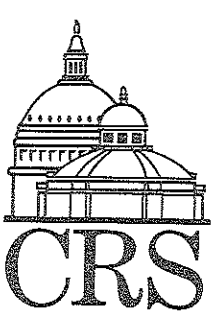
CRS Report for Congress

Tax Aspects of Clinton's Health Care Plan: The Classification of Workers as Independent Contractors or Employees

Harry G. Gourevitch
Senior Specialist in Taxation and Fiscal Policy
Office of Senior Specialists

Marie B. Morris
Legislative Attorney
American Law Division

February 7, 1994



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TAX ASPECTS OF CLINTON'S HEALTH CARE PLAN: THE CLASSIFICATION OF WORKERS AS INDEPENDENT CONTRACTORS OR EMPLOYEES

SUMMARY

President Clinton's health care plan (H.R. 3600, S. 1757) turns a spotlight on the current rules under which workers are classified as employees or independent contractors for purposes of employment and income withholding taxes. The classification issue assumes particular importance under the health plan as it would require employers to pay most of the health insurance costs of their workers if they are employees, but not if they are independent contractors. This employer mandate will subject businesses to new financial burdens which they may seek to minimize. One way of doing so would be by classifying workers as independent contractors rather than employees.

The report discusses the tax consequences of classifying workers as independent contractors or employees, and it explains the common law rules on the basis of which the classification is made. In applying the common law rules the Internal Revenue Service uses twenty factors to determine how workers should be classified. Many of these factors require subjective evaluations and, as a result, the determinations often themselves are subjective and may be inconsistent with other determinations applicable to other workers in similar occupations.

The classification of workers as employees or independent contractors has long been a controversial issue in Congress. In 1978 it imposed restrictions on the Internal Revenue Service's authority to administer the employment status rules, and to issue appropriate regulations; restrictions which are still in force today. At the present time, the Internal Revenue Service is not able to uniformly administer the employment status rules. There are two principal reasons for this: first, application of the common law rules can lead to subjective and inconsistent determinations, and second, the statutory restrictions imposed by Congress in 1978 limit the Service's ability to administer this area of the tax law.

In recent years a number of recommendations have been made by the General Accounting Office and others to reform the employment status rules and their administration. The health care bill would authorize the Service to issue regulations setting forth rules for determining whether an individual is an employee for purposes of employment taxes and income taxes. The bill would also make a number of other changes designed to prevent the misclassification of workers as independent contractors. The report notes that up to now Congress has shown little enthusiasm for itself clarifying the employment status rules or for allowing the Service to do so. It concludes that the proposed changes in the Administration's health care plan would merely adopt recommendations that had been made in prior years and that they do not represent novel or unexpected approaches.

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INTRODUCTION

President Clinton's health care plan contains a number of tax provisions. One of these relates to the tax classification of workers as employees or independent contractors. This has been and continues to be a controversial subject as Congress in 1978 enacted legislation restricting the Internal Revenue Service's (Service) authority to reclassify independent contractors as employees, legislation which is still in effect today. Under the health care plan the classification issue takes on particular importance as the proposed employer mandate would obligate a business to pay most of the health insurance costs of its workers only if they are employees, not if they are independent contractors.

The report examines the tax significance of classifying workers as employees or independent contractors and explains the rules governing such classification. There follows a review of Congressional action in recent years dealing with the classification issue. The report also looks at the Service's difficulties in administering the employment tax status rules and summarizes some of the recommendations that have been made to end the current impasse. Finally, the President's health care proposals for improving the administration of the employment status rules are discussed.

TAX SIGNIFICANCE OF CLASSIFYING WORKERS AS EMPLOYEES OR INDEPENDENT CONTRACTORS

Whether a worker is classified as an employee or independent contractor has important tax consequences, both for the business and the worker. If a worker is an employee the business that employs him will have to pay Federal Unemployment Tax Act (FUTA) taxes on behalf of the employee, the employer's half of Federal Insurance Contribution Act (FICA) taxes, and it may also have to pay significant amounts in the form of fringe benefits such as health insurance and pension benefits. In addition, the business will have to withhold income tax from the employee's wages, and the employee's share of FICA taxes. It also will incur overhead costs associated with income and FICA tax withholding, and with the administration of any health and pension plans. On the other hand, if a worker is classified as an independent contractor the business that uses his services is not required to pay FUTA or FICA taxes, or to make contributions for health benefits and/or pension plans. The business would also not have to withhold for FICA and income taxes, as payments to an

independent contractor are not subject to withholding.[1] If, however, a business pays more than $600 annually to an independent contractor it must report the amount of the payments to the Service on an information return, with a copy going to the independent contractor. Failure to file a required information return can result in a penalty of up to $50.

