# PART VII: EMPLOYEES VS. INDEPENDENT CONTRACTORS

## 8661. Who is an "employee" for employment tax purposes?

Employers are often concerned with the classification of workers as employees or independent contractors because, among other reasons, the employer is responsible for paying one-half of an *employee's* employment taxes. Conversely, an independent contractor is liable for the entire sum of employment taxes (see Q 8663 for further discussion of the self-employment tax).

Generally, for employment tax purposes, the IRC defines "employee" to include the following taxpayers:

(1) Any officer of a corporation;

(2) Any individual who is an employee under the common law rules (see Q 8662); or

(3) Any individual who performs services as

a. A driver who distributes certain products (meat, vegetables, fruit, bakery products, beverages (other than milk), or laundry or dry cleaning services);

b. A full-time life insurance salesperson; (but see below and Q 8671);

c. A home worker performing work pursuant to the specifications given by the person for whom the services are performed; or

d. A traveling salesperson who, on a full-time basis, solicits orders on behalf of a principal from wholesalers, retailers, contractors, or operators of hotels, restaurants or similar establishments for merchandise for resale or supplies for use in their business.[1]

However, an individual will not be an "employee" for purposes of (3) above if the individual has a substantial investment in facilities used in connection with the performance of services (other than an investment in transportation facilities), or if the services are in the nature of a single transaction that is not part of a continuing relationship with the person for whom the services are performed.[2] For these purposes the term "substantial investment" refers to substantial facilities being furnished by the worker for conducting the business. All of the facts of each case must be considered to determine whether the facilities furnished by the worker are substantial. For factors considered in making these determinations, see Exhibit 4.23.5-3 (Statutory Employees) of the Internal Revenue Manual.

Despite this enumeration, the IRS has ruled that a full-time life insurance salesperson is not an "employee" for purposes of IRC Section 62 (deduction of trade or business expenses)

1. IRC Sec. 3121(d).
2. IRC Sec. 3121(d)(3).

and IRC Section 67 (2 percent floor on miscellaneous itemized deductions), even though he is treated as a "statutory employee" for Social Security tax purposes.[1]

See Q 8662 for a detailed discussion of the factors that are relevant in determining employment status. See Q 8671 to Q 8674 for a discussion of the tax treatment of life insurance salespersons.

## 8662. How is it determined whether a taxpayer is an independent contractor or a common law employee?

Generally speaking, an individual will be considered an employee under the common law rules if the person or organization for which the individual performs services has the right to control and direct the individual's work, not only as to the result to be accomplished, but also as to the details and means by which that result is accomplished.[2] In other words, an individual will be classified as an employee if the employer has the right to control not only *what* will be done, but also *how* that work will be accomplished. On the other hand, if the individual performing the work is only under the control of another to the extent of the end result that must be delivered, that individual will be classified as an independent contractor.

It is important to note that the employer does not actually have to direct and control the manner of an individual's work in order for that individual to be classified as an employee. The individual will be classified as an employee if an employer has the *right* to direct and control the manner in which that employee's work is accomplished even if the employer does not actually exercise this right.[3]

The parties' classification of the relationship as anything other than an employer-employee relationship is immaterial if the facts and circumstances show that the individual is performing services as an employee.[4] The IRS has developed three categories of control: behavioral control, financial control, and the type of relationship that exists between the parties.[5] Additionally, the IRS has developed a 20 factor test that is often applied in determining whether an individual is performing services as an employee or an independent contractor. These 20 factors include the following:

(1) *Instructions*. If the individual is required to comply with another person's instructions about when, where and how he or she works, that individual is usually an employee.

(2) *Training*. If an individual is trained alongside a more experienced employee or is required to attend training meetings, this indicates that the person for whom services are performed wants the individual to perform those services in a certain manner, making it more likely that an employer-employee relationship exists.

(3) *Integration*. When the success or failure of the business is significantly dependent upon the performance of services by the individual, the individual performing those

1. Rev. Rul. 90-93, 1990-2 CB 33.
2. Treas. Reg. §31.3121(d)-1(c)(2).
3. Treas. Reg. §31.3121(d)-1(c)(2).
4. Rev. Rul. 87-41, 1987-23 IRB 7.
5. IRS Pub 15-A, Employer's Supplemental Tax Guide (2013).

services must necessarily be subject to a certain degree of control by the business owner, indicating that an employer-employee relationship exists.[1]

(4) *Services Rendered Personally*. If the services must be rendered personally, it is presumed that the person for whom the services are performed is interested in the methods used to accomplish the work, as well as the end results.

