Can Home Workers Be Independent Contractors?

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There are many tests for determining who is an employee and who is not. Yet much of it comes down to the common law right to control, where rules of agency are used to determine employee status.[3] The common law asks whether the person for whom services are performed has the right to control and direct the individual who performs the services, not only as to the result, but also as to the details and means of accomplishing the result.[4]

The IRS has developed its own twenty factor test based on the common law rules to determine employee status for federal income and employment tax purposes.[5] However, this twenty factor test provides no mechanical definition of an employee. There is no litmus test, no maximum or minimum number of factors pointing one way or another.

Rather, the entire situation and the special facts and circumstances of each case are supposed to govern the analysis. This holistic approach to employee status leaves much room for manipulation of the facts and produces irregular results. On whichever side of this Maginot line you find yourself, it can be frustrating.

Take, for example, your worker, Wanda. She works from home (or wherever she pleases), embroidering fancy designs on jeans. Although you provide the jeans and thread to Wanda and she returns the completed product to you, she receives no instructions, apart from some general specifications you require. She's a trained seamstress, and a creative spirit to boot. She provides her own needle and scissors, and she works when she pleases.

Wanda is paid based on the number of jeans she embroiders for you. The more she works, the greater her profit. Wanda works for others embroidering jeans and if she wants to stop working for you, she'll incur no liability. Based on the twenty part IRS test, most people might assume that Wanda is an independent contractor. Not so fast!

I. STATUTORY EMPLOYEES

Given the fact-sensitive mishmash of factors that go into the employee versus independent contractor conundrum, some people are surprised to find that certain workers are employees *irrespective* of whether they meet the common law definition of an employee. For over 50 years, the Internal Revenue Code has contained a codified class of workers, colloquially known as statutory employees, who are employees for employment tax purposes.[6] These workers include:

A. Drivers who distribute beverages (other than milk) or meat, vegetable, fruit, or bakery products; or who pick up and delivers laundry or dry cleaning;
B. Full-time life insurance sales agents whose principal business activity is selling life insurance or annuity contracts;
C. Individuals who work at home on materials or goods supplied by an employer that must be returned to the employer or his designate and for which the employer furnishes specifications regarding the work to be done; and
D. Full-time traveling salespersons who solicit and transmit orders to an employer from wholesalers, retailers, contractors, or operators of hotels, restaurants, or other similar establishments.

Interestingly, these statutory employees are not true "employees" for *all* tax purposes. An employer must withhold social security and Medicare ("FICA") taxes from the wages of statutory employee only if all three of the following conditions are met: (a) the contract of service contemplates that substantially all the services are to be performed personally by such individual; (b) such worker has no substantial investment in the facilities used in connection with the performance of such services; and (c) such services are part of a continuing relationship with the person for whom the services are performed and are not in the nature of a single transaction.[7]

Furthermore, no withholding of federal unemployment ("FUTA") tax is required for two classes of statutory workers: full time insurance salespeople and home workers. Finally, no federal income tax withholding is required from the wages of any of the statutory employees.[8]

II. HOME WORKERS

Of these independent contractor/employee hybrids, the most interesting is the home worker. That makes the home worker category the most dangerous.

Let's fast forward the example of our jean embroidery and bring Wanda into the 21st century. Suppose now that

Wanda works for your internet company, doing streaming video editing for your slick website. She still works from home and she's still a creative spirit, but now her work requires her to invest in expensive video editing software and a high-end computer. She works remotely using a virtual private network ("VPN") to connect to your computer servers.

Despite the fact that your 21st century Wanda's work is materially different from her work as an embroiderer, the IRS may still classify her as a home worker. But it is not clear that the home worker classification was intended to be so far reaching. The legislative history of IRC section 3121 describes to be home workers:

Included within this occupational group are individuals who fabricate quilts, buttons, gloves, bedspreads, clothing, needle craft products, etc., or who address envelopes, off the premises of the person for whom such service is performed, under arrangements whereby they obtain from such person the materials or goods with respect to which they are to perform such service and are required to return the processed materials to such person or a person designated by him.[9]

The IRS's application of the home worker classification has begun to ensnare far more workers than Congress probably intended. In fact, this could be the tip of the iceberg. Given the growing tendency for independent contractors to work from home (or at least offsite) using telecommuting and internet technologies, it is possible that many more workers will be classified as statutory employees.