For workers the classification as independent contractors has advantages and disadvantages. A worker who is classified as an independent contractor is not subject to withholding for either income or Social Security taxes, though he is required to make quarterly payments of estimated tax and to pay Social Security taxes under the Self-Employment Contribution Act (SECA). SECA taxes are approximately equal to the employer's plus the employee's shares of FICA taxes. A significant advantage of being an independent contractor is that one can take work-related tax deductions that reduce income and SECA tax liabilities. Employees are also entitled to deduct employee business expenses as miscellaneous itemized deductions, but such deductions are allowed only to the extent they exceed 2 percent of adjusted gross income. Another advantage of independent contractors is that, consistent with their treatment as sole proprietors, their liabilities for SECA and income taxes are based on business income as reduced by deductions for allowable business expenses; an employee's income and social security tax withholding are based on the gross amount of his wages.

There are also disadvantages to independent contractors status. These include the obligation to make quarterly estimated tax payments throughout the year, the payment of SECA taxes, and having to forego the health and/or pension benefits that employers may provide their employees.[2]

To summarize, misclassification of workers may be either inadvertent or deliberate. A business may have financial incentives to claim independent contractor status for its workers: it will enable the business to avoid liability for FUTA taxes, the employer's share of FICA taxes, as well as payments for

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[1] From a business' point of view, the financial considerations may also turn on tort and labor law aspects of using independent contractors rather than employees. Independent contractors are not subject to the wage and hour laws, such as those regulating overtime pay; independent contractors do not receive sick leave or vacation pay; independent contractors are unlikely to belong to unions; they can be hired and fired on an as needed basis; and businesses do not have to provide workers' compensation for independent contractors. Under tort law, an employer is generally responsible for torts committed by its employees while on the job; acts of independent contractors are less likely to be attributed to the service recipient.

[2] Self-employed individuals were entitled to deduct 25 percent of health insurance expenses for themselves, their spouse and dependents. Code sec. 162(l). The provision expired for taxable years beginning after Dec. 31, 1993. Under the health care plan the deduction would be made permanent and would be increased to 100 percent of such expenses. H.R. 3600, sec. 7203.

fringe benefits such as health insurance and pension plans. In addition, the independent contractor status of its workers may give a business financial advantages under tort and labor laws. The employer mandate in the President's health care reform plan would add a further incentive for businesses to treat workers as independent contractors rather than employees.

According to 1984 and 1985 Service studies there is significant misclassification of employees as independent contractors.[3] The studies also show that there are consistently lower compliance rates for non-wage income than for wage income despite the requirement that payors file with the Service information returns on payments that exceed $600 per year. Misclassification of employees as independent contractors causes compliance problems as misclassified employees appear to have a greater tendency to under-pay their taxes, whether due to under-reporting of income, overstatement of deductions, or other causes[4].

LEGAL TESTS FOR CLASSIFYING WORKERS AS INDEPENDENT CONTRACTORS OR EMPLOYEES

Apart from certain statutory classifications of workers in specified occupations, the Service relies on common law rules to classify workers as independent contractors or employees. These were developed in England several hundred years ago to determine whether a master was legally liable for the torts of his servant. The Internal Revenue Code (Code) defines an employee as "any individual who, under the usual common law rules applicable in determining the employer-employee relationship, has the status of an employee."[5] The common law rules turn on the degree of control that an "employer" exercises, or has the right to exercise, over a worker. An employer-employee relationship is deemed to exist if the person contracting for services has the right to control not only the result of the services, but also the means by which the result is accomplished.[6]

In order to determine whether the requisite degree of control exists, the Service relies on a list of twenty common law factors:[7]

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3 Taxation of Technical Services Personnel: Section 1706 of the Reform Act of 1986, A Report to the Congress, 47, 51, 55, Department of the Treasury (March 1991).

