Home Workers and the Debate Over "Who's a Statutory Employee" Under the Internal Revenue Code

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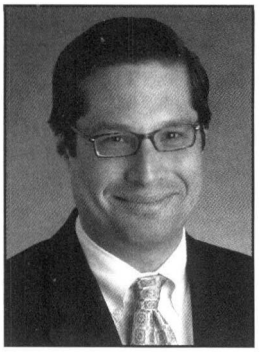

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Different governmental agencies use different tests for determining who is an employee and who is not. The Internal Revenue Service (IRS) typically uses one test,[1] the Department of Labor and many employment statutes use another,[2] and most state unemployment insurance authorities use another still.[3] This creates a great deal of confusion about what should be a relatively simple question—is a worker an employee or an independent contractor?

The test for employee status generally used by the IRS looks to the employer's behavioral and financial controls over the worker, as well as the relationship between the parties. This "twenty-factor test" is an uncodified, amorphous, facts and circumstances test that, like many of the other tests, tends to provide uneven results. Nevertheless, for more than 50 years, the Internal Revenue Code has contained a narrowly defined (and frequently overlooked) class of worker-employees, colloquially know as "statutory employees."[4] The test for statutory employee status does not involve weighing different factors to determine whether the employer exhibits the requisite control. Rather, these are *per se* categories based solely on the type of work performed by the worker. If a worker is performing services in one of these statutorily defined categories, the Internal Revenue Code says he is an employee, regardless of the control exhibited by the employer.

While such codification provides bright line rules, the statutory employee classification has become antiquated in light of changes in the workplace and technology. Indeed, the IRS may be classifying at least one segment of high technology workers as statutory employees, despite the fact that they may not meet the narrow statutory definition and would not meet the more general twenty-factor test for employee status. This double standard appears inequitable, and creates confusion for employers and workers alike.

The IRS's Twenty-Factor Test

Typically, the IRS employs a twenty-factor test based on common law rules to determine employee status for federal income and employment tax purposes.[5] The common law rules are based on agency law[6] and ask 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 of the services, but also as to the details and means of accomplishing the result.[7]

The IRS twenty-factor test does not provide a mechanical definition of an employee. There is no litmus test and 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.[8] This holistic approach to employee status leaves much room for manipulation of the facts and produces irregular results.

Take, for example, your hypothetical 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 also works for others embroidering jeans and if she stops working for you, she'll incur no liability. Since you appear to lack the requisite control over Wanda and her work pursuant to the twenty-factor IRS test, most people might assume that Wanda is an independent contractor. Not so fast!

Statutory Employees

Given the fact-sensitive combination of factors that go into the employee versus independent contractor analysis, some people are surprised to find that certain workers are employees *irrespective* of whether they meet the twenty-factor IRS test for employee status. These statutory employees include:

1. Drivers who distribute beverages (other than milk) or meat, vegetable, fruit, or bakery products, or who pick up and deliver laundry or dry cleaning;[9]
2. Full-time life insurance sales agents whose principal business activity is selling life insurance or annuity contracts;[10]
3. Individuals who work at home on materials or goods supplied by an employer that must be returned to the employer or his designee and for which the employer furnishes specifications regarding the work to be done (the "home worker(s)" for the purpose of the discussion below);[11] and
4. 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.[12]

Interestingly, these statutory employees are not true "employees" for *all* tax purposes. The employer and statutory employee are *not* liable for the panoply of taxes normally imposed on a worker who is deemed an employee. Rather, an employer must withhold social security and Medicare (FICA) taxes from the wages of a statutory employee only if all three of the following conditions are met: (a) the contract of service contemplates that substantially all of 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.[13]

Furthermore, no withholding of federal unemployment (FUTA) tax is required for the following two classes of statutory workers: full time insurance salespeople and home workers.[14] Finally, federal income tax is not required to be withheld from the wages of any of the statutory employees.[15]

Home Workers

Of the four categories of statutory employees, the home worker is the most interesting. 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 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 the 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 I.R.C. section 3121 offers the following description of 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.[16]

The IRS's application of the home worker classification has begun to ensnare far more workers than Congress probably intended. In fact, we could be seeing just 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.

