, trade union and multiemployer groups in local collective bargaining have built and maintain a system of apprenticeship training, health and welfare, pension benefits, and career advancement training that ensure an adequate supply of high-skilled trades workers with commitment to the industry engendered by substantial career opportunities. The viability of these structures - as well as the individual careers they develop and enhance - could be at jeopardy with even more permissive worker classification standards.

Misclassification of employees as independent contractors is in fact epidemic in the construction industry and is a severe threat to the quality of the workforce and service even in the union sector, spreading beyond the low-skill, open-shop segments of the market where the abuses were formerly concentrated. The industry trade press has been filled in recent years with reports of the workforce development crisis in those sectors of the industry where workforce investments and standards are not maintained.

The construction industry as a whole surpassed even the finance, insurance, and real estate industry, with rates of worker misclassification at 19.8% and 19.3% respectively, according to be 1991 Treasury Department study cited in the Coopers and Lybrand study commissioned by the Coalition for Fair Worker Classification in 1994. (Coopers & Lybrand, *Projection of the Loss in Federal Tax Revenues Due to Misclassification of Workers*, Coalition for Fair Worker Classification, June 1994, page 8.) Even more recent studies show that this abuse continues unabated. According to the U.S. Labor Department's Bureau of Labor Statistics (BLS) economists:

> "Quite unlike the occupational profile of traditional workers, that of independent contractors was skewed toward several high-skilled fields. Specific occupations that were heavily represented were writers and artists, insurance and real estate sales agents, construction trade employees, and miscellaneous managers and administrators."

> "Several industries in which independent contractors were disproportionately represented were construction, finance, insurance, and real estate and services." (BLS, *Monthly Labor Review*, October 1996, "Workers in Alternative Employment Arrangements", pp. 33)

Nevertheless, we acknowledge that there can be some legitimate classification of production and skilled craft workers in construction as well as clerical, administrative and professional workers as independent contractors. And we are proud to note, along with our colleagues in the skilled trades, that the opportunities for career progression from skilled production jobs into supervisory, management, and even business ownership and entrepreneurship are unrivaled in construction as compared with virtually all other manufacturing and goods-producing industries.

However, the epidemic rise of worker misclassification in construction has nothing to do with career enhancement, but rather everything to do with unfair low-wage competition. Our industry can ill afford declining skills and abilities at a time when our product and services are expanding in complexity and sophistication. In fact, the effect of unfair competition by firms that misclassify employees and avoid the payment of employment taxes and other requirements of employment law threatens the maintenance of workforce standards.

Simply put, fair and constructive competition can not be maintained if the classification criteria are changed to be even more permissive than they are now. All legitimate competitors should be required to pay at least the public law minimum employer overhead taxes that are a legitimate cost of conducting business as an employer. Businesses that can not afford to pay for the social policy objectives of unemployment insurance, social security and workers compensation should not be permitted greater leeway to avoid paying for these established social responsibility programs and shifting ever greater costs onto fair employers and the government as well.

Allow flexible criteria by industry to stem abuses

While perhaps well-intentioned, neither of the two new safe harbors in S. 460 is likely to stem the tide of workforce degradation brought on by worker misclassification. Many have observed that an objective, concise, simple standard for worker classification spanning all industries is much to be desired. We agree that such in ideal would be beneficial. However, that ideal may well be illusory, and failed attempts to achieve it would do great harm to the integrity of the employment relationship and the policies that are implemented through the employment relation (workers compensation, retirement security and others). Another approach is one recommended by the Commission on the Future of Worker/Management Relations (Dunlop Commission), recommending an even broader approach to consolidating worker classification criteria across the full range of tax, labor, and employment law by abandoning the common law agency

analysis in favor of an "economic reality" test. The Report went on to recommend further study of that proposal. (*Report and Recommendation*, Commission on the Future of Worker/Management Relations, December 1994, pps. 36-37.)

Unfortunately, either of the tests set out in S. 460 may have the unintended effect of being even more permissive toward abusive practices. The first test condenses the common law financial independence and control and direction analysis, and in so doing presents the real hazard of codifying a formulaic approach that will be used to attempt to legitimize misclassification. In the same way, the incorporation standard would subject to ready abuse.

While we do not contend that the current IRS standards for judging employment control and direction - along with the flexible 20 common law factors - are either a model of clarity or blueprint for consistency; we nevertheless point out that they have the virtue of established use. The classification standards are at least known, and their impact on encouraging abuse may be far less than the broad leeway and excuse from liability permitted under Section 530.

Unfortunately, both proposals suffer from the same defect - that is, they attempt to legislate, with a complex list of conjunctive and disjunctive factors, a formulaic approach to a highly fact-specific inquiry. Moreover, a legislative approach is static.

We submit that a flexible regulatory approach would be more effective. The IRS Training Manual, *Employee or Independent Contractor?*, demonstrates a more flexible approach that would remain adaptable. The IRS manual addresses the fact-specific "control factors under the common-law standard that may indicate the existence of an independent contract or an employee relationship" and "emphasizes that factors may change over time because business relationships and the work environment change over time." (IRS Manual, page 1-1).

Encourage full compliance with employment standards

The two new safe harbors proposed under S. 460 are too static to meet the changing workplace practices. Rather, we support IRS efforts to craft appropriate market segment understandings to reflect current industry practices in a more flexible way. Under either legislative proposal, whether the criteria are profit/loss, unreimbursed expenses, specific service time or performance outcome, separate place of business, or different clients, taken together they would be too permissive as applied to the construction trade workforce, the unique character of which is not reflected in the law.

Likewise, judgments that turn on investment in training or tools and equipment would encourage misclassification of highly trained, self-equipped construction workers. Similarly, any requirement of a qualifying agreement memorializing the classification

could too easily become a unilaterally imposed contract in cases where individuals are without bargaining representation.

In summary, the criteria laid out so far, as applied to a highly trained construction workforce that meets fluctuating market demand from referrals to several projects over a year, could well force a radical transformation of the employment relationships in the construction industry to the detriment of the training and benefits structures that are based on contributions for hours worked under covered employment. Moreover, all the other important legal protections that flow from employment status, including prevailing wage, workers compensation, EEO, ADA, family and medical leave, and other labor and employment protections would be jeopardized as well.

In conclusion, the Alliance would urge the committee to avoid codification of classification criteria, which perforce would be too broad to meet specific industry conditions, and encourage administrative efforts to continue market segment development of specific industry criteria. Instead, the Alliance supports efforts to narrow the liability excuses permitted under Section 530, encourage remedial employment classifications, and increase reporting and filing requirements to achieve greater taxpayer compliance.

Alliance member firms appreciate the Subcommittee's invitation to participate in the hearings. Our associations will continue to work with Congress on this most important workforce issue.

STATEMENT OF JOHN S. SATAGAJ

The Small Business Legislative Council (SBLC) is a permanent, independent coalition of nearly one hundred trade and professional associations that share a common commitment to the future of small business. Our members represent the interests of small businesses in such diverse economic sectors as manufacturing, retailing, distribution, professional and technical services, construction, transportation, tourism, and agriculture. For your information, a list of SBLC's members is attached.

We are pleased to offer our views on home office deduction rules revisions, independent contractor classification rules revisions, and self-employed health care deduction parity.

We are pleased to offer our support for S. 460, the Home-Based Business Fairness Act. It squarely addresses three important issues for our membership — independent contractor determinations, health care cost deductibility for the self-employed, and the rules for home office deduction. In all three cases, the legislation hits a "home run." In addition, we support Senator Nickles' independent contractor bill, S. 473.

INDEPENDENT CONTRACTOR DETERMINATIONS

No subject brings forth greater passion in our organization than the debate over the appropriate criteria for determining whether an individual is an independent contractor or employee. We have long held the view that the only way the debate will be resolved is for Congress to step in.

We would like to make it clear that we come to the table with no apologies for wanting to encourage entrepreneurial activity; with the presumption that free enterprise is a good thing; and that we should be encouraging individuals to become entrepreneurs and start their own businesses. It always amazes us that on one hand, praise can be heaped upon small businesses and just as quickly, the worst stereotypes about small businesses, that basically they are all tax cheats, can be bandied about. We submit that small business owners pay a healthy share of the taxes that support all of our social, defense, and other government benefits and services.

The decision on whether an individual is an employee or independent contractor is not made in a vacuum. There are many factors that go into the equation. From the business' standpoint, these issues include such concerns as: How competitive is the labor market? Is stability and commitment in the work force essential to my company? Is there information and technology involved in business that is better protected by employees? There may be some

employers who could force a change on their employees solely for tax purposes, but we submit those are few and far between. It is not as easy a decision as some would suggest.

At the same time, we do recognize that we cannot allow the system to be abused, and are committed to working to ensure that it is not.

We will be forever coming back to this debate, if we do not establish, once and for all, a specific, fair, simple, and objective test. If we can do that, then everybody will be playing on a level field. Last year, the IRS Commissioner announced several new initiatives to help small businesses faced with reclassification. We will say, it appears the Commissioner is trying to take some positive steps. But in any case, we do not believe the IRS' initiatives, good or bad, eliminate the need for this legislation. If you read through the training manual published by the IRS last year to train its examiners on how to conduct an "employment" audit, it lays out the IRS' interpretation of the 20-point common law test, indicating what it now believes is important and what is not. On a number of factors, the interpretation is favorable to the taxpayer, compared to what the IRS field staff currently uses. But what strikes you as you read it is, how subjective the common law test really is. What was important yesterday, is no longer important today, and could easily change tomorrow. S. 460/S. 473 establish simple, direct, and, as much as possible, objective standards, and codifies them into law. Indeed, the framework for the two safe harbors can be found in the IRS' training manual.

The first safe harbor focuses on how the independent contractor presents him or herself to the world and the safe harbor presents significant factors that can be found in the three principal areas identified by the IRS manual: behavioral control, financial control, and the intent of the parties. The legislation places particular emphasis on the financial control. Appropriately, the legislation anticipates an independent contractor will undertake three rather significant financial obligations: 1) have the ability to realize a profit or loss; 2) incur unreimbursed expenses; and, 3) agree to perform a specific task or to perform for a particular time. I want to emphasize that the independent contractor must meet all three. These are in the "conjunctive," not the "disjunctive." And this is only one part of the safe harbor, two other conditions must be met.

I submit to you that the "incurs unreimbursed expenses" standard, in particular, is a significant dividing line between employees and independent contractors. To quote from the training manual, "You [examiners] should, therefore, focus on unreimbursed expenses, which

better distinguish independent contractors and employees, inasmuch as independent contractors are more likely to have unreimbursed expenses...If expenses are unreimbursed, then the opportunity for profit or loss exists."

As to "behavior control," the legislation provides a disjunctive test, the primary purpose of which is to demonstrate that the independent contractor is not reliant on the recipient for performance, by demonstrating the existence of a principal place of business, or an alternative when a principal place may not be necessary to the performance of the service (for example, most of the activity takes place at a third party's location, that is a customer's home or a client's office). Finally, to address the "intent of the parties" text of the IRS manual, to meet the first safe harbor, there must be a written agreement. While the IRS manual notes a written agreement in itself is not the "be all, end all," the manual does say, "The contractual designation of the worker is very significant in close cases."

The second safe harbor also draws upon the IRS manual for its structure. The manual addresses the significance of incorporation and a written document as indication of the freedom of an independent contractor and the presence of benefits as indicia of an employment relationship. The second safe harbor is rooted in the IRS' own views as it requires incorporation and a written agreement, and prohibits the offering of employee benefits.

WHY INDEPENDENT CONTRACTORS ARE IMPORTANT TO OUR NATION

This is not a new problem for the small business community. While much is made of the fact the delegates to the 1995 White House Conference on Small Business made this a top priority, it should be noted the delegates to the ***1980*** White House Conference on Small Business agreed there was a need to articulate a small business "bill of rights." Their recommendation, while not expressly addressing the independent contractor issue, established a framework for why encouraging independent contractors to pursue the American Dream is essential to our economy and society. They said:

> "The American Dream is to be an owner of one's own business. Almost everyone has had the dream, and millions of Americans have lived it. The American Dream is the cornerstone of our 200-year-old American Heritage and also is the reason for our country's position as the most economically powerful nation in the world today. Could we have achieved this status as a nation if we had not been presented with opportunity unencumbered by government regulation? Could we have achieved this nation's status if entrepreneurs had not had the fortitude and shown the initiative to take advantage of

opportunity when it presented itself? America was founded on the principle of each individual's fundamental rights, i.e., Freedom of Speech, Freedom of Religion, Freedom of the Press, Freedom of Assembly, Freedom to Bear Arms, etc., fundamentally, the Right to 'Life, Liberty, and the Pursuit of Happiness.' The Pursuit of Happiness can and does take the form of one going into business for oneself, the fulfillment of the American Dream.