4 Id. at 50-51.

5 Code Sec. 3121(d)(2).

6 Treas. Reg. Sec. 31.3401(c)-(1)(b).

7 Rev. Rul. 87-41, 1987-1 CB296.

1. Is the individual providing services required to comply with instructions concerning when, where, and how the work is to be done?

2. Is the individual provided with training to enable him or her to perform a job in a particular manner or method?

3. Are the services performed by the individual integrated into the business operations?

4. Must the services be rendered personally?

5. Does the business hire, supervise, or pay assistants to help the individual performing services under contract?

6. Is the relationship between the individual and the person for whom he or she performs services a continuing relationship?

7. Who sets the hours of work?

8. Is the individual required to devote full time to the person for whom he or she performs services?

9. Does the individual perform work on another's business premises?

10. Who directs the order or sequence in which the work must be done?

11. Are regular and/or written reports required?

12. What is the method of payment—hourly, weekly, commission, or by the job?

13. Are business and/or traveling expenses reimbursed?

14. Who furnishes tools and materials necessary for the provision of services?

15. Does the individual performing services have a significant investment in facilities used to perform services?

16. Can the individual providing services realize both a profit or loss?

17. Can the individual providing services work for a number of firms at the same time?

18. Does the individual make his or her services available to the general public?

19. Is the individual providing services subject to dismissal for reasons other than nonperformance of contract specifications?

20. Can the individual providing services terminate his or her relationship at any time without incurring a liability for failure to complete a job?

These common law factors seek to determine the extent of control an "employer" has over workers by examining such factors as number of hours worked, place of work, and any training provided. A 1989 report by the Government Accounting Office (GAO) noted that the application of these factors to specific work situations is open to subjective and inconsistent interpretations, as not all factors are present in every situation, some of the factors do not apply to certain occupations, and the factors vary as to applicability and importance in different situations.[8] Part of the problem is the large number of factors the Service has to contend with. Because there are so many it is difficult to determine the relative weight of any one factor. A number of legislative proposals would limit the number of factors to be taken into account.[9]

CONGRESSIONAL ACTIONS RELATING TO EMPLOYMENT TAX STATUS

The common law definitions of employee originally became law in the Social Security Act of 1935 and the Current Tax Payment Act of 1942. Since that time Congress has been confronted on several occasions with an Internal Revenue Service or a Social Security Administration seeking to expand the number of occupations treated as employees.

In 1947 the Supreme Court, using an economic reality test, decided three cases determining the employment status of certain workers. *U.S. v. Silk*, 331 U.S. 704 (1947) (consolidated with *Greyvan Lines*); and *Bartels v. Birmingham*,

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[8] Information Returns Can be Used to Identify Workers Who Misclassify Workers, 2-3, GAO/GGD 89-107 (Sept. 1989).

[9] Statement of John E. Chapoton, Assistant Secretary of the Treasury (Tax Policy), Hearings before the Subcommittee on Select Revenue Measures, 7, House Committee on Ways and Means, 97th Cong., 2d Sess. (June 11, 1982). See also, B. Apostolon, J.M. Beehler, and J. M. Hassell, *The 20-Factor Worker Status Test: Would Seven Factors Work Just as Well?* (Tax Notes 1389, Dec. 13, 1993), a recent study according to which CPA tax advisers considered five factors to account for about 50 percent of their classification decisions: realization of profit or loss, significant investment, full-time required, making services available to the general public, and working for more than one firm at a time.

332 U.S. 126 (1947). The economic reality test, which was broader than the common law control test, was applied by the Supreme Court in interpreting social legislation such as the Social Security Act to treat as employees workers who as a matter of economic reality depended upon the business to which they rendered service.

Apparently in response to these decisions, the Treasury Department in 1948 proposed regulations which would have replaced the common law test. The following year Congress rejected the proposed regulations by making the common law test retroactive to the date of enactment of the 1939 Internal Revenue Code and the Social Security Act of 1935.[10] This statute was adopted over President Truman's veto.

In the late 1960s and early 1970s, the Service stepped up its employment tax audits, resulting in a number of disputes between employers and the Service over whether individuals treated as independent contractors should be reclassified as employees. In the Conference Report on the Tax Reform Act of 1976 (P.L. 94-455),[11] Congress requested that the Service not apply any changed position or any newly stated position to past taxable years until the Joint Committee on Taxation had completed a study on the issue. The Joint Committee asked the GAO to examine the Service's administration of employment taxes.