(5) *Hiring, Supervising and Paying Assistants*. If the person for whom the services are performed hires, supervises, and pays assistants, it can generally be shown that he or she exercises control over the workers on the job. However, if one worker hires, supervises, and pays the other assistants pursuant to a contract under which the worker agrees to provide materials and labor and under which the worker is responsible only for the attainment of a result, this factor indicates an independent contractor status.

(6) *Continuing Relationship*. A continuing relationship between the individual performing the services and the person for whom they are performed indicates an employer-employee relationship.

(7) *Set Hours of Work*. If the person for whom services are performed sets the individual's hours of work, this factor indicates an employer-employee relationship.

(8) *Full-Time Schedule Required*. If the individual must dedicate substantially all of the individual's time to the work, the person for whom the services are performed has control over the amount of time the worker spends working and *impliedly* restricts the individual from taking other work. An independent contractor, on the other hand, is free to work when and for whom he or she chooses.

(9) *Work on the Employer's Premises*. If work is performed on an employer's premises, control is suggested, especially if the work could be done elsewhere. Work done off premises indicates freedom from control, but is not sufficient, on its own, to show that the individual is not an employee.

(10) *Order or Sequence Set*. If the individual must complete the work in a certain order, this factor shows that it is likely that another is controlling his or her pattern of work.

(11) *Oral or Written Reports*. If oral or written reports must be submitted by the individual completing the work, it is likely that another is controlling his or her work.

(12) *Payment by Hour, Week or Month*. Payment by the hour, week, or month usually indicates an employer-employee relationship, provided that the payment method is not just a convenient way of paying a lump sum agreed upon as the cost of a job. Payment made by the job or on a straight commission generally indicates that the worker is an independent contractor.

1. See, for example, *United States v. Silk*, 331 U.S. 704 (1947).

(13) *Payment of Business or Traveling Expenses*. If another pays the individual's business or traveling expenses, an employer-employee relationship is indicated because the employer, in order to control the individual's expenses, generally must have the right to direct the individual's business activities.

(14) *Furnishing Tools and Materials*. If the person for whom services are performed furnishes significant tools and material, this tends to show an employer-employee relationship.

(15) *Significant Investment*. If the individual invests in facilities that are usually used by workers in performing services, but are not typically maintained by employees (such as office space), the factor indicates that the individual is an independent contractor. Special scrutiny is applied in the case of home offices.

(16) *Realization of Profit and Loss*. An individual who can realize profit or loss as a result of his or her services is generally an independent contractor. The IRS uses the example of an individual who has a risk of loss with respect to liability for expenses, such as payment to unrelated employees (indicating independent contractor status), and distinguishes this type of risk from the risk that the individual will not receive payment for services (which is common to both employees and independent contractors).

(17) *Working for more than One Firm at a Time*. If an individual performs more than de minimis services for more than one firm at a time, this factor indicates that the individual is an independent contractor.

(18) *Making Services Available to General Public*. If an individual makes services available to the general public on a regular and consistent basis, this factor indicates that the individual is an independent contractor.

(19) *Right to Discharge*. The right to discharge an individual suggests an employer-employee relationship is present. An independent contractor, on the other hand, cannot be fired so long as the individual produces the end result that meets the contract specifications.

(20) *Right to Terminate*. If the individual has the right to terminate the relationship without incurring liability, this indicates an employer-employee relationship is present.[1]

All of the facts and circumstances of the relationship must be considered in weighing these factors to determine whether the relationship is an employer-employee relationship or an independent contractor relationship. No one factor will be determinative in making the correct classification.

1. Rev. Rul. 87-41, 1987-23 IRB 7.

## 8663. What is the self-employment tax? Who is liable for paying it?

An individual whose net earnings from self-employment as an independent contractor equal $400 or more for the taxable year must pay the self-employment tax.[1]

In 2014, an individual who is liable for the self-employment tax must file a Schedule SE and pay Social Security taxes on up to $117,000 of self-employment income ($113,700 for 2013). The hospital insurance tax is imposed on all of a taxpayer's self-employment income.