"Now, therefore, in consideration of the foregoing and; whereas the Small Business Community is represented by some 14 million small and independent businesses, and; whereas these 14 million businesses represent 100 million people and 58 percent of all private sector jobs in America and; whereas 97 percent of all newly-created jobs in the past seven years have been created among these 14 million small and independent businesses representing 48 percent of America's gross business product and; whereas 50 percent of all new inventions, innovations, and patents are developed in the small and independent sector of American business...

"Therefore, be it resolved that said 14 million small and independent businesses have fundamental, inalienable, and constitutional rights:

1. The right to start, own, and manage a business without government interference.

2. The right to compete fairly for capital with the assurance that capital will be available for private use.

3. The right to reward for the risk, effort, and genius necessary to make an independent business work.

4. The right to determine price just as the buyer has the right to buy or not at that price.

5. The right to be governed by reasonable and understandable laws set forth by elected representatives, not by bureaucratic dictate.

6. The right to be innocent until proven guilty by a jury of our peers; not by administrative edict.

7. The right to equal representation with Big Business, Big Labor, and Government on matters relating to America's economic policies."

"The right to start, own, and manage one's own business" — the American Dream. It seems like a principle we all automatically assume is as much a part of our nation's heritage as the Constitution and the Bill of Rights. After all, Thomas Jefferson's independent yeoman

farmers were the forebearers of our entrepreneurial sector. Our nation is built upon a foundation of individual opportunity.

As a noted authority on small business once observed:

> "As Jefferson realized at the nation's birth, economic independence is the only guaranty of political liberty. This country's 14 million small businesses provide 14 million sources, not only for economic opportunity, but also for that liberty. Every one of this nation's business owners can say anything he or she pleases. No one can fire these people or take their jobs away. If you spread the wealth and power in society, you inevitably spread freedom. The larger the small business sector, the more equality of opportunity we have for individuals and the safer our freedom of expression is from abuse. Small business fosters creativity and innovation. It is the bulwark against concentration and the remorseless abuses of power to which that leads."

While we seem to accept the belief that there is a right to start, own, and manage one's own business, we have never had a formal game plan to ensure that right is encouraged, promoted, and exercised. Just as an example, we might note, despite the fact there are some 20 million sole proprietors, partners, and S Corporation shareholders, today after several years of trying, we are still discussing how we can get 100 percent parity for their health care costs, sooner rather than later. What signal does that send to entrepreneurs?

To us, independent contracting is both the embodiment of the American Dream and the means by which it becomes an achievable dream. The essence of the American spirit is individual opportunity. For most "would be" entrepreneurs, the only asset they can bring to their new business is their own skills. Few small businesses start out with the venture capital, informal or formal, to open their business on day one, complete with employees, assets, suppliers, and customers. Independent contractor status is, in fact, the first step on the small business ladder. The risk of becoming an independent contractor is a very limited but direct risk. If I fail, I do not eat. I do not have the comfort of punching a time clock and knowing the check will be there on payday. But if I am a success, I do not carry the burden of that time clock on my back. We are sure that few individual independent contractors want to remain one-person operations, but that is clearly the avenue of opportunity.

To us, it seems clear why individuals would seek to become entrepreneurial independent contractors. The choice is theirs to make, and the risks and rewards theirs to evaluate. Likewise, it is equally clear to us why the nation benefits. Not only does it reflect our heritage of

individual opportunity, entrepreneurial activity brings with it innovation, creativity, productivity, and economic growth.

Therefore, the first thing Congress should do is establish that encouraging independent contractors is consistent with our nation's economic heritage and social philosophy. All public policy should be built around the presumption that Americans should be encouraged to start, own, and manage a business, not the presumption that they are "misclassifications."

It is clear to us why independent contractors seek the status and why the nation benefits, but we are not convinced it is well understood in public policy circles why the availability of independent contractors is critical to the survival of other small businesses. To explain why they are a critical cog in a functioning small business economy, we must lapse briefly into public policy-speak. A service provider is an independent contractor. The service recipient is the business that utilizes them. It might be more accurate to refer to the service recipient as a service expediter, because frequently the general public or other customers are the beneficiaries of the service, not the so-called service recipient.

Nevertheless, the service recipient does benefit from the independent contractor relationship. As remains too often the case, sinister motives are attributed to the business that utilizes an independent contractor. Many of these motives relate to tax liability. The truth is, behind most decisions to use independent contractors, you find the word flexibility — the hallmark of a successful small business.

In the dynamic tension between big and small business, the tradeoff is between economies of scale and flexibility. In a big business, enough work may be found to employ one individual with a particular skill or asset. If the market or technology changes, many big businesses find themselves caught with resources no longer productive or efficient.

On the other hand, if the work is not there for the skill or asset which the individual can provide, the small business owner is either going to tap an independent contractor or not provide the service. Too often, big businesses must try to force the market to adjust to them. In the small business sector, the business adjusts to the market. If a market or demand changes, the small business is able to adapt to it. If new skills and new technologies are needed, the small business can re-tool itself for those changes. Responding sooner, faster, better, and more efficiently is what allows small businesses to survive, compete, and prosper. Utilizing independent

contractors is part of that success story. Mandating that the individual be reclassified as an employee solves nothing because inefficiency and excess capacity is a quick route to bankruptcy.

At the same time, an independent contractor can maintain a standard of living and a way of life, and keep skills and assets in the market place available to a number of industry participants. Utilizing an independent contractor facilitates the sale of the service recipient's goods or services. Because the services or assets of the service provider and service recipient are mutually interdependent, they do not, and should not, lead to the conclusion that the relationship should be that of employer-employee.

Sadly, the chasm between the rhetoric of embracing small business and promoting it through meaningful public policy is a wide one. This has been most evident in the government's past history on the use of independent contractors by other small businesses. In short, the policy has been to aggressively reclassify independent contractors as employees. We can only speculate as to the various reasons for this policy, but we are certain it is ***not*** based on the presumption that independent contractors represent the achievement of the American Dream.

We hope we can write the final chapters to this long-simmering debate, and look forward to working with you to find a solution that works for the small businesses of America.

HEALTH CARE DEDUCTION

As you know, until 1986, sole proprietors and partners were not permitted to deduct any of their own health care costs (primarily health insurance). The general theory was that unincorporated businesses could be used as tax shelters to deduct expenses that, for the "average" American, would otherwise be considered personal expenses. In 1986, Congress acknowledged that unincorporated businesses were, in fact, likely to be "legitimate" businesses, and created a temporary three-year window for such businesses to deduct health care expenses, but limited the deduction to 25 percent of the costs.

In 1982, Congress also changed the law regarding the tax treatment of fringe benefits received by S Corporation shareholders who own more than 2 percent of the company, requiring them to treat such benefits as if they were partners or sole proprietors. Congress, however, deferred the effective date of that provision for five years. As a result, when Congress enacted the 25 percent deduction, S Corporation shareholders were subjected to the limitation. Sole

proprietorships, S Corporations, and partnerships may deduct fully the cost of health care for other employees.

There is no logic to permitting some businesses and not others to deduct health care costs, solely on the basis of business organization. While it is theoretically possible for individuals to establish a business primarily for tax purposes, the vast majority of S Corporations, partnerships, and sole proprietorships are contributing, ongoing businesses.

Through the years, the deduction has become a "revenue football," kicked around in almost every tax bill. It was finally made permanent, and put on a track to 80 percent in the last Congress. It is currently 40 percent and scheduled to rise in slow increments until it reaches 80 percent in the year 2006. S. 460 would establish 100 percent parity immediately. We can only say, "it is about time."

HOME OFFICE DEDUCTION

As you know, the 1993 U.S. Supreme Court decision, *IRS v. Nader Soliman*, significantly narrowed the ability of individuals to take a deduction for home office expenses on their tax returns. Under the U.S. Supreme Court's ruling, a doctor was found not to be entitled to a home office deduction because the doctor's principal place of business was determined by the court to be the hospitals where the physician performed services for patients. The doctor's home office did not qualify for the deduction, despite the fact that ***none*** of the hospitals, where he performed services, provided him with an office, and he spent a substantial amount of time in the home office administering records and billings for patients. The court disallowed the deduction, even though the home office was the doctor's ***only*** office for his practice.

In the aftermath of the Supreme Court decision, the IRS issued guidance on how it would apply the decision to specific cases. The revised guidance focuses on the principal-place-of-business test used in determining home office deductions. In the *Soliman* decision, the court set forth two factors taxpayers must consider in determining their principal place of business — 1) the relative importance of activities conducted at each business location, and 2) the amount of time spent at each location.

According to *Soliman*, "great weight" must be given to the location where required meetings with clients are usually held, or where goods or services are delivered to clients. According to the guidance, this means that taxpayers who must meet with their client, or deliver

goods or services to customers, will usually conclude that their principal place of business is where those meetings or deliveries occur.

Taxpayers who meet clients in more than one location, or have businesses involving no customer meetings, need to determine which activities are most important to the conduct of their business and where those activities take place.

The guidance states, taxpayers should also look at the time spent in each business location, especially where a comparison of activities performed at each business location provides no clear answer as to the location of the most important activity.

Prior to the Supreme Court decision, home office expenses were deductible only if: 1) the space in the home was devoted to the "sole and exclusive use" of the office; 2) the taxpayer used no other office for the business; and 3) the business generated enough income to cover the deduction.

The Supreme Court, in effect, added two additional conditions to the eligibility of most taxpayers for the home office deduction: 4) the customers of the home-based business must physically visit the home office; and 5) the business revenue must be produced within the home office itself.

The proposed solution would keep intact the three previous criteria for the deduction, while making clear that essential administrative and management activities — such as tax preparation, bookkeeping, billing, and soliciting business — are legitimate uses of business time and office space for the purpose of deducting the expenses of a home office.

We believe the proposed criteria is a realistic reflection of how technology has reshaped traditional notions of doing business. An office on Main Street is no longer indicative of the investment in a business.

ESTATE TAX RELIEF

We cannot let this opportunity pass without mentioning that estate tax relief is a high priority for us. With each passing day, it takes on new urgency. The demographics of our nation and economy tell the story. If you look at our history, you know we have reached another critical juncture in the cycle of families and businesses. It is a time of generational change.

Family-owned firms spend a lot of time running around in circles trying to prevent an estate tax catastrophe. Sometimes, here in Washington, we focus on the wrong thing. Many

look at the amount of estate tax being collected at the current time and say, "How can this be such a big deal to small business?" Instead, one should look at the amount of time small businesses spend arranging and re-arranging their business operations for one purpose — to ensure that the next generation does not have to liquidate the business to pay estate taxes. It is an embarrassment to our economy that so much time and money should be wasted trying to keep family-owned businesses viable from generation to generation. It may not show up as estate taxes paid, but we pay a high price for keeping the family business in the family from one generation to the next.

All things being equal, our preference would be to repeal the estate tax in its entirety. It makes no sense that we tout the fact that anyone in America can start a business, be successful, and prosper and then, have it all destroyed at death. Talk about a mixed message.

In this Congress, we should at least make a "down-payment" on repeal. Frankly, many small businesses cannot wait for the two or three more Congresses that might be necessary before we can convince the majority to "put up the revenue" necessary to offset total repeal. We applaud the decision of the President and the Republican leadership to provide significant estate tax relief in the balanced budget agreement. We hope as much of that relief is directed to small family-owned businesses.

CONCLUSION

While much of what is discussed in this testimony can be described as modest in nature, enactment of the relief proposed would go a long way in allowing small business to do what it does so well — innovate and create new jobs. We thank you for the opportunity to present our views.