The GAO issued its report in November 1977.[12] It recommended a four-part test to determine independent contractor status. The Treasury and Service criticized the GAO report because it would allow many workers then classified as employees to be reclassified as independent contractors. They feared the factors were sufficiently manipulable to allow workers to arrange their affairs to achieve the status they desired.

Congress reacted to the Service's energetic reclassification efforts by enacting Section 530 of the Revenue Act of 1978 (the 1978 Act), which was not made part of the Internal Revenue Code. Section 530 has two parts. First, it provides that employers who in the past had a reasonable basis for treating workers as independent contractors could continue such treatment without incurring employment tax liabilities. Three statutory safe harbors in Section 530 specified the circumstances under which an employer would have a reasonable basis for not treating workers as employees: One, acting in reasonable reliance on judicial or administrative precedent; two, acting in reasonable reliance on a prior Internal Revenue Service audit of the employer; and three, acting in reasonable reliance on a long-standing practice of a

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10 Chap. 468, 62 Stat. 438 (June 14, 1948).

11 H. Rept. 1515, 94th Cong., 2d Sess. 489 (1976).

12 Tax Treatment of Employees and Self-Employed Persons by the Internal Revenue Service: Problems and Solutions,GAO/GGD-77-88, Nov. 21, 1977.

significant segment of the industry in which the worker was engaged. In order to take advantage of section 530, an employer had to treat all other workers in similar positions as independent contractors as well, and all tax returns (including information returns) required to be filed had to treat the workers in question as independent contractors.

The second part of Section 530 prohibits the Treasury Department (including the Internal Revenue Service) from issuing before January 1, 1980 regulations on the employment status of individuals for purposes of employment taxes.[13] Section 530, including the prohibition on issuance of employment status regulations, applies to the classification of workers for employment tax purposes, not for income tax purposes.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) extended Section 530 indefinitely, including the prohibition on the Service from issuing employment status regulations. TEFRA adopted two other employment tax provisions. In new Section 3508 of the Code it specified that real estate agents and direct sellers are to be treated as self-employed for Federal income and employment tax purposes. And in new Code Sec. 3509 TEFRA limited the liability for back taxes of employers who had misclassified workers as independent contractors and who did not qualify for the protection of Section 530 of the 1978 Act. Prior to TEFRA, the consequences to a business of reclassification of workers as employees could be severe. The business would be assessed with back taxes for nonpayment of its and the employees' shares of FICA taxes, the business' FUTA taxes, the non-withheld employee income taxes, and penalties and interest. Under certain circumstances the Service allowed income tax and FICA/SECA tax offsets if the reclassified worker had on his returns paid the proper amounts of income and employment taxes.[14]

The Tax Reform Act of 1986 (Section 1706) amended Sec. 530 of the 1978 Act to provide that individuals who are retained by firms and who provide for third persons technical services such as those of an engineer or computer programmer are to be classified for income and employment tax purposes under the common law rules without regard to Section 530. The Section 530 prohibition on the issuance of Treasury employment status regulations was also lifted with respect to such technical personnel. Congress had enacted these changes in response to the urging of some employers in the technical services industry who claimed that certain competitors were able to gain unfair advantages by taking aggressive employment status positions that their workers qualified as independent contractors.[15]

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[13] Public Law 95-600, 92 Stat. 2763.

[14] Many small businesses today still feel that the tax liabilities of reclassification of independent contractors as employees are onerous.

[15] General Explanation of the Tax Reform Act of 1986, 1343-5, Joint Committee on Taxation (JCS-10-87, May, 1987).

DIFFICULTIES IN ADMINISTERING EMPLOYMENT TAX STATUS

Withholding for social security taxes and withholding for income taxes evolved separately and at different times. On top of the inconsistencies in the common law classifications of workers are the inconsistencies between the income and social security taxes themselves. For example, qualified real estate agents and direct sellers are classified as independent contractors for purposes of "this title," meaning income, social security, and FUTA taxes.[16] On the other hand, full-time life insurance salesmen and certain traveling or city salesmen are treated as employees for purposes of FICA taxes,[17] while their status for income tax purposes is determined under the common law rules. And under the common law rules these workers bear some of the hallmarks of independent contractors. Similarly, Code section 3121(a)(7)(B) requires withholding social security taxes on domestics employed in the home, but this same type of service is exempted from income tax withholding under Code section 3401(a)(4). In addition, as already noted, Section 530 of the 1978 Act may allow employers to treat workers as independent contractors even though under common law rules, they would have been classified as employees. Section 1706 of the Tax Reform Act of 1986 denies the relief of Section 530 to certain employers in the technical services field.