Despite this, an above-the-line deduction is permitted for one-half of the self-employment tax paid by an individual and attributable to a trade or business carried on by the individual as an independent contractor (not as an employee).[2] If the individual also works in covered employment as an *employee*, his self-employment income (subject to the self-employment tax) is only the difference, if any, between his "wages" as an employee and the maximum Social Security earnings base.

See Q 8547 for a detailed discussion of the Social Security tax as it applies to self-employed individuals and Q 8549 for a discussion of estimated tax payments.

## 8664. How are employment expenses treated differently based on whether a taxpayer is an employee or an independent contractor?

An employer is entitled to deduct amounts paid as reasonable compensation to its employees.[3] Therefore, whether an individual is classified as an employee or as an independent contractor is important to an employer in determining whether or not that employer is entitled to deduct amounts paid to that individual as compensation.

If an individual is properly classified as an independent contractor, the individual is entitled to deduct business-related expenses without regard to the 2 percent floor on miscellaneous itemized deductions (see Q 8525) that would otherwise apply. Conversely, the business expense deductions of an employee are limited based on whether or not the employee is reimbursed for the expense.[4]

## 8665. Can a self-employed individual participate in a retirement savings plan?

While employers are often required to include all employees in fringe benefit plans and retirement plans, the same requirement does not apply with respect to independent contractors. If an employer includes non-employees (including independent contractors) in a qualified plan, that plan may lose its qualified status by violating the "exclusive benefit" rule of IRC Section 401(a). Therefore, most self-employed individuals who operate as independent contractors will be ineligible to participate in retirement savings plans maintained by another taxpayer-entity.

1. IRC Sec. 6017.
2. IRC Sec. 164(f).
3. IRC Sec. 162.
4. IRC Sec. 62(c), Treas. Reg. §1.162-17(b)(2), 1.162-17(c).

For plan qualification purposes, a self-employed individual, as an owner-employee, is considered an "employee" for purposes of qualified plans established by that owner-employee.[1] An "owner-employee" is an employee who owns the entire interest in an unincorporated trade or business or, in the case of a partnership, owns more than 10 percent of either the capital interest or the profit interest in the partnership.[2]

Even if a partnership agreement does not specify that there exists a "more than 10 percent interest in profits" for any partner, if the formula for dividing profits (e.g., based on a partner's earnings productivity during the year) in *operation* produced a distribution at the end of the year of more than 10 percent of profits to a partner, the Tax Court has ruled that the partner is an owner-employee for the year.[3]

An individual who owns the entire interest in an unincorporated trade or business is treated as his or her own employer.[4] Thus, a proprietor or sole practitioner who has earned income (including "self-employment income") can establish a qualified plan under which the individual is both employer *and* employee.

A partnership is treated as the employer of each partner who is an employee.[5] Thus, partners individually cannot establish a qualified plan for a firm, but the partnership can establish a plan in which the partners can participate.

Individuals who are classified as independent contractors (see Q 8662) are able to set up their own retirement plans, including IRAs and Roth IRAs, so long as they have compensation (whether in the form of self-employment income, alimony or income earned as an employee in some capacity) and did not attain age 70½ during the year in which the account is established.[6] To establish a Roth IRA, the same income limitations apply to self-employed taxpayers as apply to employees, so that the self-employed taxpayer must not have adjusted gross income in excess of the annual income thresholds. For 2014, those thresholds are: (a) $191,000 or above in the case of a taxpayer filing a joint return; (b) $129,000 or above in the case of a taxpayer filing a single or head-of-household return; or (c) $10,000 or above in the case of a married individual filing separately.[7]

## 8666. If a self-employed owner-employee establishes a qualified retirement plan, is that plan entitled to ERISA protections that are normally granted to employees who participate in similar plans?

In some instances, a plan established by an owner-employee (see Q 8665) will be entitled to ERISA protections (such as rules regarding the vesting of benefits and ERISA's anti-alienation provisions), but in other cases, participants in such a plan will not be entitled

1. IRC Sec. 401(c).
2. IRC Sec. 401(c)(3).
3. *Hill, Farrer & Burrill v. Commissioner*, 67 TC 411 (1976), *aff'd*, 594 F.2d 1282 (9th Cir. 1979).
4. IRC Sec. 401(c)(4).
5. IRC Sec. 401(c)(4).
6. IRC Secs. 219, 408A.
7. IR-2013-86 (Oct. 31, 2013).

to the same protections as are available to traditional employees. The answer turns on whether employees *other than* the self-employed individual and the individual's spouse also participate in the plan.