Antiquated Rules and Statutory Shortcomings

The home worker classification has been applied to a wide variety of workers.[17] The IRS has typically classified garment workers working from home as statutory employees of the home worker variety.[18] 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.[19]

One problem with the static codification of the home worker classification is that it fails to account for recent technological changes. Two integral aspects of the home worker classification are: (1) the worker does not make a substantial investment in the facilities used in connection with the performance of services;[20] and (2) 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.[21] The IRS currently applies both these criteria in ways that do not account for recent technological and telecommuting changes that are ubiquitous in business today.

Substantial Investment

Independent contractors working at home now often spend thousands of dollars on their computer equipment. Some inde-

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and risk distribution. However, if the participant had twelve subsidiaries that generally met the same fact pattern in Rev. Rul. 2002-90 and the requirements of the twelve entity rule, then the policies issued from the cell company to the subsidiaries of the participant would constitute insurance for federal tax purposes. Prior to Rev. Rul. 2008-8, PCCs were often used as a less costly alternative to the pure captive and to avoid the twelve entity requirement of Rev. Rul. 2002-90. [20] ■

**As noted above, Part 2 of this article will be published in Issue 3, 2010 of Business Law News. Look for Issue 3, 2010 in your mailbox this September or visit http://businesslaw.calbar.ca.gov/ for our online edition.*

Endnotes

1 Karl, Holzheu, & Raturi, *The Picture of ART* (December 9, 2002) Swiss Re, *Sigma* No. 1/2003.

2 *See* I.R.C. §§ 831-835.

3 I.R.C. § 816(a).

4 Treas. Reg. § 1.801-3(a)(1), issued prior to the 1984 revisions to subchapter L of the IRC. The 1984 legislation changed the test from "primary and predominant business activity" to "more than half of the business" of the company.

5 312 U.S. 531 (1941).

6 Rev. Rul. 2002-90, 2002-52 C.B. 985.

7 797 F.2d 920 (10th Cir. 1986). *See also Clougherty Packing Co. v. Comm'r*, 84 T.C. 948 (1985), *aff'd* 811 F.2d 1297 (9th Cir. 1987); *Gulf Oil Corp. v. Comm'r*, 914 F2d 396 (3d Cir. 1990); *Malone & Hyde Inc. v. Comm'r*, 62 F.3d 835 (6th Cir. 1995).

8 *Harper Group & Subsidiaries v. Comm'r*, 96 T.C. 45, aff'd, 979 F.2d 1341 (9th Cir. 1992); *Ocean Drilling & Exploration Co. v. United States*, 69 AFTR 2d 92-338 (Cl. Ct. 1991), aff'd, 988 F.2d 1135 (Fed. Cir. 1993).

9 1977-2 C.B. 53; *see also* Rev. Rul. 88-72, 1988-2 C.B. 31

10 2001-26 C.B. 1348.

11 881 F.2d 247 (6th Cir. 1989).

12 *Id*. at 257.

13 96 T.C. 45 (1991).

14 2002-52 C.B. 984.

15 2002-52 C.B. 985.

16 2002-52 C.B. 991.

17 *Humana Inc. v. Comm'r*, 881 F.2d 247 (6th Cir. 1989).

18 2005-27 C.B. 4.

19 Rev. Rul. 2008-8, I.R.B. 2008-5.

20 Rev. Rul. 2008-8. In Notice 2008-19, the IRS requested comments regarding the status of a protected cell as an insurance company under Sections 816(a) and 831(c). Another recent IRS ruling is Rev. Rul. 2007-47 where Company X engaged in business process and government regulations required X to incur costs to remediate the harm caused by business process. Insurance company and X entered into a contract where insurance company would pay costs incurred by X above a certain amount, if applicable. The IRS held that this arrangement did not constitute insurance for federal tax purposes because no insurance risk exists as to whether X will have to incur remediation costs, rather the arrangement is akin to a timing and investment risk.