The ambiguities of the common law rules, statutory inconsistency, inconsistent enforcement, and the Section 530 restrictions prohibiting the Service from promulgating uniform guidance, make it difficult for the Service to uniformly administer the employment status rules. Under existing law, the Service may lack the authority to prevent certain employers from misclassifying workers as independent contractors. This situation could undermine the health plan if an employer mandate is adopted. If the mandate is considered sufficiently burdensome, under the current employment status rules many businesses will have additional motivations to reduce the number of workers that are considered employees.

In 1979, The Treasury Department made an effort to get away from the endless controversy over employment status classification and proposed withholding at a flat rate of 10 percent on compensation paid by a business to independent contractors.[18] The proposal, which in recent years has also been championed by the General Accounting Office, was not enacted.

There have been a number of other proposals to improve the employment tax status rules. The GAO since at least 1989 has recommended that Congress consider repealing the section 530 restrictions on the Service's authority to

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16 Code Sec. 3508,

17 Code Sec. 3121(d)(3).

18 Statement by Donald C. Lubick, Assistant Secretary of the Treasury (Tax Policy), Hearings of the Subcommittee on Select Revenue Measures, 15, House Committee on Ways and Means, 96th Cong., 1st Sess., June 20, 1979.

reclassify on a prospective basis employees who had been misclassified as independent contractors.[19] Under this proposal the section 530 safe-harbor would continue to protect against the reclassification of workers for back years, but not for future years. There has also been criticism of the prior audit safe-harbor of section 530 which protects an employer from reclassification of its workers as employees if a prior audit did not challenge the employment status of the workers, even if the prior audit dealt only with income taxes, not employment taxes.[20] In addition, the GAO and others believe that compliance by independent contractors can be substantially improved if the $50 penalty for a business' failure to file information returns on payments to independent contractors were significantly increased.[21] IRS data show that independent contractors report 97 percent of income that appears on information returns filed by businesses, but only 83 percent of income not reported on such returns.[22]

EMPLOYMENT TAX CHANGES IN THE CLINTON HEALTH CARE PLAN

The President's health care reform plan raises the stakes in the controversy over the tax classification of employees and independent contractors. Under the Health Security Act (H.R. 3600, S. 1757) employers will be required to pay most of the health insurance premiums for their qualified employees.[23] A qualified employee is defined as an employee who meets certain standards involving minimum working hours.[24] The amounts that an employer will have to pay as premiums will be directly related to the number of its workers who are qualified employees. The term "employee" in the bill has the same meaning as under Code Sec. 3121(d)(2), which provides that an employee is an individual who under the applicable common law rules has the status of employee.[25] Under the bill, a self-employed individual is considered to be his or her own employer and to pay wages to himself or herself equal to the amount of net

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19 *Information Returns can be used to Identify Employers who Misclassify Workers*, 10, GAO/GGD 89-107, Sep. 1989.

20 Tax Administration Problems Involving Independent Contractors, 6, Twenty Sixth Report, House Committee on Government Operations, Rept. No. 101-979, 101st. Cong., 2d Sess. (Nov. 1990).

21 Approaches for Improving Independent Contractor Compliance, 5, GAO/GGD 92-108, July 1992.

22 Id.

23 H.R. 3600, Sec. 6121.

24 H.R. 3600, Sec. 1901(b)(1)(A).

25 H.R. 3600, Sec. 1901(a)(1)(B).

earnings from self-employment.[26] Partners are considered employees of their partnership and shareholders in S corporations are considered employees of the S corporation (elective small business corporations with a single level of tax like a partnership). Net earnings from self employment attributable to the partnership or the S corporation are deemed to be wages.[27]