/S3781
Enclosure

Members of the Small Business Legislative Council

ACIL
Air Conditioning Contractors of America
Alliance for Affordable Health Care
Alliance for American Innovation
Alliance of Independent Store Owners and Professionals
American Animal Hospital Association
American Association of Equine Practitioners
American Association of Nurserymen
American Bus Association
American Consulting Engineers Council
American Machine Tool Distributors Association
American Road & Transportation Builders Association
American Society of Interior Designers
American Society of Travel Agents, Inc.
American Subcontractors Association
American Textile Machinery Association
American Trucking Associations, Inc.
Architectural Precast Association
Associated Builders & Contractors
Associated Equipment Distributors
Associated Landscape Contractors of America
Association of Small Business Development Centers
Automotive Service Association
Automotive Recyclers Association
Bowling Proprietors Association of America
Building Service Contractors Association International
Business Advertising Council
Christian Booksellers Association
Computing Technology Industry Association
Council of Fleet Specialists
Council of Growing Companies
Direct Selling Association
Electronics Representatives Association
Florists' Transworld Delivery Association
Health Industry Representatives Association
Helicopter Association International
Independent Bankers Association of America
Independent Medical Distributors Association
International Association of Refrigerated Warehouses
International Formalwear Association
International Franchise Association
International Television Association
Machinery Dealers National Association
Mail Advertising Service Association
Manufacturers Agents for the Food Service Industry
Manufacturers Agents National Association
Manufacturers Representatives of America, Inc.
Mechanical Contractors Association of America, Inc.
National Association for the Self-Employed
National Association of Home Builders
National Association of Plumbing-Heating-Cooling Contractors
National Association of Realtors
National Association of RV Parks and Campgrounds
National Association of Small Business Investment Companies
National Association of Surety Bond Producers
National Association of the Remodeling Industry
National Chimney Sweep Guild
National Community Pharmacists Association
National Electrical Contractors Association
National Electrical Manufacturers Representatives Association
National Food Brokers Association
National Funeral Directors Association, Inc.
National Knitwear & Sportswear Association
National Lumber & Building Material Dealers Association
National Moving and Storage Association
National Ornamental & Miscellaneous Metals Association
National Paperbox Association
National Shoe Retailers Association
National Society of Public Accountants
National Tooling and Machining Association
National Tour Association
National Wood Flooring Association
Opticians Association of America
Organization for the Promotion and Advancement of Small Telephone Companies
Petroleum Marketers Association of America
Power Transmission Representatives Association
Printing Industries of America, Inc.
Professional Lawn Care Association of America
Promotional Products Association International
The Retailer's Bakery Association
Small Business Council of America, Inc.
Small Business Exporters Association
SMC Business Councils
Society of American Florists
Turfgrass Producers International
United Motorcoach Association

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Statement of Olympia J. Snowe

The Home-Based Businesses Fairness Act of 1997

June 5, 1997

Thank you, Mr. Chairman, for giving me the opportunity to testify before your Subcommittee today. I appreciate you holding this important hearing and your efforts to clarify the definition of independent contractor. And I would also like to thank Senator Bond for his hard work and dedication to advancing S. 460, the Home-Based Business Fairness Act, and for his leadership as Chairman of the Small Business Committee on numerous issues critical to our Nation's small businesses.

As a member of the Small Business Committee and as an original cosponsor of S. 460, I have come before you to ask that the Subcommittee include the provisions of S. 460 in the Reconciliation tax package. As currently written, our tax code unjustly penalizes millions of our Nation's small and home-based

businesses and, with this bill, we have the opportunity to start correcting that injustice.

We need to help small businesses because they are our number one job creator. Last year, small businesses produced 75 percent of the 2.5 million new jobs created, and in my home state of Maine, small businesses provide 97.8 percent of all jobs.

Additionally, women-owned businesses employ one out of every four workers and provide jobs for over 15.5 million people. In fact, 66 percent of those covered by the Home Based Business Fairness Act will be women. And as long as the tax code continues to discourage the creation and expansion of these businesses, we are putting future jobs at risk.

This past March, I hosted a Small Business Committee field hearing in Bangor, Maine chaired by Senator Bond. We heard from a number of small business owners about what Congress

could and should do to help them, including three home-based business owners who would benefit from passage of our bill. Alice Bredin, author of the syndicated column "Working at Home" and "The Virtual Office Handbook", testified that she hears from dozens of small business owners a week as a result of her work and those entrepreneurs have only one question: "Why is the government making it so difficult for me to run my business?"

The two other witnesses echoed that same question. Daniel Crowley, owner of Screen Scene in Skowhegan, Maine, testified that his inability to deduct the full cost of his health insurance and the cost of his home office had placed him at a disadvantage because his competitors could fully deduct these expenses. Dan explained that for the first four years of his business, he was forced to keep a part time job selling insurance. This took much-needed time away from starting and marketing his business, but it was the only way he could keep his health care coverage.

Unfortunately, his wife and children had to go without insurance for five years until Dan could afford to pay the nearly $10,000 in insurance premiums for his family. If Dan had been able to fully deduct his health insurance, he would have been able to concentrate on his new business and ensure that his family had health insurance coverage.

James Harriger is an independent sales representative for the apparel industry. Sales representatives have traditionally been classified as independent contractors. Increasingly, however, the Internal Revenue Service has been conducting reclassification audits that, based on a given agent's interpretation of the IRS 20 factor common law test, have often resulted in the reclassification of sales representatives as employees. The resulting back taxes and fines frequently are so severe that they put many smaller manufacturers out of business. So not only are the manufacturers forced out of business, but also the sales representatives who rely on that business for their jobs and income.

The Home-Based Business Fairness Act will correct these inequity in America's tax code. As Senator Bond mentioned, our bill will allow the full deductibility of health insurance for the self-employed. This provision will place the self-employed on an equal footing with large corporations that already are afforded the right to deduct the full health insurance costs of their employees. The last Congress made some progress -- increasing the deduction to 30 percent and phasing it in up to 80 percent by 2006. But, we must put the self employed on equal tax footing with corporations, and providing 100 percent deductibility will do that. Our bill not only will help small businesses, but also will provide affordable health care for 11 percent of the population who are currently self-employed and uninsured.

We also need to restore equity to our tax code by expanding the deductibility of the home office. Again, S. 460 will place home-based businesses on a level playing field with larger companies who are currently able to deduct the cost of their

commercial office space. Our tax code does not reflect the growing reality that more and more people work out of their home rather than a traditional workplace. New technology, corporate downsizing and the demand for flexible work arrangements have contributed to a rapid growth in home-based businesses.

Our country's 14 million home-based businesses are now one of the fastest growing sectors of our economy. In Maine, for example, over half of the 81,000 small businesses are home-based. But, as long as our tax code continues to discourage small and home-based businesses, we are placing our economic future at risk and the ability of individuals to earn a living at risk. In my view, it is only fair that home-based businesses be given a tax benefit equal to that of their larger competitors.

The final provision of our bill addresses the number one tax priority of the 1995 White House Conference on Small Business -- the need to clarify the definition of independent contractor. The

Conference Delegates cited this as their highest tax priority because the Internal Revenue Service's guidelines are unclear and have been enforced inconsistently. In some instances, two identical cases can be construed differently depending on the interpretation of the law by the IRS agent. Our legislation addresses this classification issue and protects small businesses from retroactive reclassifications by the IRS--which can destroy a business through the demand for back taxes, interest, and penalties.

The Home-Based Business Fairness Act will level the playing field for small businesses by making the tax code more simple and fair. Business author Peter Drucker once wrote, "We are dedicated to the preservation and strengthening of small business and our tax policy is designated to destroy small business." We must seek to encourage, not discourage, the development of our nation's businesses. This means reforming our tax code and adopting this bill. I am convinced that our legislation will help the millions of small, home-based businesses currently hurt by our tax code, and will expand entrepreneurial opportunities and job creation in the future, and I urge the Subcommittee to include these provisions in the Reconciliation tax package.

National Association for the Self-Employed
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TESTIMONY

OF

MS. SUSAN THOMAS

PRESIDENT

BEST OF SERVICE AND SALES INTERNATIONAL

ON BEHALF OF

THE NATIONAL ASSOCIATION FOR THE SELF-EMPLOYED

BEFORE

COMMITTEE ON FINANCE

U.S. SENATE

ON

THE HOME-BASED BUSINESS FAIRNESS ACT OF 1997

AND

THE ELECTRONIC FEDERAL TAX PAYMENT SYSTEM

JUNE 5, 1997

My name is Susan Thomas, President of the Best of Service and Sales International, Inc. -- a home-based business located in Annandale, Virginia. I am pleased to testify today on behalf of the National Association for the Self-Employed (NASE), the national association representing over 325,000 small business persons and self-employed individuals. The NASE thanks Chairman Don Nickles and the other members of the Senate Finance Subcommittee on Taxation and IRS Oversight for holding this very important hearing on S. 460 and S. 570, two bills strongly supported by the small business community. S. 460, the Home-Based Business Fairness Act of 1997, has been introduced by Senators Christopher S. Bond and Don Nickles. Moreover, Senator Nickles has introduced S. 570, a bill to make the Electronic Federal Tax Payment System (EFTPS) voluntary for hundreds of thousands of small businesses.

S. 460 and S. 570 are two very significant bills for the small business community and home-based businesses like my own. I initially started a home-based business several years ago because I was tired of working for the large company/corporate culture. I originally setup my business in my home upon leaving Wang Corporation because I had very little working capital at the time. Ironically, it was my intention when I started my business to ultimately move the business out of my home and into commercial office space at a later date. Today, I would not trade my home-based business for any commercial office location anywhere. I love my home office because of the conveniences that it affords me.

I am extremely proud of my home-based business. My company -- Best of Service and Sales International, Inc. -- employs 3 individuals to market computer equipment, peripherals, software, and computer supplies to the federal government. In addition, I have started a new venture called Best Travel Services which markets vacations, and educational and group study tours.

Like many other members of the NASE, I am very supportive of S. 460 and its three provisions. The bill provides for modernization of the home office deduction, clarification of the tax treatment of independent contractors, and enactment of a full 100 percent health insurance deduction for the self-employed. In addition, S. 570 makes the EFTPS program voluntary for small business. The NASE strongly recommends that the Senate Finance Committee adopt all of the provisions of S. 460 and S. 570 as part of the panel's upcoming markup of the 1997 budget reconciliation/tax legislation.

Home Office Deduction

Under the Internal Revenue Code, an individual is not generally permitted to deduct any expenses associated with a home office deduction unless such expenses are attributable to a portion of the home (or a separate structure) *used exclusively on a regular basis as* (1) the principle place of business for the individual, or (2) as a place of business that is used by the individual to see patients, clients, or customers in the normal course of business. The 1993 Supreme Court decision in *Soliman v. IRS* substantially narrowed the availability of the home office deduction even further.

Now, as a result of this court decision, I must also effectively (1) see my clients in the home office and (2) generate the revenues of the business out of my home office in order to qualify for the home office deduction.

While I operate a home-based business, I don't take the home office tax deduction on my tax return. Why? Not because the IRS requires businesses that take the deduction to see their clients in the home office or that they should generate their income there. Those tests are unfair and discriminatory against home-based businesses, even though I actually meet them. No, **the reason I don't take the deduction is the warning that I and millions of others like me got from our accountants: don't.** Taking the deduction, my accountant told me, is like waving a red flag at the IRS... a flag saying, "Audit me!"

This is ridiculous. Congress passes a law to help home-based businesses. The IRS then tries to impose the narrowest possible interpretation on the law, losing two court cases, but taking the issue all the way to the U.S. Supreme Court as represented by the *Soliman* case. After finally convincing the Supreme Court to narrow the deduction, the IRS then audits those who still qualify for it so aggressively that millions of people legitimately entitled to the deduction are afraid to take it.

Look at the numbers. IRS statistics of income show that 1.5 million people claimed the home office deduction in 1994. Yet the number of full-time home-based businesses is variously estimated at between 7 million and 14 million. So only about 10 to 20 percent of all home-based businesses are claiming the deduction. And 80 percent or more aren't.

Why don't 80-90 percent of home-based businesses take the deduction. Don't they qualify? I believed a great many of them are like me. They do qualify, but are forced to choose between the time and stress of an audit or the modest tax savings of the deduction. I choose to forego the deduction.

Once there has been a determination that a home office does exist, the tax deduction allowed in any given year for the self-employed person is limited to the net income from the activity performed in the home office. Any excess expenses are allowed to be carried forward to offset income in later years. The IRS has made it very clear that by attaching Form 8829 (the home office deduction form) to a Form 1040 will put the person in line for a tax audit. Contrast this with other businesses which have no such limitation placed on them in terms of rent paid for commercial office space.

The current home office deduction limitations are unfair and unwise for other reasons, too. All over the country, larger businesses are laying off employees. If we want to help these people get on their feet, we should make it a little easier for them to start a business. The same goes for people who are forced off the welfare rolls under the 1996 welfare reform law. They should be given the opportunity to start up businesses, as self-employed people, with a minimum of up-front costs. Home-based businesses are an obvious way to help facilitate that. Then there are the people who are caught in a classic governmental "Catch-22". The IRS tells them that they have to bring their customers or clients into their home office in order to "qualify" for the home office deduction, but their local zoning regulations prohibit them from doing so!

Give us the certainty -- the "safe harbor" -- which S. 460 would provide and we will use the home office deduction. Don't allow the IRS to administratively defeat Congress' original purpose with the deduction. Improve the fairness and clarity of the home office deduction. Not only will more home-based businesses have a better chance to succeed, but more potential home-based businesses will decide to try. And that's better for America.