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pendent contractors, such as technical or medical transcriptionists, may spend additional sums on equipment dedicated solely to their technical services. However, 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.[22]

However, this simplistic analysis overlooks the very real possibility that computer equipment now used by web designers and computer programmers may in fact constitute a substantial investment. Indeed, a federal district court in Texas has ruled that an investment in certain types of technology may be substantial. In *Lee v. U.S.*, 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, therefore, were not "employees" for Social Security purposes.[23]

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 court determined that the cost of such equipment was clearly substantial as *a matter of law*.[24]

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

Based on the legislative history of the home worker classification, lawmakers clearly envisioned workers who make minimal investments in needles and thread—not computer programmers whose work requires investments in technology worth thousands

of dollars. The general rule that an investment in a computer is not substantial 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.

Receipt and Return of Materials and Goods

A second element of the home worker classification is the requirement that the worker must receive goods or materials from the employer, perform services on those goods or materials, and then return them to the employer. The application of this element of the home worker classification to individuals working from home using VPN telecommuting technology appears tenuous.

There are no statutory or regulatory definitions of the term "materials or goods." Recently, the tax court offered an interpretation of this phrase in *Vanzant v. Commissioner*.[25] Unfortunately, its wooden analysis fails to address the questions raised by modern electronic communications.

In *Vanzant*, 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.[26] The court acknowledged that there is no guidance on the definition of materials or goods and consulted the dictionary.

Reading the American Heritage Dictionary, the court found the definition of "materials" encompasses "tools or apparatus for the performance of a given task."[27] 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" for the purposes of the home worker classification. Since she was required to return the template (*i.e.* materials) to the employer, the court found that she was a statutory employee.

It is unfortunate that the tax court failed to articulate a more thorough analysis of the use of the phrase "materials or goods" for the purpose of the home worker classification in *Vanzant*. Technology today 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. This means the worker does not receive any "materials or goods."

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.[28]

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 *Vanzant*, where the worker returned the software template as part of her piece work.

Furthermore, in the typical 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 of the home worker classification.[29]

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 classification. Indeed, many workers using secure remote access technology arguably should 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 fifty 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 often means that such workers simply do not receive goods or materials and return them after performing services on them with their expensive computer equipment.

Conclusion

There are many factors that could validly demonstrate that an individual telecommuting from home is a statutory home worker.[30] However, a modern video programmer like Wanda probably should not be deemed a statutory home worker since she is readily distinguishable from the workers Congress originally sought to protect with the codification of the home worker classification. First, the IRS should reassess whether the furnishing of a computer and other technology, by itself, can ever 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. Moreover, "substantial" is a relative term and permits much flexibility.

Second, the IRS and courts should carefully apply the requirement that home workers receive and return goods or materials. Without that requirement being fulfilled, the worker simply cannot be a home worker. Today, many workers deemed independent contractors in the technology field never actually 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. ■

Endnotes

1 The Twenty-Factor Test is described in Rev. Rul. 87-41, 1987-1 C.B. 296.

2 The Economic Realities Test (for purposes of Title VII protection) is described at *Spirides v. Reinhardt*, 613 F.2d 826, 831 (D.C. Cir. 1979).

3 The ABC Test is described in, for example, *Carpet Remnant Warehouse, Inc. v. N.J. Dep't of Labor*, 125 N.J. 567, 571 (N.J. 1991).

4 *See* I.R.C. § 3121(d)(3) (2010).

