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Independent Contractors: Repeal of Section 1706 of the Tax Reform Act of 1986 for Technical Service Workers: S. 1924

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Summary

In three-party employment situations involving technical service workers, companies that use the workers, and firms that supply or broker the services of workers, the common law rules, and only the common law rules, apply to determine whether or not the workers are employees of the placement firms. Section 530 of the Revenue Act of 1978[1] permits many firms to use a more liberal set of rules to determine the employment status of their workers. Among other things, section 530 prevents the Internal Revenue Service from challenging an employer's misclassification of a worker as an independent contractor if the employer has a reasonable basis for treating the worker as an independent contractor and certain other requirements are met (including consistent treatment of the worker and similarly situated workers.) Section 1706 of the Tax Reform Act of 1986 bars certain firms from claiming the protection of section 530. Section 1706 took away the statutory safe harbor for firms that place technical service workers (engineers, designers, drafters, computer programmers, systems analysts, and similarly skilled workers) with the companies that use the workers' services.

S. 1924, 105th Congress, would repeal section 1706 of the Tax Reform Act of 1986 (which is section 530(d) of the Revenue Act of 1978, as amended). Entitled the "Technical Workers Fairness Act of 1998," S. 1924 was introduced on April 2, 1998. This report discusses the background and possible effects of S. 1924.

For further information about the classification of workers as employees or independent contractors, see CRS Report 93-622 A, *Employees and Independent Contractors.* For information about recent tax legislation affecting worker classification, see CRS Report 96-715A, *Independent Contractors: Changes in the Small Business Tax Bill* and ALD General Distribution Memorandum dated August 15, 1997, entitled

[1] Section 530 of the Revenue Act of 1978 is not part of the Internal Revenue Code. Neither is section 1706 of the Tax Reform Act of 1986.

Employment Classification (Independent Contractor) Provisions in the Taxpayer Relief Act of 1997, P.L. 105-34.

Background

Although workers and the firms for which they work can have any number of arrangements for providing services and being paid for the services, for tax purposes workers are either employees or independent contractors, and the firms are either employers or not. Each status carries specific tax and legal obligations on the part of the workers and the firms. There are advantages and disadvantages to each classification for workers. For firms, there is a fairly strong incentive to classify workers as independent contractors.

Prior to 1982, the combined total of employer and employee taxes for social security and medicare was more than the self-employment taxes imposed on independent contractors. Of course, a firm could avoid paying any employment taxes if the workers were independent contractors. The firm only incurred employment tax obligations for employees. After 1982, the combined social security and medicare tax burden approximated the self-employment tax burden, but the advantage to a firm of classifying workers as independent contractors remained.

The IRS had fairly strong revenue incentives to assure that workers who were misclassified as independent contractors were reclassified as employees. A big problem for the firms was the statute of limitations provisions. If a taxpayer has filed a return, the statute of limitations is normally three years. If the taxpayer failed to file a return, the statute of limitations never starts to run. If an employer treated workers as independent contractors, the employer would not have filed employment tax returns. Consequently, the IRS could potentially assess the employer for taxes back to the effective date of the social security and medicare. That could be a heavy burden for what may have been a good-faith mistake.

In the 1970s and 1980s, when the IRS stepped up enforcement efforts in the employment tax areas, taxpayers sought legislative relief. In 1978, Congress provided statutory relief by enacting section 530 of the Revenue Act of 1978 (P.L. 95-600). Section 530 did three things: (1) It terminated any retroactive employment tax liability for employers who had treated workers as independent contractors before January 1, 1980, unless there was no reasonable basis for not treating the worker as an employee. (2) It spelled out reasonable bases for classifying a worker as an independent contractor, requiring consistent treatment of the worker and similarly situated workers as independent contractors, and reliance on judicial or administrative precedent, past IRS audit, or long-standing industry practice . (3) It prohibited the IRS from issuing regulations or revenue rulings addressing the status of workers as employees or independent contractors for employment tax purposes. Originally, section 530 was intended to be temporary legislation to retain the status quo while Congress took time to figure out what the correct solution should be.

In the Tax Equity and Fiscal Responsibility Act of 1982 (P.L. 97-248), section 530 of the 1978 Act was extended indefinitely, again to give Congress time to decide whether a different statutory design would be desirable. In addition, Congress designated qualified

real estate agents and direct sellers as statutory independent contractors. Since a large number of pending employment status controversies involved those occupations, the 1982 Act provided real estate agents and direct sellers with an immediate solution to their classification problems. It also took the pressure off Congress to develop a new statutory worker classification system.

In section 1706 of the Tax Reform Act of 1986 (P.L. 99-514), which originated as a Senate floor amendment, a subsection (d) was added to section 530 of the Revenue Act of 1978. The provision barred technical service placement firms from claiming the protections of the section 530 safe harbors. This meant that placement firms could rely only on the common law as a defense for their classification of the workers, and it meant that the IRS was not prohibited from issuing regulations or rulings relating to the employment status of technical service workers in three-party situations.