Health Insurance Deduction for the Self-Employed

S. 460 also addresses another major type of discrimination against home-based businesses and the self-employed. That's the health insurance deduction for the self-employed. The deduction is now on a ten year schedule; as it will gradually increase from the current level of 40 percent and eventually rise to 80 percent of the self-employed's health insurance premium costs.

The Tax Code further limits this health insurance deduction to the extent of the self-employed's earned income from his or her self-employment activity. Earned income is defined as net income from the activity minus one-half of the calculated self-employment tax and any self-employed retirement plan contributions. So if the earned income from the activity (as defined above) is a loss for the current year, no tax deduction will be allowed. Also, the deduction for health insurance is not taken into account when calculating the self-employment tax, so the benefit of this deduction is further reduced for the self-employed person.

All self-employed persons should be allowed a full 100 percent tax deduction for health insurance premiums. It is just not fair that nearly all corporate executives receive their health insurance free of charge, yet self-employed Americans must pay for their coverage and aren't even allowed to deduct the cost from their taxes. Tax fairness (i.e, a full 100 percent health insurance deduction for the self-employed) could sharply reduce the number of uninsured, because it would make health insurance more affordable.

S. 460 will result in better health insurance for the self-employed -- and it will result in more health insurance coverage for the children of millions of self-employed Americans. That's something to think about as Congress considers how to get more people working and more children insured.

Independent Contractors

The NASE supports the provision of S. 460 which dramatically simplifies the tax treatment of independent contractors. When it is necessary to determine whether a person is an employee or an independent contractor, tax accountants turn to the 20 common-law factors spelled out in IRS Revenue Ruling 87-41. The determination is then made based on whether or not there is sufficient control in the relationship to establish a common-law employer-employee relationship. The factors in the Revenue Ruling come with a warning from the IRS that they are just a guide. And the actual case law has shown that apparently identical situations have been decided in very opposite ways by the IRS and the courts when interpreting the 20 common-law factors. It would appear that the real emphasis of the determination by the IRS is to try to classify as many people as employees as possible.

There does exist a "safe harbor" test to provide some relief to businesses from IRS independent contractor audits. The test determines whether or not the employer had a "reasonable basis" for its treatment of persons as independent contractors. However, the first part of the test, judicial precedent or IRS rulings, won't work because of the various outcomes of many previous cases; the second part, a past IRS audit in which there was no assessment of employment taxes, won't work if this is the first audit; and the third part of the test, a long-standing industry practice of treating workers as independent contractors, won't stand in the IRS's way of trying to change that industry practice.

If I ask an independent contractor to do something specific for me, the IRS can come back and say that since I told the contractor what to do, the contractor was really an employee. And I would then be responsible for thousands of dollars in back taxes, penalties and interest. That's what makes the IRS' archaic and confusing 20 factor test so threatening. Almost any business relationship can be made to look like an employer-employee relationship, not to mention that the IRS has decided seemingly identical cases in opposite ways.

Over the last ten years, the IRS has collected more than three-quarters of a billion dollars in such cases -- from businesses that are probably the least able to pay. These rulings have bankrupted quite a few small businesses, and make it harder for freelancers to get assignments. The Home-Based Business Fairness Act would confer independent contractor status on workers who meet certain clear, specific tests, including factors like incorporation, having a written contract, using one's own office space (including home office space), etc.

Electronic Federal Tax Payment System

One problem many small businesses are facing is the IRS' new Electronic Federal Tax Payment System (EFTPS). Last year, Congress passed legislation to delay further extension of the EFTPS to any more businesses until July 1, 1997. The NASE vigorously lobbied for this legislation. Without passage of this EFTPS delay measure, most businesses with yearly payroll tax deposits of $50,000 or more would have been required to transmit their payroll tax deposits electronically.

Small businesses are worried about EFTPS. Many want the security of a paper receipt to prove they made a deposit just like what they are provided under the current paper coupon system. Others worry that EFTPS will have glitches -- not exactly an unfounded worry, given the IRS' recent history with Tax Systems Modernization and computers.

The NASE believes that the use of the unfamiliar EFTPS program over the coming months is likely to be fraught with inadvertent acts and mistakes. For this reason, the NASE commends Senator Nickles, Senate Finance Committee members, and Small Business Committee Chairman Bond for their strong support for an abatement by the IRS of the penalties associated with the next phase of the EFTPS program scheduled to begin on July 1, 1997. In this regard, the NASE further commends Acting Commissioner Michael P. Dolan for his announcement earlier this week regarding the IRS decision to abate the tax penalties under the EFTPS program until December 31, 1997.

Nevertheless, an even more desirable solution would be to make the EFTPS system voluntary

for small business as has been proposed by Senator Don Nickles.

Conclusion

The NASE thanks the Senate Finance Committee for holding this very important hearing on home-based businesses. The Committee clearly recognizes that home-based businesses offer benefits to the public as a whole. Such businesses mean fewer commuters and fewer cars on the road. That means less pollution, less energy consumption, and less money spent building and maintaining roads and bridges.

Above all, technology is pushing more and more self-employed persons in the direction of home-based businesses. With E-mail, the Internet, faxes, overnight mail, teleconferencing and the rest of it, there really is less and less reason to require large groups of people to work in close proximity to one another. It's a mystery - and very frustrating - to those of us with home offices why the Tax Code is trying to stop all these things from happening - instead of encouraging them.

My heartfelt gratitude goes out to the Senate Finance Committee for caring enough about home-based business people to look into the issues that effect us the hardest in trying to stay alive. We are not a passing phase. And we are becoming a stronger force to be reckoned with. Thank you for permitting me to testify on behalf of the membership of the National Association for the Self-Employed.

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS

TESTIMONY OF DEBORAH WALKER

SENATE TAXATION AND IRS OVERSIGHT SUBCOMMITTEE HEARING ON SMALL BUSINESS ISSUES

S. 460 THE HOME-BASED BUSINESS FAIRNESS ACT OF 1997

JUNE 5, 1997

AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
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INTRODUCTION

Good afternoon. My name is Deborah Walker. I am Immediate Past Chair of the American Institute of Certified Public Accountants (AICPA) Tax Executive Committee. The AICPA appreciates this opportunity to offer its comments on *S. 460, The Home-Based Business Fairness Act of 1997.* The AICPA is the national professional organization of CPAs, with over 331,000 members who advise clients on Federal, state and international tax matters as well as prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-size businesses, as well as America's major businesses, including multi-national corporations. Many serve businesses as employees. It is from this broad base of experience that we offer our comments on *S. 460.* We believe the bill will be well received among the many home-based businesses in our country.

HEALTH INSURANCE DEDUCTION FOR SELF-EMPLOYED

As an organization that values simpler approaches to tax legislation, we continue to support section 2 of *S. 460* that increases the health insurance deduction for self-employed individuals to 100% beginning in 1997. Simplification and equity will be achieved by eliminating the current phase-in rules (which currently allow only 40% of such costs to be deducted and do not reach an ultimate level of 80% until 2006) and treating self-employed business owners the same as their corporate competitors C corporations enjoy a full deduction for health insurance costs for all employees, including owner/employees. However, those who operate as proprietors, partners, or S corporation shareholders/employees, are penalized by allowing them only a partial deduction.

HOME OFFICE DEDUCTION

The AICPA also strongly supports the home office deduction provision of section 3 of *S. 460*, which would modify the U.S. Supreme Court *Soliman* decision (113 S.Ct. 701 (1993)), to recognize the changing working environment and lifestyles. By clarifying the definition of "principal place of business," the proposal allows a deduction for a home office used for essential administrative or management activities conducted on a regular and systematic basis, where no other office space is provided for such activities.

The *Soliman* decision curtailed deductions for legitimate home office business expenses relating to the home office for many taxpayers -- particularly those who have no other office provided or otherwise available to them. It penalizes home-based businesses solely because they operate from their homes rather than from a store front, industrial park, or office building, even though these businesses may be practically the same. Since the *Soliman* decision, IRS rulings (Rev. Rul. 94-24 and Rev. Rul. 94-47), have further restricted the deductibility of home office expenses, as well as related travel expenses.

Technological advances have made a fixed office location less important or, in many cases, unnecessary. Even the Internal Revenue Service has encouraged many employees to work out of

alternative offices. These advances have also alleviated the need for hiring many support personnel and for coming in personal contact with colleagues on a daily basis. As a result, many taxpayers have found it advantageous to work from their homes. Home offices are utilized by sole proprietors, and owners of small businesses operating in partnership and corporate form. In addition, many businesses have found it necessary to promote flexible and alternative work schedules for their employees, to better balance work and family priorities. As a result, many of these employees utilize a separate area of their homes for business needs.

We support this bill because it provides standards that reflect the realities of the business world today and reestablishes the original intent of the home office deduction. It recognizes that essential administrative and management activities, such as bookkeeping and billing, are legitimate and essential uses of business time and office space and provides a corresponding home office deduction for that use.

INDEPENDENT CONTRACTORS

Finding a solution to the confusing worker classification rules has been, for years, a priority for many organizations involved or interested in tax administration. The traditional focus of those efforts has been on solving the business problem of retroactive reclassification of independent contractors to employee status. More recently, there has been an acknowledgment of a reciprocal issue of the possible coercion of employees into an independent contractor status. Indeed, in 1996, the AICPA developed an independent contractor legislative proposal that, in our view, balances the businesses' need for protection from retroactive worker status reclassification with protection of workers from coerced adoption of an independent contractor status.

The AICPA believes that the independent contractor clarification provisions in section 4 of *S. 460* are an improvement over both an earlier version of the bill (which was used as the starting point for the AICPA-designed legislative safe harbor) and existing law. However, we recommend two changes to the new bill:

1. The bill contains an alternative safe harbor to the economic and workplace independence tests. The safe harbor can be met if the worker conducts business through a corporation or an LLC. This safe harbor should be dropped from the bill since it is relatively simple for an employer to coerce an employee to become an independent contractor by offering to undertake incorporation procedures for the less sophisticated worker.

2. While the bill requires the existence of a written contract, most of the AICPA recommended detail has been eliminated. The details should be restored. The written contract should include the following:

   - a description of the services to be provided and the duration of the agreement;

- the remuneration to be paid by the service recipient or the payor to the service provider;
- acknowledgment that the service provider is responsible for his or her own Federal and state income taxes, including self employment taxes and any other taxes;
- acknowledgment that the service recipient or the payor will not provide the service provider with fringe benefits;
- acknowledgment that the service provider has complied with applicable business licensing requirements;
- acknowledgment that the service provider has, or will maintain appropriate books and records;
- acknowledgment that the service provider is free to perform similar services for others;
- a representation that the above factors have been met; and
- acknowledgment that the service provider will not be treated as an employee with respect to such services.

The AICPA recognizes that in today's environment, some companies will do business with an independent contractor only if it operates in corporate form and that such a requirement does seem to provide a measure of protection from reclassification. However, the AICPA believes that removing that type of relationship from any potential for IRS scrutiny will place workers at higher risk. The AICPA believes that the addition of detailed written document requirements is necessary to ensue a bilaterally fair independent contractor relationship, which may or may not be achieved by the use of an agreement containing only a few generalized sentences.

CONCLUSION

The AICPA appreciates the opportunity to testify on *S. 460*. We commend you for your advocacy on behalf of small business and look forward to working with you on these issues in the future. I would be glad to respond to any questions you may have.

COMMUNICATIONS

STATEMENT OF THE AMERICAN GUILD OF MUSICAL ARTISTS

Dear Mr. Chairman:

On behalf of the over 5,000 classical performing artists across the United States who are members of the American Guild of Musical Artists (AGMA), I am writing to voice our opposition to proposed changes in worker classification laws now being considered by the Senate in bills S. 473 and S. 460. While these proposed changes are being touted as a much-needed simplification of existing law, they will, if enacted, cause great hardship and distress for many performing artists who may be reclassified as independent contractors, thus losing important rights and benefits they are entitled to under current law.

AGMA represents opera and concert singers, ballet and modern dancers, and staging staff in opera and dance companies. While each workplace is likely to be affected, the impact of this proposed legislation is perhaps most clearly demonstrated in considering its effect on over 1,200 AGMA solo singers and staging personnel.

AGMA solo singers and staging personnel work for many employers of varying size, from small summer festivals, to regional opera companies, to the Metropolitan, Chicago Lyric, and the San Francisco Operas. A typical contract may cover two to six weeks of rehearsals and six or fewer performances. Consequently, many of these artists work for six or more employers each year. It is also common for solo singers and staging personnel, like many other members of AGMA and other performing arts unions, to fashion a yearly career from short-term employment relationships in order to develop their skills and reputation.