Regulations promulgated by the Department of Labor provide that an owner-employee and spouse are *not* considered employees of a business that is wholly owned by those individuals.[1] Therefore, if only the owner-employee and spouse participate, the plan will not be subject to ERISA. Accordingly, Section 514(a) of Title I of ERISA would not preempt state regulation of the arrangement.[2]

However, the Supreme Court has ruled that if the owner-employee and spouse allow additional employees to participate in the plan, that plan will be subject to ERISA and entitled to its protections. In this case, both the employees *and* the owner-employee and spouse are entitled to ERISA protection.[3]

**Planning Point**: In some instances, it may be desirable for a qualified plan to become subject to ERISA's rules and protections rather than the state law provisions that may be found to apply if ERISA does not preempt state law. In other instances, state law provisions that would otherwise govern may be preferable.

## 8667. Is a taxpayer classified as an independent contractor, and thus self-employed, entitled to deduct the cost of health insurance coverage?

A self-employed individual is generally entitled to deduct the cost of health insurance coverage. The IRS has ruled that a self-employed individual may deduct the medical care insurance costs for himself and his spouse and dependents under a health insurance plan established for his trade or business up to the net earnings of the specific trade or business with respect to which the plan is established.

In determining this deduction limit under IRC Section 162(l)(2)(A), a self-employed individual may not combine the net profits from all his trades and businesses. However, if a self-employed individual has more than one trade or business, the individual may deduct the medical care insurance costs of the self-employed individual and his spouse and dependents under *each* specific health insurance plan established under *each* specific business up to the net earnings of that specific trade or business.[4]

According to the IRS, a self-employed individual may not deduct the costs of health insurance on Schedule C. The deduction under IRC Section 162(l) must be claimed as an adjustment to gross income on the front of Form 1040.[5]

Partners and sole proprietors are self-employed individuals, not employees. However, the deduction is not available to a partner or sole proprietor for any calendar month in which the

1. DOL Reg. §2510.3-3(c)(1).
2. Labor Dept. Advisory Opinion 92-21A (10/19/1992).
3. *Raymond B. Yates Profit Sharing Plan v. Hendon*, 541 U.S. 1 (2004).
4. CCA 200524001.
5. CCA 200623001.

individual is eligible to participate in any subsidized health plan maintained by any employer of the self-employed individual or spouse.[1]

Beginning in 2003, 100 percent of amounts paid during a taxable year for long-term care insurance up to the annual limits (see below) for an individual or spouse, or dependents can be deducted by a self-employed individual.[2] Sole proprietors, partners, and S corporation shareholders owning more than 2 percent of an S corporation's shares generally may take advantage of this deduction.

The deduction for eligible long-term care premiums that are paid during any taxable year for a qualified long-term care insurance contract[3] is subject to an annual dollar amount limit that increases with the age of the insured individual. In 2014, for taxpayers age forty or less, the limit is $370. For ages forty-one through fifty, the limit is $700. For ages fifty-one through sixty, the limit is $1,400. For ages sixty-one through seventy, the limit is $3,720. For those over age seventy, the limit is $4,660.[4] The age is the individual's attained age before the close of the taxable year. The limits are indexed annually for increases in the medical care cost component of the CPI (this is the so-called Medical Care Cost Adjustment) [5]

## 8668. What are the consequences if an employer wrongly characterizes an employee as an independent contractor?

The proper classification of individuals by an employer as either employees or independent contractors is important in many areas, and an employer who misclassifies its workers will be responsible for the consequences of the misclassification.

An employer who misclassifies an employee as an independent contractor may be liable for that employee's Social Security taxes because, in an employer-employee relationship, the employer is responsible for one-half of the tax owed, and the employer is responsible for deducting the employee's portion of the tax from wages.[6] Independent contractors, on the other hand, are liable for the entire amount of the tax, but are entitled to deduct one-half of the taxes paid (see Q 8663).