Empowered by section 1706, the IRS promptly issued Revenue Ruling 87-41, 1987-1 CB 296. The ruling spelled out the types of arrangements where the IRS would treat a placement firm as the employer of technical service employees. Basically, if the placement firm retained the right to control the worker, either by supervising performance or hours worked or guaranteeing the quality of the work of the worker to the client, then the relationship was an employer-employee relationship. If the placement firm simply acted as a broker with no guarantees about performance of the worker and no supervision of the worker's hours or relationship to the client, then the worker was an independent contractor and the firm was not the worker's employer. Although there was dissatisfaction with the Revenue Ruling on the part of workers and firms who could not arrange for their desired employment classification, the ruling had the advantage of providing clear standards for technical service workers in three-party situations.

Since section 1706 was enacted, Congress has held a number of hearings[2] on employment classification. None of the hearings focused specifically on section 1706, but at each of them, there has been testimony both for and against the repeal of 1706.

Those in favor of the repeal argued that section 1706 makes the technical services industry the only industry that cannot benefit from section 530. They pointed out that section 1706 was enacted without hearings. They noted that the March 1991 Treasury study entitled *Taxation of Technical Services Personnel: Section 1706 of the Tax Reform Act of 1986* found that technical service workers are at least as compliant with tax requirements as those in other industries. They argued that there is no justification for singling out the technical services placement industry for special treatment. They noted that a company that contracts directly with a technical service worker gets the benefit of section 530, if it can qualify, but that placement firms dealing with technical service

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[2] See *Misclassification of Employees and Independent Contractors for Federal Income Tax Purposes: Hearing before the Subcommittee on Select Revenue Measures of the* House Committee *on Ways and Means*, 102d Cong., 2d Sess. (1992); *Updated Review of Tax Administration Problems Involving Independent Contractors: Hearing before the Commerce, Consumer, and Monetary Affairs Subcommittee of the House Committee on Government Operations*, 103d Cong., 1st Sess. (1993); *Employment Classification Issues: Hearings before the Subcommittee on Oversight of the House Committee on Ways and Means* 104th Cong. 2d Sess. (1996).

workers do not enjoy this advantage. They believed 1706 is difficult to apply, especially in multiparty situations such as those contemplated by 1706.

Those opposed to the repeal argue that section 1706 does not cause true independent contractors to be classified as employees. They claimed that repeal would set a dangerous precedent by encouraging those who concede they cannot meet the common law test for independent contractor status to claim they are independent contractors anyway. They argued that the law is relatively clear and the industry is able to distinguish employees from independent contractors. They quoted the March 1991 Treasury report to the effect that section 1706 presents relatively few administrative problems, especially in comparison with section 530. They believed that the years since the passage of section 1706 have been profitable for the information technology and technical services industries, in part, because of the relative stability of the work force. They complained that before the enactment of section 1706, taxpayers that consistently misclassified their workers were entitled to relief under section 530, while taxpayers who diligently followed the law would not be entitled to relief because of the consistency requirements. They felt that the repeal of 1706 would place them at a competitive disadvantage.They asked for consistency in tax policy to avoid financial disruptions.

S. 1924

S. 1924 would repeal section 1706 of the Tax Reform Act of 1986 (which is section 530(d) of the Revenue Act of 1978). Entitled the "Technical Workers Fairness Act of 1998," S. 1924, 105th Congress, was introduced on April 2, 1998. The bill would be effective after the date of enactment. The bill would prospectively restore the benefits of section 530 to placement firms that serve the technical services industries. It is not clear that the bill would actually benefit existing placement firms, since they would still be bound by the duty of consistency contained in section 530. If existing firms have been treating workers as employees since 1987, it is unlikely that section 530 would permit them to treat those workers as independent contractors, even if S. 1924 is enacted. If existing firms have been treating workers as independent contractors, then enactment of S. 1924 would probably make such a choice less likely to be challenged by the IRS.

There appear to be two possible benefits from enactment of the bill. First, there may be an intangible benefit to the workers. There is anecdotal evidence that workers who believe that they are independent contractors cannot convince the placement firms or the companies that ultimately receive their services to treat them as independent contractors. The workers believe that the repeal of section 1706 will make the placement firms and the companies more receptive to treating them as independent contractors. Whether that will be the result cannot be determined. If the placement firms and companies have a strong preference for the status quo, enactment of S. 1924 may not change anything. If the technical services community regards S. 1924 as a green light to classify technical service workers as independent contractors, then S. 1924 may provide the workers with the ability to determine whether they want to be employees or independent contractors. Second, enactment of S. 1924 may decrease the perception of unfairness to the technical services industry. Even though section 1706 applies only to technical services placement firms, there seems to be a belief that the whole technical services industry is being unfairly targeted.