H.R. 3600 (S. 1757) makes the following employment tax status changes. First, it repeals Section 530 of the 1978 Act, and the Secretary of the Treasury is authorized to issue regulations setting forth rules for determining whether an individual is an employee.[28] The regulations would apply for employment tax purposes, and to the extent provided in the regulations, for income tax purposes. H.R. 3600 requires that, in drafting such regulations, significant weight be given to the common law rules and prohibits modification of certain existing statutory provisions. This bow to the common law rules and existing statutory provisions was inserted in the bill's revised version in order to disarm critics who objected to an earlier draft of the health care legislation on the grounds that it was being used to rewrite rules that have ramifications beyond the health care area. The revised version of H.R. 3600 would allow the regulations to override current rules (including statutory rules and regulations) relating to employment taxes, except for specified statutory rules that may not be modified. For example, the regulations could override the current definition of employee in Code sec. 3121(d)(2) which provides that an employee is an individual who, under the common law rules, has the status of an employee.

Second, any reclassification of an individual as an employee shall have prospective effect only, provided the employer meets a consistency requirement, a return filing requirement, and a new safe-harbor requirement.[29] Under the consistency requirement the employer must have treated the individual under examination and all other individuals in substantially similar positions as not being employees. Under the return filing requirement the employer must have filed all required Federal tax returns, including information returns, on a timely basis consistent with the taxpayer's treatment of the workers as independent contractors.

Under the safe-harbor requirement, the employer needs to have met one of four safe-harbors: First, the employer must have treated the individual under examination as not being an employee based on an employment tax status ruling or other Service written determination; second, the employer must have acted in reasonable reliance on an audit in which the individual's employment status was examined without change; third, the employer must have acted in reasonable reliance on a longstanding recognized practice of a significant

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26 H.R. 3600, Sec. 6126.

27 H.R. 3600, Sec. 6123(f).

28 H.R. 3600, Sec. 7301.

29 H.R. 3600, Sec. 7303.

segment of the industry in which the individual is engaged; or four, the employer must have acted on the basis of substantial authority (excluding letter rulings issued to other taxpayers). These safe-harbors tighten some of the loopholes in existing Section 530 and remove a major obstacle to achieving uniform national treatment of particular occupations by permitting prospective reclassification of any worker. Under the bill, the safe harbors would only prevent retroactive reclassification of employees; they would no longer prevent future reclassification. In addition, to rely on the audit safe harbor, an employer could no longer rely on any audit; the audit would have to have addressed the employment status of the individual under examination or an individual holding a substantially similar position without change to the status of any such individuals. The prior audit safe harbor as well as the industry practice safe harbor would cease to apply to workers after publication by the Service of any inconsistent regulation, revenue ruling, revenue procedure, or other authority before the beginning of the tax period in question.

In addition, the bill provides that if an individual was treated as an independent contractor under the safe harbor rules for employment taxes, then the individual would be treated as an independent contractor for income tax purposes as well.[30] This has the potential to remove many of the internal inconsistencies in the enforcement of the employment status provisions of the Code.

Third, H.R. 3600 (S. 1757) increases the penalty imposed on a business for failing to file required information returns with respect to payments of $600 or more per year. The penalty is increased from $50 to the greater of $50 or 5 percent of the amount that should have been reported on the information return.

CONCLUSION

The Clinton Health Care Plan (H.R. 3600, S. 1757) would adopt a number of tax changes, including changes in the tax rules governing the classification of workers as employees or independent contractors. It is important for the health care plan's success that the misclassification of workers as independent contractors be prevented or kept to a minimum because one of the plan's principal features, the employer mandate, applies only to workers who are classified as employees.

The changes proposed by the health care plan would simplify and rationalize the Service's administration of the employment status rules. The changes would make it harder for employers to misclassify workers as independent contractors and easier for the Service to correct misclassifications. The increased penalties for failure to file information returns may also improve compliance by independent contractors.

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30 H.R. 3600, Sec. 7303(b).

If the changes are enacted they may break the logjam that now restricts the Service's administration of the employment status rules. It cannot be said that the bill's employment tax proposals are unexpected or represent novel approaches, as they were earlier recommended by the GAO and others and have been under consideration for years. But it must be noted that Congress has never been able to reach a consensus on how to balance the interests of employers, particularly small businesses, against the interests of the Treasury and the public. Given the prior history of employment tax controversies, and the congressional preference to retain the status quo, one may wonder whether any significant changes will result from this proposal. However, if the Health Security Act becomes law, along with its employer mandate, the issue of who is and who is not an employee will take on additional significance beyond existing income and employment taxes.