III. ANTIQUATED RULES AND STATUTORY SHORTCOMINGS

The home worker classification has been applied to a wide variety of workers.[10] The IRS has typically classified garment workers as statutory employees of the home worker variety.[11] There is also a long line of IRS administrative materials in which workers performing secretarial work, typing work, and more recently, computer work, have been deemed to be home workers.[12]

One problem with the static codification of the home worker designation is that it fails to account for recent technological changes. Two integral aspect of the home worker designation are: (1) that the worker makes no substantial investment in the facilities used in connection with the performance of such services;[13] and (2) that the materials or goods upon which the worker performs his services are furnished by the person for whom the services are performed and returned by the worker to such person.[14] The IRS is applying both these criteria in ways that do not account for recent technological and telecommuting changes that are ubiquitous in business today.

IV. SUBSTANTIAL INVESTMENT

First, independent contractors working at home now often spend thousands of dollars on their computer equipment. Some independent contractors, for example, technical or medical transcriptionists, may spend addition sums on equipment dedicated solely to their technical services. The IRS has ruled that the furnishing of a computer by the home worker, standing alone, does not constitute a substantial investment in facilities used in the work, (because a computer may be used for purposes not related to the particular services).[15]

However, this analysis overlooks the very real fact that computer equipment now used by web designers and computer programmers may constitute a substantial investment. Indeed, a federal district court in Texas has ruled just that. In *Lee v. U.S.*,[16] the court held that home workers who manufactured or assembled garments for a clothing manufacturer *did* have a substantial investment in facilities used in connection with the performance of their services, and were therefore not "employees" for Social Security purposes.

In *Lee*, each piece-worker owned at least one indispensable piece of sewing equipment, a commercial grade sewing machine, costing approximately $1,000. Most of the piece-workers also owned a sew-serger, costing anywhere from $1,400 to $2,600. Some of the piece-workers even owned a computerized sewing machine, costing approximately $2,400. The district court found that the cost of such equipment was clearly substantial as *a matter of law.*

The court in *Lee* appears to have recognized that increasingly sophisticated technology used by workers at home may require a substantial investment. This may be even truer in certain industries, such as the technology sector. For example, computer engineers and video programmers often perform services from home as independent contractors. They may use computer equipment that requires investments in the tens of thousands of dollars.

The legislative history of the home worker definition clearly envisioned workers making minimal investments in needles and thread—not computer programmers whose work requires investments in technology of thousands of dollars. Thus, if the IRS continues to apply its general rule that an investment in a computer is not substantial, such analysis fails to take into consideration the very real and significant cost of equipment required of certain workers to remain competitive in the computer and technology industries.

V. RECEIPT AND RETURN OF MATERIALS AND GOODS

A second prerequisite to the home worker category is that the worker must receive goods or materials from the employer on which he performs services, and then returns such goods or materials to the employer. This requirement, applied literally, should not sweep into the statutory employee category many individuals working from home using VPN telecommuting technology.

There is no statutory or regulatory definition of the terms "materials or goods." Recently, the Tax Court offered an interpretation of this phrase. Unfortunately, its wooden analysis fails to address the questions that modern electronic communications create.

In *Vanzant v. Commissioner*,[17] the Tax Court assessed the home worker status of an educational consultant who collected data from different schools, input such data onto a "software template" supplied by the employer, and later emailed the template back to the employer. The court acknowledged that there is no guidance on the definition of materials or goods. Consequently, the Tax Court deferred to that old saw, the dictionary.

The *American Heritage Dictionary's* definition of materials: "tools or apparatus for the performance of a given task."[18] According to the court, the taxpayer was required to use the software template to perform her duties. Therefore, the court found the software template was a "material."

The Tax Court's failure to articulate a more developed analysis is unfortunate. Technology today clearly allows workers to perform their tasks remotely, while never actually receiving tangible goods or materials from an employer, and never actually returning goods or materials. For example, much secure telecommuting now occurs using a VPN. A VPN allows an offsite worker to access electronic information stored on an employer's servers. The employer never "furnishes" the information to the worker.

Rather, this data physically remains on the servers of the employer at the employer's place of business (or server location). The worker simply manipulates the information remotely. That means the worker never "returns" such goods or materials to the employer either. The worker is effectively performing services as though he were actually at the employer's site. (Of course, maybe that analysis by itself suggests the worker would be an employee under the traditional twenty factor test, but that is a separate question.)