In response to our artists' need for health insurance coverage, AGMA has recently expanded our Health Plan to accept pro-rated contributions by individual employers. Before this plan was enacted, many AGMA artists would almost never have sufficient tenure with an individual company to qualify for an in-house health plan. Now, the

combined contributions of many employers under the new plan provide them with an equivalent option for provision of health benefits.

By facilitating the reclassification of our artists as independent contractors -- thus denying them the benefits of union membership -- passage of S. 473 and S. 460 would end this long-needed health insurance solution. This loss, and other financial hardships stemming from the loss of unemployment insurance, the employer shares of Medicare and Social Security taxes, and pension contributions, would not only directly affect the health and well-being of AGMA members and their families, but also seriously compromise the ability of American artists to pursue careers in this very demanding profession.

The proposed worker classification changes, if enacted, will increase the cost of our members' nurturing of their talents, and this increased cost will further disadvantage American soloists and staging personnel vis-à-vis their foreign counterparts, who are protected by single-payer systems provided by their home countries. A likely result of the Senate bills is a reduction in opportunities at home for American artists seeking to emerge on the international circuit.

Thus S. 473 and S. 460 not only compromise the survival of our artists and their families, they also threaten the international reputation of the United States in the classical performing arts. At a time when members of our House of Representatives are considering a total phase-out of the National Endowment for the Arts, an event which would also devastate key career-development opportunities for American artists, passage of the worker classification portion of S. 473 and S. 460 is clearly something our artists, our audiences, and our nation cannot afford.

I therefore urge you to fight against passage of these bills and any other such efforts which would compromise access to existing protections of employee status.

Sincerely,

Michael Byars
1st Vice President, AGMA
Soloist, New York City Ballet

cc: The Honorable Daniel P. Moynihan
Senate Finance Committee members

Statement of Eileen M. Willenborg
Executive Director of the Chicago AFTRA Local
June 18, 1997

On behalf of the 3,000 members of the Chicago Local of the American Federation of Television and Radio Artist, AFL-CIO (AFTRA), I wish to express our opposition, in the strongest possible terms, to the independent contractor legislation (S. 460 and S. 473) that is currently before the U.S. Senate Committee on Finance. This anti-worker legislation would harm AFTRA members by expanding the definition of "independent contractor" in the tax code, thereby allowing businesses to classify many AFTRA-represented performers and broadcasters as independent contractors. These workers are clearly employees by any common sense – or common law – definition, and the attempt to take away their legal status as employees for the purposes of tax law is unacceptable. We urge you to oppose this attempt to weaken the rights of workers.

For many broadcasters and freelance performers, the expansion of the definition of independent contractor will mean the loss of their health care coverage and pension benefits. Furthermore, these reclassified employees will have to pay the employer share of the Social Security and Medicare tax over and above their individual contributions, and they will lose state workers' compensation and unemployment insurance benefits. Finally, because many employers use the tax code definition of employee for all purposes – i.e. to interpret federal and state labor laws – if this legislation becomes law, these workers may no longer receive overtime compensation and minimum wage guarantees as well as protection against discrimination based on age, race, sex, age, ethnicity, religion, and disability.

The claim that this legislation is necessary for small businesses to be competitive is not new and remains unpersuasive. This argument has been used to fight increases in the minimum wage and other worker protections. This legislation would apply to businesses of all sizes, not just small businesses. The fact is that workers in the United States absolutely deserve some basic rights on the job. The passage of this legislation would erode those already minimal protections and allow employers to increase profits at the expense of workers.

We understand that this anti-worker legislation may be attached to a tax reconciliation bill. Considering the broad implications of this legislation, it needs to be voted on as independent, stand-alone legislation, and not folded into a tax reconciliation bill.

Again, we urge you to vote no on this expansion of the independent contractor definition.

97-10

SUBMITTED STATEMENT OF THE AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS TO THE SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT OF THE SENATE COMMITTEE ON FINANCE ON S. 460 AND S. 473

June 5, 1997

Introduction

The American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) appreciates this opportunity to present its views on S. 473 and Section 4 of S. 460 and the principles that should guide any legislative effort to clarify the distinction between an "employee" and an "independent contractor" for federal tax purposes. The AFL-CIO approaches this issue from a longstanding conviction that the tax laws' current treatment of employee classification is untenably imprecise and subject to manipulation; and that the influence tax code principles often exert on federal employment law statutes warrants considerable care in any legislative response.

S. 473 and Section 4 of S. 460 would harm workers and their families by expanding the circumstances under which employers can classify their employees as independent contractors. Such newly legitimated reclassification would enable employers to escape their current obligations under the tax and employment laws with consequences adverse to the economic well-being and security of the workers whose status they alter.

I. Classification Choices Entail Significant Consequences for Workers Under Federal Tax and Employment Statutes

For purposes of both the Internal Revenue Code and other statutes that regulate workplace relations, important legal and practical consequences depend upon whether jobholders are defined as employees or independent contractors. The minimal changes such reclassifications bring in the actual, day-to-day relationships between enterprises and job performers sharply contrasts with the radically different treatment accorded them by the tax code and federal employee protection laws. In most respects these laws make it cheaper and administratively simpler for enterprises to classify employees as independent contractors. These are powerful incentives that more and more employers choose not to resist. Unfortunately, the expense resulting from this definitional sleight of hand is borne by the workers and their families in the form of higher costs, economic insecurity and foregone benefits and legal protections, and by the U.S. Treasury in the form of lost revenue. And, businesses that treat their workers fairly, in compliance with the tax laws, are placed at a competitive disadvantage in relation to unscrupulous employers that misclassify their employees.

Under the tax laws, the independent contractor-employee distinction governs whether enterprises must withhold income tax, withhold and pay Social Security and Medicare contributions, and pay federal and state unemployment taxes: businesses must do so for employees, but not for independent contractors. Independent contractors, but not employees, are fully responsible for the calculation and payment of federal income tax and Social Security and Medicare contributions, and they may deduct from their income certain business expenses not available to employees -- all burdens not easily carried, particularly by misclassified workers who are not skilled or professional persons. Three years ago the bipartisan Commission on the Future of Worker-Management Relations (the "Dunlop Commission") succinctly summarized the consequences of misclassification:

> The employer will not have to make contributions to Social Security, unemployment insurance, workers' compensation, and health insurance, will save the administrative expense of withholding, and will be relieved of responsibility to the worker under labor and employment laws. The worker will lose the protection of those laws and benefits and the employer's contribution to Social Security, but may accept the arrangement nonetheless because it gives him or her an opportunity for immediate and even illegitimate financial gains through underpayment of taxes. Many low-wage workers have no practical choice in the matter.[1]

Classification of employees as independent contractors effectively repeals their coverage by national employee protection laws. Virtually all federal statutes that protect workers -- including the Fair Labor Standards Act, the Occupational Safety and Health Act, the Civil Rights Act, the Americans with Disabilities Act, the National Labor Relations Act, and many more -- protect employees, not independent contractors. State laws that provide additional workplace protections, such as workers' compensation statutes, also usually apply only to the employer-employee relationship. And, the same is true under other worker protection statutory arrangements where federal and state law complement each other, such as unemployment insurance laws. In short, the employee-independent contractor distinction can make all the difference to those performing the work.

The stakes here are also great for the availability of employee benefits essential to the health and economic security of workers and their families. At a time when the Health Insurance Portability and Accountability Act of 1996 is taking effect, and Republicans and Democrats alike are promoting other bills to assure health care and pension coverage to more Americans, misclassification remains one of the most potent practices that undermine those critical needs. Indeed, many employers have amended their employee benefit plans in order to explicitly

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[1] Commission on the Future of Worker-Management Relations, "Report and Recommendations" 36 (December 1994).

exclude independent contractors from coverage.[2] They have don so because health and life insurance and pension plans are customarily provided by employers, if at all, only to employees, and when employers reclassify their employees as independent contractors these coverages ordinarily terminate. These workers must then finance such coverage themselves usually with no increase in actual take-home pay; but this is often an impossible task due to expense, complexity or both. The resulting social costs fall heavily on these workers, their families and society.

II. Misclassification of Workers Affects All Employment Sectors

During the past two decades there has been a fundamental evolution in the relationships between enterprises for which services are performed -- that is, "employers" in a broad and non-statutory-specific sense -- on the one hand, and those who provide these services -- "employees," again in a broad and non-statutory-specific sense -- on the other hand. Part-time, temporary, contractual and other "contingent" jobs have exploded in number. Many of these positions did not exist 20 years ago; but an overwhelming number are simply new arrangements for the same work that both the law and common sense ordinarily considered to be performed in the relation of employer and employee.

Increasingly, workers are classified by businesses as independent contractors.[3] There are now construction industry companies that treat every one of the craftpersons who perform work for them as an independent contractor; taxi companies that "discharge" all their drivers and then require that they lease their cabs for a week at a time if they wish to continue to work, now as independent contractors; telephone companies that "lay off" service and other personnel and then contract for their services as "consultants," again with independent contractor status; and even agricultural employers that call the migrant farmworkers who pick their produce independent contractors, despite the fact that these workers are as completely dependent upon these employers for their livelihoods as they were when they were "employees." Indeed, *The New York Times* recently reported that as many as one-fifth of contract workers formerly were employees of the businesses for whom they now perform services.[4]

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[2] Jeffrey Green, "Are Independent Contractors Eligible for Employee Plans?" New York Law Journal (February 18, 1997).

[3] Commission on the Future of Worker-Management Relations, "Fact Finding Report" 93-94 (May 1994).

[4] "More Downsized Workers Are Returning as Rentals," *The New York Times* (December 8, 1996).

Some examples of misclassification drawn from different sectors of the economy illuminate these abuses. By adding new opportunities for businesses to classify their workers as non-employees, S. 473 and Section 4 of S. 460 would further entrench those abuses and expand their scope.

A. Misclassification of Construction Industry Employees

Misclassification of workers as independent contractors instead of employees is especially rampant in the construction industry, where improper classification not only results in contractors' evasion of employment tax duties but also frequently produces violations of overtime and prevailing wage requirements. Investigations around the country have found that misclassification is flagrant and on the rise; the IRS estimates that roughly 20% of construction industry employers nationwide misclassify workers.

In one recent example, a New York drywall contractor hired seven drywall workers for a public construction project. The workers were directly supervised by the contractor. Although the terms of their employment made it clear that they were employees, the contractor nevertheless advised the workers that it would report their earnings on 1099s rather than W-2s. In addition, the contractor paid the workers less than required under the state's prevailing wage law. When a New York State Department of Labor inspector conducted a surprise inspection, the contractor directed the workers to "disappear," and later offered one $5,000 to claim -- falsely -- that he, and not the contractor, was the employer of the other workers. The workers filed complaints and supporting affidavits with the IRS and the state Department of Labor. The IRS matter is still pending, but the workers have already received backpay for the contractor's violation of the state's prevailing wage law.

B. Misclassification of Low Paid Service Workers

The economic dependence of low paid service workers makes them especially vulnerable to employee misclassification. Sometimes these misclassifications reflect elaborate schemes designed to imbue workers with the technical trappings of independent contractor status, such as written contracts and franchise fees, despite the reality of their "employee" relationship. These misclassifications not only perpetuate service workers' low earnings and limited benefits but also interfere with their ability to assert and protect their rights under state and federal labor laws.

For example, a large Seattle cleaning service contractor used an elaborate misclassification ruse to secure a city cleaning contract. After coming in with the low bid, the contractor "leased" franchises to janitors, who paid $4,000 to $7,000 for the opportunity to clean a floor. Most of the "franchisees" were working poor Central American and Asian immigrants. Notwithstanding a clear employment relationship, the contractor disclaimed any responsibility for complying with state and federal tax and worker protection requirements, including minimum wage and overtime laws, on the basis that the janitors were contractors and not employees.

C. Misclassification of Farm Laborers and Garment and Other "Piece Rate" Workers

Farm laborers and other workers whose pay is determined, in whole or in part, on a piece rate basis are frequent victims of employee misclassification. For example:

- Two years ago, Texas A & M University, which operates 18 agricultural extension programs throughout the state, admitted that it had misclassified around 400 farm laborers over a three-year period. The farm workers, who were paid slightly more than the minimum wage to hoe and harvest crops, functioned as employees but were classified as independent contractors. Because their wages were so low, paying the entire Social Security contribution -- as independent contractors must -- would have reduced their hourly earnings below the minimum wage. The misclassification came to light when laborer Berene Merideo sought legal assistance after she was denied unemployment benefits and received notice from the IRS that she owed back taxes and penalties. Texas A & M agreed to change its classification practices and pay $83,000 in back taxes, plus monetary damages to the farm workers.