5 Rev. Rul. 87-41, 1987-1 C.B. 296. More recently, the IRS has begun to group the 20 factors into three general classes, testing (1) behavioral controls; (2) financial controls; and (3) relationship of the parties. See the line of IRS administrative rulings beginning with IRS Priv. Ltr. Rul. 98-43-012 (July 20, 1998); see also I.R.S. Pub. 15-A at 6 (2009).6 *See Cmty. for Creative Non-Violence v. Reid*, 490 U.S. 730, 751 (1989).

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

7 Treas. Reg. § 31.3121(d)-1(c)(2) (2010); *Tri-State Employee Services, Inc. v. Mountbatten Sur. Co.*, 295 F.3d 256, 269 (2d Cir. 2002) ("Thus, for federal employment tax purposes, it has generally been found that, pursuant to the common law, 'the relationship of employer and employee exists when the person for whom services are performed has the right to control to control and direct the individual who performs the services, not only as to the result to be accomplished by the work but also as to the details and means by which that result is accomplished.'").

8 *See* Rev. Rul. 87-41 ("The degree of importance of each factor varies depending on the occupation and the factual context in which the services are performed. The twenty factors are designed only as guides for determining whether an individual is an employee…")

9 *See* I.R.C. § 3121(d)(3)(A).

10 *See* I.R.C. § 3121(d)(3)(B).

11 *See* I.R.C. § 3121(d)(3)(C).

12 *See* I.R.C. § 3121(d)(3)(D).

13 *See* I.R.S. Pub. 15-A at 5 (2009).

14 *See id.*

15 *See id.*

16 H.R. Rep. No. 81-1300 (1949), *reprinted in* Internal Revenue Cumulative Bulletin; 1950-2 C.B. 255, 287.

17 Some of these are so specific as to be comical: *e.g.,* grading math exercises (IRS Priv. Ltr. Rul. 5802112390A (Feb. 11, 1958)); salvaging hypodermic needles (P.L.R. 6008102630A (Aug. 10, 1960)); tying fishing flies (P.L.R. 6207268610A (July 26, 1962)); removing insects from nests and sorting them (IRS Priv. Ltr. Rul. 81-10-143 (Dec. 12, 1980)).

18 *See* IRS Priv. Ltr. Rul. 6308233110A (Aug. 23, 1963); IRS Priv. Ltr. Rul. 6310102290A (Oct. 10, 1963); Rev. Rul. 72-88; 1972-1 C.B. 319; and IRS Priv. Ltr. Rul. 95-11-001(Nov. 21, 1994).

19 *See* Rev. Rul. 64-280, 1964-2 C.B. 384; Rev. Rul. 70-340, 1970-1 C.B. 202; IRS Priv. Ltr. Rul. 84-51-004 (Aug. 1, 1984); and IRS Priv. Ltr. Rul. 95-35-002 (Mar. 29, 1995).

20 I.R.C. § 3121(D)(3) flush language; Treas. Reg. § 31.3121(d)-1(d)(4)(i).

21 I.R.C. § 3121(D)(3)(C); Treas. Reg. § 31.3121(d)-1(d)(1)(iii).

22 IRS Priv. Ltr. Rul. 84-51-004 (August 1, 1984).

23 870 F. Supp. 137 (W.D. Tex. 1994).

24 *Id.* at 140.

25 T.C. Summ. Op. 2007-195 (July 19, 2007); 2007 Tax Ct. Summary LEXIS 204.

26 T.C. Summ. Op. 2007-195 (July 19, 2007); 2007 Tax Ct. Summary LEXIS 204, at 4.

27 1079 (4th Ed. Houghton Mifflin 2006).

28 This analysis may suggest the worker would be an employee under the IRS's traditional 20-factor test, but that is a separate question from consideration of the statutory definition of a home worker.

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

30 Of course, quite apart from the home worker issue, one must confront the question of whether the worker meets the common law criteria. That requires an analysis using the twenty factors or the IRS's attempt at the modernity of only three: behavioral controls, financial controls, and relationship.