Often, the lone material or good an employer may supply to a worker using a VPN is the code or a portable key fob allowing the worker access to the server. However, the worker does not "return" this code or key fob as part of the completed work. That makes the situation distinguishable from the situation in *Vanzart*, where the worker returned the software template as part of her piece work.

Furthermore, in the typical modern telecommuting situation, the worker returns nothing to the employer that is even remotely analogous to the tangible objects—quilts, gloves, bedspreads, or envelopes—contemplated in the legislative history to the home worker provision.[19]

All in all, the technological advances available to workers working with computers and their remote access capability have created a working relationship that seems at odds with the home worker nomenclature. Indeed, many workers using secure remote access technology should arguably not meet the statutory definition of a home worker. At the very least, the dynamic has changed—and is continuing to evolve—dramatically.

The problem, it appears, is that the IRS is trying to assess these workers using criteria that are nearly 50 years old. Perhaps that is not the IRS's fault, but it is not the fault of the workers or of the companies paying them either. The changing technology used by offsite workers means that such workers simply do not receive goods or materials and return them after performing services on them.

VI. CONCLUSION

There are many factors that may validly demonstrate an individual telecommuting from home is a home worker. However, a modern video programmer like Wanda probably shouldn't be a statutory home worker. First, the IRS should reassess whether the furnishing of a computer and other technology, by itself, can never be a substantial investment. The financial investment in equipment required of certain independent contractors in the technology sector is often substantial in a very literal sense. Besides, "substantial" is a relative term and permits of much flexibility.

Second, the IRS and courts should carefully apply the literal requirement that home workers receive and return goods or materials. Without that being present, the worker simply cannot be a home worker. Today, many workers denominated as independent contractors in the technology field never actual receive or return tangible physical goods upon which they have performed any services. Advances in computer technology and telecommuting may mean that such workers simply do not meet the statutory definition of a home worker.

Of course, quite apart from the home worker issue, one must confront the question whether the worker meets the common law criteria. That requires a séance with the IRS twenty factors, or the IRS's attempt at the modernity of only three: behavioral controls, financial controls, and relationship.[20] Even setting aside the statutory employee home worker canard, there are (with apologies to Robert Frost) miles to go before you sleep.

ENDNOTES

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3. *Cmty. for Creative Non-Violence v. Reid*, 490 U.S. 730, 751 (1989).

4. Treas. Reg. § 31.3121(d)-1(c)(2).

5. Rev. Rul. 87-41, 1987-1 C.B. 296. More recently, the IRS has begun to use a three part test: (1) behavioral controls, (2) financial controls, and (3) relationship of the parties. *See* the line of IRS administrative rulings beginning with LTR 9843012 (July 20, 1998); *see also* IRS Pub. 15-A (2009) p. 6.

6. IRC § 3121(d)(3).

7. *See* IRS Pub. 15-A (2009) p. 5.

8. *See id.*

9. H.R. Rep. No. 81-1300, 85th Cong., 1st Sess. (1949), 1950-2 C.B. 255, 287.

10. Some of these are so specific as to be comical: *e.g.,* grading math exercises (LTR 5802112390A (Feb. 11, 1958)); salvaging hypodermic needles (LTR 6008102630A (Aug. 10, 1960)); tying fishing flies (LTR 6207268610A (July 26, 1962)); removing insects from nests and sorting them (LTR 8110143 (Dec. 12, 1980)).

11. *See* LTR 6308233110A (Aug. 23, 1963); LTR 6310102290A (Oct. 10, 1963); Rev. Rul. 72-88; 1972-1 C.B. 319; LTR 9511001(Nov. 21, 1994).

12. *See* Rev. Rul. 64-280, 1964-2 C.B. 384; Rev. Rul. 70-340, 1970-1 C.B. 202; LTR 8451004 (Aug. 1, 1984); LTR 9535002 (Mar. 29, 1995).

13. IRC § 3121(D)(3) flush language; Treas. Reg. § 31.3121(d)-1(d)(4)(i).

14. IRC § 3121(D)(3)(C); Treas. Reg. § 31.3121(d)-1(d)(1)(iii).

15. LTR 8451004.

16. 870 F. Supp. 137 (W.D. Tex. 1994).

17. T.C. Summ. Op. 2007-195.

18. 1079 (4th Ed. 2006).

19. H.R. Rep. No. 81-1300, 85th Cong., 1st Sess. (1949), 1950-2 C.B. 255, 287.

20. IRS Pub. 15-A (2009) p. 6.