- According to operators of past and present garment manufacturing plants in the Dallas area, the legitimate garment manufacturing industry there has been decimated by the proliferation of "sewing contractors," companies that subcontract work to "home sewers." One former plant operator has estimated there are several hundred such contractors in the area, farming out work to 40,000 to 50,000 home sewers. Legitimate plant operators that classify and treat their workers as employees are undercut by competition from these sewing contractors, who treat their workers as independent contractors. This competition has driven a number of plants out of business or into bankruptcy and forced others to reduce their work forces.

- Last fall, the U. S. Department of Labor found that 134 workers employed by RP Coatings Corp. of Cuyahoga Heights, Ohio to assemble screws and washers in their homes were improperly treated as independent contractors. Paid on a piece rate basis, some affected workers received as little as $1.50 per hour. The company's minimum wage liability resulting from its misclassification came to $130,000 in back pay and penalties.

D. Misclassification of Professional and Technical Employees

Misclassification is also prevalent among professional and technical employees, and the incidence is likely to rise as newly downsized companies increasingly turn to former employees to meet their labor needs. For example:

- Computer specialist Jimmie Ruth Daughtrey of Atlanta, Georgia was laid off by Honeywell, Inc., after eight years with the company. Younger co-workers who had not acquired a vested right to a pension were retained. Ms. Daughtrey was later hired back as an independent contractor, performing the same duties, on the same schedule and in the same location as during her employment. As a contractor, however, she received no health or pension benefits. After her contract was terminated, Ms. Daughtrey sued Honeywell, and five years later she received a favorable settlement. Ms. Daughtrey's experience is far from unique. Today, hundreds of former employees of Pacific Bell are suing the company for alleged breach of job-guarantee agreements. Some, like plaintiff Linda Corbett, were "downsized" out of jobs they held for years, only to be invited back as independent contractors with no benefits.

- Kristina Rebelo was terminated after working for eight years as a full-time contract writer for *Sports Illustrated*, a subsidiary of *Time, Inc.* During her tenure, Ms. Rebelo had no other clients and regularly reported to *SI*. Though Ms. Rebelo reported her earnings as an independent contractor, the IRS concluded she was, in fact, an employee and assessed her $10,000 in back tax liabilities. Overall, *Time, Inc.* employs about 5,000 employees and 1,000 contract workers in New York alone. One former manager estimates that as many as ten percent of the contract workers are really employees.

Current litigation involving Microsoft Corporation, the world's largest software company and one of our nation's most celebrated and fastest-growing businesses, demonstrates how misclassification has penetrated the new technology products industry, and how IRS classification of workers can influence the application of employment laws.

Microsoft employed a regular core permanent staff along with a complement of "freelance" software testers, production editors, proofreaders, formatters and indexers. They worked on teams with the regular employees, shared the same supervisors, performed the same functions, worked the same hours, and received office equipment and supplies from Microsoft. However, they wore badges of a different color, had different e-mail addresses, were afforded a different orientation, could not assign work to others, were not paid overtime, and were paid through accounts receivable rather than by regular payroll. All had signed "independent contractor" and non-disclosure agreements, which stated that they would not be paid benefits. Some of these arrangements lasted for years.

In 1989 and 1990, the IRS examined Microsoft's employment records and determined that these "freelancers" were, in fact, employees for purposes of withholding income tax and Social Security and Medicare contributions. Microsoft responded by converting some to regular employee status, but gave others only the options of either severing their employment entirely or continuing as employees of a temporary employment agency. Those who chose "temporary" status continued to work the same hours on the same projects under the same supervisors.

The freelancers then sued Microsoft under the federal Employee Retirement Income Security Act (ERISA) and state law for retroactive 401(k) plan and stock-option benefits coverage. Microsoft argued that they were independent contractors not entitled to such coverage, but the United States Court of Appeals for the Ninth Circuit, relying on the IRS determination, disagreed. Its decision begins with this apt observation: "Large corporations have increasingly adopted the practice of hiring temporary employees or independent contractors as a means of avoiding payment of employee benefits, and thereby increasing their profits." Vizcaino v. Microsoft Corp., 97 F. 3d 1187, 1189 (1996).

The full Ninth Circuit has since decided to rehear this case, so the final chapter hasn't been written for the Microsoft freelancers. But their situation reflects what is befalling more and more workers, and how technological and computer industry work may be particularly susceptible to misclassification.

III. Worker Misclassification Causes a Substantial Loss of Government Revenue

The adverse impact of erroneous and intentional misclassification of employees as independent contractors on revenue collection and tax code administration is also severe. In 1990 the House Government Operations Committee issued a report estimating that the misclassification of workers under the federal tax laws results in annual revenue losses in the billions of dollars.[5] Meanwhile, from 1979 to 1994 the number of annual IRS audits of employment tax returns declined by 38%.

An earlier IRS study in 1984 focusing on employee misclassification determined that nearly 15% of employers misclassified employees as independent contractors.[6] The IRS survey found that when employers classified workers as employees, the employers reported more than 99% of their wage and salary income, but when they classified workers as independent contractors, only 77% of gross income was reported, and only 29% was reported when the appropriate IRS form (Form 1099) was not filed. The IRS estimated a net loss to the federal treasury of $1.6 billion from misclassification for that year alone.

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[5] House Committee on Government Operations, "Tax Administration Problems Involving Independent Contractors," H.R. Rep. No. 101-979, 101st Cong., 2d Sess. (1990). This report in turn was based on three studies by the General Accounting Office.

[6] Internal Revenue Service, "Strategic Initiative on Withholding Non-Compliance (SVC-1) Employer Survey Report of Findings" (June 1989).

More recently, in 1994, a private study by the accounting firm Coopers & Lybrand projected that the proper classification of workers misclassified under current law would raise $29.9 billion over nine years; and that the reclassification as employees who remain misclassified under the various "safe harbor" provisions under current tax laws (which we discuss below) would raise $4.9 billion over the same period.[7]

IV. The Bills Under Consideration: S. 460, "Home-Based Business Fairness Act of 1977," and S. 473, "Independent Contractor Tax Reform Act of 1997"

We address our comments to S. 473, and the identical portion -- Section 4 -- of S. 460. These bills would effectuate four changes in the tax law to expand the ability of employers to establish that their work relationships are with independent contractors rather than employees.

First, these bills would provide new alternatives for employers to qualify for independent contractor treatment while preserving the inadequate current tax law provisions that already provide excessive opportunities for employer to reclassify or misclassify.

Second, these bills would bar the IRS from pursuing back taxes and other remedies for misclassification if the non-complying employer satisfies certain documentation requirements and "reasonab[ly]" and in "good faith" failed to comply with the law.

Third, for purposes of deciding under either the current or the new standards whether there is independent contractor status, the bills would eliminate from the IRS's analysis consideration of any other statutory or regulatory requirement that dictates an aspect of the work relationship.

Fourth, the bills would extend the employer misclassification "safe harbors" in current law to employers of engineers, computer programmers and similar workers.

A. The New "Safe Harbor"

S. 473 and Section 4 of S. 460 would afford employers a new so-called "safe harbor" to classify or reclassify their workers as independent contractors. Understanding the impact of this proposal requires consideration of what the tax law currently provides.

Almost 20 years ago, Section 530(b) of the Revenue Act of 1978, P.L. 95-600, precluded the Department of the Treasury (including the Internal Revenue Service) from issuing regulations or revenue rulings regarding the "employment status of any individual for purposes of the

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[7] Coopers & Lybrand, Projection of Loss in Federal Tax Revenues Due to Misclassification of Workers: June 1994.

employment tax" governed by the Internal Revenue Code until Congress enacts a statute clarifying that status. Section 530 was enacted as a one-year, temporary measure while Congress devised a permanent solution to the employee-independent contractor issue. Instead, Congress has failed to achieve one, and Section 530 since has been extended indefinitely. So, for 19 years now this unwise legislative restraint has tied the government's hands in providing guidance to taxpayers other than by private letter rulings that lack precedential force.

The practical effect of Section 530(b) has been to maintain the IRS's reliance on the so-called "20-factor test" set forth in Revenue Ruling 87-41, 1987-1 C.B. 296, which lists 20 factors the IRS must consider in making the employee-independent contractor finding in any particular situation. This test assigns no relative weight among these factors.

Another provision of Section 530 affords a so-called "safe harbor" to employers by permitting them to treat a worker as an independent contractor for employment tax (but not income tax) purposes regardless of the person's actual status under the 20-factor test due to the mere happenstance that the employer had consistently treated the individual as an independent contractor for tax purposes, unless the employer "had no reasonable basis for not treating such individual as an employee." Section 530(a)(1). In order to satisfy this standard, Section 530 permits the employer to continue treating an individual as an independent contractor so long as it relied on judicial precedent, published rulings or IRS advice; underwent an IRS audit that resulted in no employment tax assessment for similarly situated individuals; there is a longstanding recognized practice of such classification in the employer's industry; or there exists some reasonable basis. Last year, Section 1122 of the Small Business Job Protection Act amended Section 530, in most respects by making its safe harbors even easier to satisfy.

We highlight this legal backdrop because S. 473 and Section 4 of S. 460 would not improve, change or replace either the 20-factor analysis or Section 530; rather, these bills would establish additional opportunities for employers to lawfully classify their workers as independent contractors. And, as we now describe, many employers would encounter little difficulty in taking advantage of them, to the detriment of the workers who otherwise could be classified only as employees.

These bills would add a new Section 3511 to the Internal Revenue Code, containing a new, three-part test for defining a worker as an independent contractor.

Under proposed Section 3511(d), the test would first require a "written contract" between the worker (the "service provider" in the parlance of the bill) and the employer (the "service recipient") that "provides that the service provider will not be treated as an employee . . . for federal tax purposes." Such a requirement could be met easily where classification abuse occurs, since the inequality of bargaining power between employer and worker would render this a

matter largely of form rather than substance. Also, this requirement would hardly provide useful notice to employees of the employer's treatment of them; most workers already understand the basic difference between paychecks that are subject to federal and state mandated withholdings and those that are paid in lump sum without them.

The second part of the test would be composed of two alternative groupings of indicia; an employer would have to satisfy either of them.

The first alternative, set forth at Section 3511(b), would require that the worker have "the ability to realize a profit or loss"; incur unreimbursed expenses amounting to at least 2% of his or her adjusted gross income attributable to the services at issue; and "agree[ ] to perform services for a particular amount of time or complete a specific result or task."

The opportunity for profit and the risk of loss are certainly essential components of any meaningful standard of independent contractor status. We also support the inclusion of an unreimbursed expenses requirement, but we are concerned that the precise mathematical formulation here would not embrace many workers who ought to be treated as independent contractors. The third requirement, however, describes arrangements that routinely characterize employer-employee relationships; it has no real value, then, in identifying who is an independent contractor.

The first alternative also requires employers to satisfy any one of four other indicia, set forth at Section 3511(c): namely, that the service provider (a) have a "principal place of business"; (b) not "primarily provide" services at a single service recipient's facilities; (c) pay a "fair market rent" for the use of such facilities; or (d) primarily use equipment that the service recipient does not provide. An unscrupulous employer will have no trouble satisfying one of these factors.

The second alternative grouping of indicia, set forth at proposed Section 3511(e), would require only that the worker conduct his or her business as a "properly constituted corporation or limited liability company" under state law, and that the worker receive no benefits from the service recipient that the latter provides to its "employees." But these requirements would be simple to meet: incorporation is easy to do in virtually all jurisdictions, and the denial of benefits is, after all, one of the employer's goals in classifying a worker as an independent contractor.

The third and final part of the test, set forth at Section 3511(f)(1), would require the service recipient (or any third party "payor") to file employment tax forms with the IRS consistent with independent contractor status, or fail to do so with "reasonable cause" and not due to "willful neglect." Like the first part of the test, this requirement consists only of a formality, and a half-hearted one at that.

Another aspect of S. 473 and Section 4 of S. 460 further waters down any rigor that might be read into the standards these bills would establish. For example, Section 3511(f)(2) would

impose the burden of proof on the IRS to prove employee status so long as the service provider, service recipient or payor "establishes a prima facie case that it was reasonable not to treat a service provider as an employee" and "has fully cooperated with reasonable requests" from the IRS. This provision is identical to Section 530(e), which was added by Section 1122 of the Small Business Job Protection Act of 1996. Like Section 530(e), proposed Section 3511(f)(2) would unjustifiably excuse law compliance if the taxpayor "reasonably" failed to obey the law -- a concept that is alien to most other statutory civil law. Congress should curtail, not expand, this approach to law enforcement. And, with respect to the "reasonable requests" in Section 3511(f)(2), although the bill's sponsors explain that this refers to IRS information requests the statutory language reflects no such limitation.

