DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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[redacted]

Dear [redacted]:

This letter is in response to your inquiry of March 5, 2004, on behalf of the [redacted]. You want the Internal Revenue Service to thoughtfully consider the arguments made by the [redacted] when determining whether certain workers of [redacted] are independent contractors or employees.

Thank you for taking the time to provide us your comments. To help you understand the process of making such a determination, I am providing you general information to explain the context under which we determine whether a business's workers are employees or independent contractors. I am also providing you information on Section 530 of the Revenue Act of 1978 (section 530), which sets forth conditions under which an employer can obtain relief from employment taxes for workers who we may consider to be employees, but who the business has treated as independent contractors.

Worker Status

In general, employers must withhold and pay federal employment taxes on wages paid to its employees.[1] Guides for determining a worker's employment status for purposes of federal employment taxes are in three substantially similar sections of the Employment Tax Regulations under the FICA, FUTA, and income tax withholding sections of the Internal Revenue Code (the Code) [sections 31.3121(d)-1, 31.3306(i)-1 and 31.3401(c)-1]. The regulations provide generally that the employer's right to control the manner in which the work is performed is the most important factor in determining employment status.

[1] Federal employment taxes generally consist of income tax withholding under section 3401-3405 of the Code, the tax imposed by the Federal Insurance Contributions Act (FICA) under sections 3101-3128 of the Code, and the Federal Unemployment Tax Act (FUTA) under sections 3301-3311 of the Code.

Courts have commonly considered various factors to determine if an employer-employee relationship exists. These factors include, but are not limited to, the following:

1. The degree of control exercised by the principal over the details of the work.
2. Which party invests in the facilities used in the work.
3. The opportunity of the individual for profit or loss.
4. Whether or not the principal has the right to discharge the individual.
5. Whether the work is part of the principal's regular business.
6. The permanency of the relationship.
7. The relationship the parties believe they are creating.

Courts look at all the facts and circumstances of each case, with no single factor dictating the result.

The IRS identified, for use as an analytical approach, twenty factors to apply when determining employment status under the Code [Revenue Ruling 87-41, 1987-1 C.B. 296]. We based the twenty factors on an examination of cases and rulings considering whether workers were employees. The degree of importance of each factor varies depending on the occupation and the factual context in which the individual performs the services. Because of the difficulty in applying the twenty-factor test and because many of the factors are no longer relevant due to changes in business practices over the years, the IRS adopted a new approach for worker classification.[2] Rather than listing items of evidence under the twenty factors, we now group items of evidence into three main categories.

1. Behavioral Control. This category considers whether the business retains the right to direct and control how the worker performs the specific tasks it hired the worker to perform, regardless of whether the business actually exercises that right. Facts that show behavioral control include the training and the type and degree of instructions the business gives to the worker.

2. Financial Control. This category considers whether a business retains the right to direct and control how the business aspects of the worker's activities are conducted. Facts that show financial control include the method of paying the worker; the worker's opportunity for profit or loss; and whether the worker has a significant investment, incurs significant unreimbursed expenses in his business, or provides his services to the relevant market.

3. Relationship of the Parties. This category includes facts that illustrate how the parties perceive their relationship. Relevant facts include those that show the intent of the parties in establishing their relationship and whether the parties are free to terminate their relationship at will.

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[2] For an in-depth discussion of this new approach, see the IRS training materials available through the IRS website on determining employment status. "Independent Contractor or Employee?" Training 3320-102 (Rev. 10-96) TPDS 84238I.

Section 530 Relief

In certain circumstances, section 530 provides businesses with relief from employment taxes with respect to workers we may consider to be employees of the business, but who the business has treated as independent contractors. Generally, a business may qualify for relief from employment taxes under section 530 if it filed all required Forms 1099 (reporting consistency), treated all workers in similar positions the same (substantive consistency), and had a reasonable basis for treating the workers whose status is in question as independent contractors [Rev. Proc. 85-18, 1985-1 C.B. 518].

Section 530, as amended, is not a part of the Code. The Congress initially intended it as a temporary solution for employers facing potentially large assessments because of increased IRS enforcement activity in the employment tax area [Joint Committee on Taxation, General Explanation of the Revenue Act of 1978, 95th Cong., 2nd Sess. 300 (1979)]. The Congress extended the provision indefinitely by section 269(c) of the Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248. A taxpayer that qualifies for section 530 relief is not only protected from employment tax liabilities for the periods examined, but prospectively as well.

If a business is not eligible for section 530 relief, other relief provisions and programs may be available. For example, the Classification Settlement Program, an optional settlement program, allows businesses to resolve worker classification cases as early in the administrative process as possible and may reduce the amount of federal employment taxes owed with respect to the covered workers [Notice 98-21, 1998-1 C.B. 849].

I hope this information is helpful. If you have further questions, please call me or [redacted] (Identification [redacted]) of my staff at [redacted].

Sincerely,

Janine Cook
Chief, Employment Tax Branch 1
Division Counsel/Associate Chief Counsel
(Tax Exempt & Government Entities)