B. Precluding the IRS From Assessing Back Tax Liability

Section 3511(g) would bar the IRS from assessing back taxes and other liabilities for misclassification under all circumstances so long as the taxpayor filed the proper form (unless excused for "reasonable cause," though not if due to "willful neglect"); entered into a "written contract" specifying independent contractor status; and acted in "good faith" with a "reasonable basis" for its misclassification. This is a particularly distasteful proposal. It would apply to all misclassification, and further absolve employers of their obligation to comply with civil tax laws through the notion of "reasonable" lawbreaking. Such indulgence certainly protects the interests of employers, but it denies remedies to the employees who are the victims of misclassification.

C. Limiting the Scope of IRS Analysis

Section 2(b) of S. 473, and Section 4(b) of S. 460, direct that "compliance with statutory or regulatory standards shall not be treated as evidence of control" by the employer/service recipient in determining employee status. This provision draws an artificial distinction and lacks principled justification. All aspects of the actual work and authority relationships on the job ought to be relevant to the determination of whether a worker is an employee or an independent contractor. Regardless whether on-the-job behavior and relationships arise because a legal standard requires them or because an employer chooses to comply with a legal standard in a particular manner, those workplace practices are just as real as any others. Excluding law-prompted conduct from consideration is wholly arbitrary, unrealistic and certain to produce absurd results.

D. Repealing the Exemption from Section 530(d) for Certain Skilled Workers

Finally, Section 2(c) of S. 473, and Section 4(c) of S. 460, would repeal Section 530(d)'s exemption from Section 530 of engineers, designers, drafters, computer programmers, systems analysts and other similarly skilled workers. These workers were exempted by Section 1706 of the Tax Reform Act of 1986 because misclassification of them was particularly rampant. The

proponents of repeal say that misclassification is now a relatively rare problem among such workers. We do not believe there is conclusive data to support that proposition -- and the Microsoft case provides a sobering cautionary that bears directly on this issue.

V. Principles to Guide a Legislative Solution

Because the federal tax code so potently influences how employers structure their business operations and their relationships with those who provide services to them, the AFL-CIO believes that only legislative action can fix the misclassification mess. But the appropriate action would have little in common with the bills now under consideration.

Since the Supreme Court's decision in Nationwide Mutual Insurance Company v. Darden, 503 U.S. 318 (1992), the common law distinction between employee and independent contractor has been understood to apply under every federal statute that uses the term "employ" (or a variation of it) without defining this term. But pressing this common law distinction into such broad statutory service has failed for several reasons.

First, the common law distinction was developed primarily to determine the circumstances in which a business would be held vicariously liable for injuries caused by individuals performing work on its behalf. Consistent with that purpose, the common law test turns principally upon factors relevant to an enterprise's ability to direct or control the individual performing services for it. But as Judge Frank Easterbrook of the United States Court of Appeals for the Seventh Circuit has noted, while this emphasis upon direction and control makes sense in the vicarious liability context, it should not necessarily govern elsewhere. Secretary of Labor v. Lauritzen, 835 F.2d 1539, 1544 (7th Cir. 1987) (concurring opinion).

As Judge Easterbrook observed, where the question is "who is answerable for a wrong (and therefore, indirectly, to determine who must take care to prevent injuries)," the emphasis on direction and control is appropriate because that approach focuses upon "[who] is in the best position to determine what care is appropriate, to take that care, or to spread the risk of loss." But "[t]he reasons for blocking vicarious liability at a particular point [may] have nothing to do with the functions of" the various federal statutory schemes into which the common law concept has been incorporated. Id.

For example, the federal income tax withholding and Social Security and Medicare contribution schemes are primarily concerned with collecting revenue due to the government. While so-called "independent contractors" are themselves liable for paying these taxes -- but not federal or state unemployment taxes -- the practical consequence of creating incentives for businesses to treat workers as "independent contractors" and placing a compliance obligation on individuals who are not well-equipped to shoulder that burden is to drive more and more of these individuals into the underground economy, and to make it more and more difficult for the government to ascertain compliance with the tax laws. It is surely relevant, in devising and administering a federal tax collection enforcement scheme, that businesses ordinarily can easier

undertake to withhold various taxes than can individual workers. Fairly defining work relationships in a manner that enhances reporting and collection of taxes lessens the likelihood of taxpayer compliance problems and removes opportunities for out-and-out evasion of tax obligations. The common law, tort-oriented approach to this issue, of course, takes none of these considerations into account.

Second, in spelling out the common law distinction, the courts and agencies have tended toward standards that are both complex and subjective. For example, the IRS's own 20-factor test, which is expressly derived from the common law, ranges from how the worker is trained to how the worker is paid to whether the worker works on or off the business's premises. In any given situation these factors will almost always pull in more than one direction, although most of the factors are certainly relevant to ascertaining the actual nature of an employment relationship. And, because the analysis assigns no weight to any factor and lacks a unifying theme or principle, its application is highly subjective and uncertain.

The IRS standard also lends itself to manipulation by businesses seeking to minimize their tax burden. A business can set up its relationship with its workers so as to meet a substantial number of the criteria for independent contractor status -- by altering, for example, the mode of pay, work hours or degree of direct supervision of job performance -- and it can do so without varying the underlying realities of entrepreneurial control, capital investment and economic dependence.

In light of both the grave problems with the current criteria for determining employee status and the broad-ranging impact of the misclassification problem, the AFL-CIO believes that Congress should abandon the current, common law-based test for distinguishing "employee" from "independent contractor" status for determining tax obligations and, indeed, for all purposes unrelated to the tort liability analysis function for which that test was created. At the very least, Congress must adopt a simpler and more consistent approach than the 20-factor test. The AFL-CIO agrees with the conclusion of the 1995 White House Conference on Small Business that "realistic and consistent guidelines" must govern the employee-independent contractor issue.

In the AFL-CIO's view, any statutory definition should contain a presumption in favor of a determination that a work relationship is that of employer and employee unless the worker's status satisfies a relatively rigorous definition of independent contractor status. Although we are not prepared now to propose an alternative formula, the Fair Labor Standards Act and the states' workers' compensation experience suggest the proper direction.

The ultimate question to be answered under such standards would be whether the job performer is a discrete, economically independent enterprise, or a subordinate provider of services operating within and dependent upon another's enterprise. A standard directed toward

this end would stress factors such as opportunity for profit and loss; investment in office equipment and materials; exclusivity of the worker's relationship with the service recipient; the worker's liability for task completion; and whether the services rendered are core functions of the business.

Conclusion

Because the reclassification of workers from employees to independent contractors often results in less cost to the employer, the existence of loose and manipulable standards provides a potent temptation to employers to gain a competitive advantage by going the independent contractor route, while punishing employers who in good faith act in accordance with ordinary and responsible norms by classifying those they employ as the employees they are. Because S. 473 and Section 4 of S. 460 would only exacerbate rather than correct the deeply flawed treatment of the employee-independent contractor distinction under the Internal Revenue Code, the AFL-CIO opposes their enactment.

The AFL-CIO instead favors a legislative effort to rectify those flaws. Because so much is at stake in any legislative solution, we urge that Congress approach this matter with considerable deliberation and a clear understanding of the practical consequences that will ensue in the workplace and in judicial treatment of the employee-independent contractor distinction under employee protection laws. For all these reasons we also urge that any legislation -- including the bills now under consideration -- that treats these issues be presented and subjected to a vote on its own merits, and not simply attached to greater and unrelated legislation, such as a reconciliation bill, that the Congress might feel constrained to pass regardless of what subsidiary legislation adorns it.

STATEMENT OF ARTHUR A. COIA

GENERAL PRESIDENT, THE LABORERS' INTERNATIONAL

UNION OF NORTH AMERICA

TO THE

U.S. SENATE FINANCE SUBCOMMITTEE ON TAXATION AND IRS OVERSIGHT

ON

S. 473 and S. 460, INDEPENDENT CONTRACTORS

June 4, 1997

As General President of the Laborers' International Union of North America (LIUNA), which represents 750,000 working men and women across the United States and Canada, I wish to comment on S. 473, and identical provisions in S. 460, that would make it easier for *large and small* employers to reclassify millions of traditional "employees" as "independent contractors". Classifying workers as independent contractors has such financial advantages for employers -- escape from federal payroll taxes, unemployment insurance, workers compensation, health and pension benefits coverage -- that even the most conscientious of "corporate citizens" would eventually have to cave in to the competitive pressure AND reclassify traditional employees.

Increasingly, employers are engaging in a practice of worker misclassification whereby workers who are in fact "employees" and have always historically been classified that way, are reclassified as independent contractors under the tax code. Reclassification bears a great benefit for the employers since they do not have to pay Social Security, Medicare, or Federal

unemployment taxes for independent contractors. Neither do employers, in most cases, extend to independent contractors employer-provided benefits, such as health and pension benefits that are available to employees. The result is a substantial cost savings to employers who classify workers as independent contractors. The *New York Times* recently reported that as many as one-fifth of today's contract workers were formerly employees of the companies for which they now work as contractors. ("More Downsized Workers are Returning as Rentals," December 8, 1996). In many cases, these so-called independent contractors are actually performing the same tasks under the same conditions as when they were the company's employees.

The practice of worker misclassification is particularly prevalent in the construction industry, where improper classification not only results in contractors' evasion of employment tax duties but also frequently produces violations of federal and local overtime and prevailing wage requirements. Results from an Internal Revenue Service (IRS) study indicated that 20 percent of the construction industry employers misclassified workers.[1] Additionally, unlike employees, independent contractors have no unemployment or workers' compensation protection derived from their employment. This is particularly problematic for construction workers where substantial periods of unemployment are commonplace, and the workplace injury rate is relatively high.

Worker misclassification is also of particular concern in the construction industry because of the competitive advantage an employer gains in a low bid situation from the labor cost savings resulting from worker misclassification.

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[1]"Efforts in Addressing Misclassification of Employees as Independent Contractors in the Construction Industry," Department of Treasury, Internal Revenue Service, January 1995.

S. 473, and identical provisions in S. 460 would essentially codify worker misclassification. The legislation represents a significant public policy shift. These bills will make it *even easier* for employers to classify traditional "employees" and "independent contractors," thereby shifting to workers the employers' share of Social Security, Medicare and unemployment taxes as well as employer-provided benefits. The disadvantages of such a policy shift not only for workers, but also the federal government and good businesses, is tremendous.

Under current law, worker misclassification is estimated to cost the U.S. Treasury roughly $4 billion dollars in lost tax revenues annually.[2] Additionally, state tax revenues are lost resulting in unemployment insurance and worker compensation systems being underfunded. S. 473 will mean the U.S Treasury and state treasuries will forego even more tax revenues.

The legislation will also undercut legitimate businesses. Businesses that treat their workers fairly, in compliance with tax and labor laws, are placed at a competitive disadvantage when they must bid and compete against unscrupulous companies that lower costs by stripping workers of employee status.

The loss is probably greatest for workers. In addition to picking up the employers' share of employment tax liability and health and pension benefits, they would also lose a number of worker protections. Only "employees" receive protection under most federal and state labor and employment laws, including laws addressing: labor-management matters, minimum wage and overtime, family and medical leave, and civil rights. Even though some of these laws define "employee" differently than the tax code definition, many employers use the tax code definition

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[2]"Projection of the Loss in Federal Tax Revenues Due to Misclassification of Workers" by *Coopers & Lybrand*, June 1994. Prepared for the Coalition for Fair Worker Classification.

for all purposes. As a result, many workers may not receive the labor and employment protections to which they are entitled under the law.

Currently, whether a worker is classified as an independent contractor or an employee under the tax code is based on a somewhat complicated and unclear 20-factor common law test -- a test that is problematic for both employers and workers. S. 473, however, will simply make it easier to reclassify traditional employees as independent contractors -- a solution that is unfair to workers. Either of the two new tests set out in S. 473 could be used in lieu of the 20-factor test; both tests create enormous loopholes in the tax code.

The first option under the bill allows a worker to be reclassified as an independent contractor if the worker has a written agreement with the business and if there is a minimal showing of economic and workplace independence. This test could easily be manipulated by the employer. First, a written agreement could be easily met because the unequal bargaining power between the employer and the worker renders this a matter of form over substance. Second, the test is met, for example, if the worker agrees to perform work for a particular amount of time and invest a small amount of money in his or her own tools. This minimal standard would mean that millions of employees could be reclassified as independent contractors. This is particularly true in the construction industry, which has the fastest growing segment of independent contractors and an increasing number of misclassified workers.

The second option provided under S. 473, in addition to requiring a written agreement, requires that the worker conduct business through a corporation or limited liability company, and that the worker does not receive benefits from the business. Again, this test is problematic. Incorporating is a fairly simple and inexpensive process, particularly if the business assisted

individuals in incorporation. In sum, this test could also be manipulated easily by an employer to ensure that its workers are classified as independent contractors rather than employees. And, considering the considerable financial incentives of reclassification there is just no reason why an employer would not reclassify as many workers as possible.

The power of the incentives is evident, for example, in the health industry. In a May 22nd *Wall Street Journal* article on Small Business entitled "Slim Pickings: Health insurance? Retirement plans? Good Luck," they cite to the fact that an increasing number of employees are working for subcontractors, small businesses that farm out workers to doctors and hospitals: **"Subcontractors typically put these workers on their books as independent contractors to avoid giving them health-benefits,"** says Leo Blatz, chief executive officer of Supplemental Group Services, a health-care consulting service in Buffalo.

While we have strong interest in seeing worker misclassification addressed and a better test developed, we do not believe S. 473 provides a proper solution. We believe a better test can be crafted that is simpler, but that also protects millions of traditional employees from reclassification as independent contractors. In addition to costing the treasury billions in lost tax receipts, worker misclassification is very much a pocketbook issue for workers. Workers have a lot to lose -- health and pension benefits, unemployment insurance, workers compensation, federal and state employment protections -- and they could be faced with a lot of individual tax headaches.

Founded in 1903, LIUNA represents some 750,000 workers in construction, environmental remediation, maintenance, food service, health care, clerical, and other occupations.

NFIB
National Federation of Independent Business

The Voice of Small Business

Statement for the Record By
National Federation of Independent Business

Before: **Subcommittee on Taxation and IRS Oversight**
Senate Finance Committee

Date: **June 5, 1997**

Subject: **Use of Independent Contractors**

The National Federation of Independent Business (NFIB) appreciates the opportunity to submit testimony on the issue of independent contractors and how they are being impacted by Internal Revenue Service (IRS) enforcement. NFIB is the nation's largest small business organization representing 600,000 small business owners from all fifty states. The typical NFIB member has five employees and has $350,000 in gross sales. NFIB sets its public policy positions through regular polling of the membership.

What is an Independent Contractor?

Independent contractors are men and women who have decided to work for themselves instead of working for an employer. They are found in a wide variety of industries, and they usually control their own hours, work with their own equipment, and are not subject to the direct control of the business owner for whom they work.

Independent contractors play a very important role in both our economy and our society. An independent contractor is a budding small business. Deciding to work for yourself is the first step for many toward establishing a business. The United States has a strong tradition in encouraging entrepreneurs and business creations. The decision to strike out on one's own as an independent contractor is often the first step in this process.

Independent contractors also serve a variety of functions that are not easily performed by employees. They allow a small business owner to temporarily hire someone with a skill that is needed by the business for a short period of time or on an occasional basis. It is not unusual for a business to have a variety of jobs arise during the year that cannot be handled with the current work force but that do not require hiring an additional employee. By hiring an independent contractor, a business owner can have the job taken care of quickly without having to hire

someone that may soon have to be let go. The availability of independent contractors allow small businesses to be more flexible and more competitive.

Imagine that you are a small retailer and you determine that you need to computerize your operations to keep better inventory control and to permit your business to grow. So you contract with a specialist to design the system for you, and you pay the person for the work after the product is delivered.

One or two years later the Internal Revenue Service (IRS) is performing a standard audit, and you are asked for the documentation on the work that was done. At that point, the IRS says that you failed to treat this individual as an employee, should have withheld taxes for social security and income, and are going to be penalized 100 percent of the liability. If you do not agree, then the IRS will place a lien on your bank accounts effective in 60 days without any right to appeal.

You never considered this person an employee, certainly the individual who did the work never considered himself an employee, but because of a vague set of rules, the IRS can come back after the fact and dictate this treatment of that individual.

Thousands of small business owners face this issue every day and yet we wonder why small business owners have no confidence in our tax system. Should we also wonder why the 1995 White House Conference on Small Business considered this the number one small business issue?

This issue has festered long enough and needs to be resolved. NFIB, along with the Small Business Legislative Council, have for the past six years co-chaired a coalition of some 50 organizations who have the common goal of reform of the independent contractor rules. Year after year, legislation has been drafted which would clarify the definition of who is an independent contractor, though efforts continually have missed the mark for passage. This issue continues to be one of NFIB's top priorities and we feel that passage of both, S. 473, The Independent Contractor Tax Reform Act, and S. 460, The Home-Based Business Fairness Act, are critical to resolving this important economic justice issue.

Background

The issue of independent contractor classification has literally vexed Congress, the IRS, and taxpayers for more than twenty years. Current law provides little real guidance to either the IRS or taxpayers with the result being lengthy court actions and many small businesses faced with the threat of bankruptcy from government action. Congress has attempted to address this issue in the past only to find itself faced with a wide array of complex issues raised to address special situations.

The growth in small business being attested to this week -- Small Business Week -- provides the clearest reason why the classification rules for independent contractors need to be clarified. The millions of new small business owners need to know that the purpose of the tax

code is to fairly collect taxes, not to destroy jobs and opportunities.

The importance of this issue was highlighted in June of 1995, when the 2,000 business owners attending the White House Conference on Small Business ranked the classification issue as their number one concern.

In 1996, the IRS offered a major revision to its training manual for IRS employees, illustrating how the 20-factor test should be utilized in performing a classification audit. Although an important step forward for the IRS, the manual only serves to illustrate the need for permanent legislation.

Comments on IRS Training Manual for Determining Employee or Independent Contractor --Published 2/96

The manual does not have the force of law or regulations, therefore, neither Congress nor taxpayers had the opportunity to comment on its contents. The Section 530 safe harbor poses many problems for small business owners and yet, the manual fails to address issues relating to operation of the Section 530 safe harbor and how to interpret the consistency standard in a way that is rational and makes sense.

While the manual states that independent contractor status is a "valid and appropriate business choice", the IRS and Congress have the responsibility of interpreting the law to prevent the abuse of individuals who choose to be independent contractors and self-employed small business owners.

Overview of Training Manual

The manual seeks to dissect the 20 factor rules and provide IRS employees with a realistic view of the way in which business is done today and the nature of how relationships have changed. Where the manual falls short is where it fails to give the agents clear guidance on how to weigh and balance the 20 factors in different circumstances other than to tell them that certain factors are irrelevant in specific circumstances.

In many ways the manual makes the case that small business owners have made for years, i.e. that the 20 common law factors are extremely ambiguous and that the application of the 20 common law factors is highly subjective. The second issue where the manual also makes a positive although minor contribution is in the application of the Section 530 safe harbor, even though it fails to completely follow through in this area.

The manual provides that the examining agent must, even if the taxpayer fails to raise the issue, determine whether the Section 530 safe harbor can apply. Yet the guidance then fails to help the agent determine what is a reasonable basis for taking a position and what constitutes as an industry practice.

Legislation

The 600,000 members of NFIB encourage this committee to push for enactment of S. 473, The Independent Contractor Tax Reform Act and S. 460, The Home-Based Business Fairness Act. Both pieces of legislation go a long way to resolving the key issue in the independent contractor debate: What are the rules? Once everybody -- taxpayers and the IRS -- knows what the rules are, issues of enforcement can be addressed more clearly and straightforwardly without the need for unreasonable compliance rules.

Bond-Nickles Bills, S. 473, The Independent Contractor Tax Reform Act and S. 460, The Home-Based Business Fairness Act

Senator Bond's and Nickles' bills will make it easier for small business owners to know if they can hire independent contractors and build upon the progress made by the enactment of the Small Business Job Protection Act. That legislation made adjustments to Section 530 of the 1978 Revenue Act, providing limited protection against worker reclassifications by the IRS. S. 473 and S. 460 build upon that progress by establishing a clear, safe harbor that a business or a worker can use to determine independent contractor status.

Both S. 473 and S. 460 provide that under the general safe harbor, either of two tests must be met for an individual to be treated as an independent contractor. The first test requires that the independent contractor demonstrate economic independence and workplace independence in addition to having a written contract with the service recipient.

- Economic independence exists if all apply: the independent contractor has the ability to realize a profit or loss; he/she incurs unreimbursed expenses that are consistent with industry practice and that equal at least 2 percent of the independent contractor's adjusted gross income from the performance of services during the taxable year; and the independent contractor agrees to perform services for a particular amount of time or to complete a specific result or task.

- Workplace independence exists if one applies: the independent contractor has a principal place of business; he/she pays a fair-market rent for the use of the service recipient's facilities; or the independent contractor uses his/her own equipment.

- The written contract between the service recipient and the independent contractor must state that the independent contractor will not be treated as an employee.

Under the second alternative test, an individual will be treated as an independent contractor if he/she conducts business through a corporation or a limited liability company and he/she does not receive benefits from the service recipient and is responsible for his/her own benefits. The independent contractor must also have a written contract with the service provider stating that the independent contractor will not be treated as an employee.

S. 473 also provides additional relief for cases in which a worker is treated as an an

independent contractor under the safe harbor, and the IRS later contends that the safe harbor does not apply. In that case, the burden falls on the IRS, rather than the small business owner, to prove that the safe harbor does not apply.

This legislation was designed so that both parties have control. Its purpose is not to permit employers or service recipients to enforce wholesale changes to their workforces. Concurrently, it provides flexibility to the service recipient. It permits a business with employees performing one function to utilize an outside independent contractor when circumstances warrant, without fear of IRS retaliation.

Conclusion

As clearly stated earlier, the issues surrounding independent contractors and worker classification have, year after year, been a top priority for small business owners. With the absence of legislative guidance, small businesses have been forced to rely upon vague and ambiguous IRS guidelines for classifying workers. As a result, many small business owners often face bankrupting penalties despite good faith efforts to properly classify employees for tax purposes. The Independent Contractor Tax Reform Act and the Home Based Business Fairness Act send much needed relief to our nation's small business owners and the millions of budding entrepreneurs who have an interest in becoming an independent contractor.

1995 White House
Conference on Small Business
★★★★★★★★★★★★★★

April 23, 1997

The Honorable Christopher Bond
Chairman
Committee on Small Business
United States Senate
Washington, DC 20510

Dear Senator Bond:

The undersigned are the elected Regional Taxation Chairs and the Regional Human Capital Chairs representing the 2000 delegates to the June 1995 White House Conference on Small Business. We were elected by delegates from each federal region and given the responsibility for advancing implementation of the conference's recommendations with regard to the tax and human capital issues and reporting progress back to the delegates. Because federal tax laws impact every small business, it is critical to the growth and progress of the small business community that the law reflect sound public policy and fundamental fairness while imposing as little burden as possible.

We are writing to say that we have carefully reviewed the bill which you recently introduced in the Senate, the Home Based Business Protection Act (S 460), going over it line-by-line with your staff and we feel it fulfills the recommendations of the White House Conference in 3 key areas.

Health Insurance Deductions for the Self-Employed: S 460 would raise the tax deduction for the cost of health insurance for the self-employed to 100% upon enactment. Under current law, 40% can be deducted this year and, by the year 2006, 80% can be deducted. As we have said, this is a matter of fundamental fairness. There is no good reason why the full deduction should not be extended to the business owner regardless of business structure.

Home Office Deduction: S 460 would restore a sensible definition for "principal place of business" so that a home-based business can deduct its reasonable and necessary expenses like any other business. Once again, there are excellent public policy reasons for encouraging individuals to start a business even if they choose to work at home.

Independent Contractor Classification: The recommendation receiving the most votes from the delegates at the 1995 White House Conference was the recommendation to set a clear standard for worker classification. The delegates felt reasonable precautions should exist to protect the rights of legitimate employees, yet, there must also be a clear standard so that a business can select its business structure with integrity and not fear the loss of a life's work because the law is unclear. S 460 sets a

clear standard to provide safety to law-abiding small businesses while protecting the rights of legitimate employees. We know this is a controversial area and you know from our Congressional testimony last year that we had certain misgivings about previous proposals that Congress was considering . S 460 provides responsible tests that small businesses can read and understand.

It is clear that you and the staff of the Small Business Committee listened carefully to our recommendations, reports and testimony. The attention which the recommendations received is greatly appreciated and the Tax Chairs and Human Capital Chairs intend to contact all the delegates and recommend that they support your proposal and spread the word throughout the small business community.

Sincerely,

The White House Conference Tax Chairs

Region I	Debbi Jo Horton	Providence Rhode Island
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	Joy Turner	Piscataway, New Jersey
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