The IRS has ruled that if an employer wrongly classifies an individual as an independent contractor, the IRS can offset the refund of any self-employment taxes paid by that individual, but only with the employee portion of the employment taxes that would have been owed had the employee been properly classified.[7]

Therefore, if an employer hires an independent contractor who is later found to be an employee, the employee can claim a refund for the self-employment taxes paid while the employee was erroneously believed to be an independent contractor. The IRS, when processing the refund, can reduce the amount refundable to the employee by the employment taxes the

1. IRC Sec. 162(l).
2. IRC Sec. 162(l)(1)(B).
3. See IRC Sec. 7702B(b).
4. Rev. Proc. 2009-50, 2009-45 IRB 617, as modified by Rev Proc. 2010-24, 2010-25 IRB 764. Rev Proc. 2013-35, 2013-47 IRB 537.
5. IRC Sec. 213(d)(10).
6. Treas. Reg. §31.3102-1(a).
7. See *Beane v. Commissioner*, TC Memo 2009-152 (2009) and IRS ECC 201315023.

*employee* would have paid with proper classification. The employer, however, remains liable for the remaining balance that was refunded to the employee.

Further, an employee who has been wrongly classified as an independent contractor may be entitled to claim benefits under the benefit plans that the employer has established for traditional employees. For example, the Ninth Circuit has held that certain "leased" employees that an employer leased from an employment agency, and sought to classify as independent contractors, could claim their rights to benefits under that employer's employee benefit plans (including health insurance coverage) if they qualified as employees under the 20-factor test laid out by the IRS in Revenue Ruling 87-41 (see Q 8662).[1]

Similarly, in *Vizcaino v. Microsoft Corp.*, the Ninth Circuit held that individuals whom the employer sought to characterize as independent contractors may have had rights under the employer's benefit plans after an IRS audit found that the individuals were common law employees, and the employer conceded that it had mischaracterized the individuals.[2]

In contrast, the Tenth and Eleventh Circuits have held that the contract language of the employer's benefit plans will control. In these circuits, "leased" employees that met the 20-factor test to qualify as employees were *not* permitted to claim benefits under the employer's benefit plans when the plan language specifically excluded temporary and leased employees.[3] This was the case even though the leased employees at issue performed substantially similar services as the employer's common law employees who qualified for plan benefits.

Until this split in the circuits is resolved, it seems that the question of whether an employee who is wrongly characterized as an independent contractor is entitled to employment related benefits under the employer's benefit plans will be answered based on where the question is litigated.

**Planning Point**: Upon a request by a firm or worker, the IRS will determine whether a specific individual is an employee or independent contractor, provided the request is submitted for a tax year for which the statute of limitations on the tax return has not expired. A request is made by filing Form SS-8, *Determination of Worker Status for Purposes of Federal Employment Taxes and Income Tax Withholding*. Form SS-8 is filed to request a determination of the status of a worker for purposes of federal employment taxes and income tax withholding. A Form SS-8 determination may be requested only in order to resolve federal tax matters.[4]

## 8669. Are there any safe harbor provisions that an employer can use in order to ensure that its independent contractors are properly classified so that they will not retroactively be deemed employees?

Although it has not been incorporated into the Internal Revenue Code, Section 530 of the Revenue Act of 1978 provides a limited safe harbor for employers to prevent the IRS from retroactively reclassifying certain independent contractors as employees.[5] The purpose of the

1. *Burrey v. Pacific Gas and Electric Co.*, 159 F.3d 388 (1998).
2. 97 F.3d 1187 (9th Cir. 1996).
3. See *Bronk v. Mountain States Telephone & Telegraph*, 140 F.3d 1335 (10th Cir. 1998), *Wolf v. Coca-Cola Co.*, 200 F.3d 1337 (11th Cir. 2000).
4. IRS Tax Topics No. 762.
5. Section 530 of the Revenue Act of 1978, P.L. 95-600 (as made permanent by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), P.L. 97-248.

safe harbor rule is to prevent reclassification in situations where an employer has a reasonable basis for classifying an individual as an independent contractor.

An employer must satisfy three tests in order to qualify for relief under the Section 530 safe harbor:

(1) The employer must have a reasonable basis for treating the individual as an independent contractor (the "reasonable basis" requirement (see Q 8670));

(2) The employer must consistently treat all similarly-situated workers as independent contractors (the "substantive consistency" requirement); and

(3) All tax returns must have been filed on a basis consistent with independent contractor classification (the "reporting consistency" requirement).[1] The Tax Court has found that the untimely filing of a taxpayer's Forms 1099 would *not* preclude relief under Section 530.[2]

Whether the requirements of Section 530 have been satisfied is a question of fact to be decided by the courts. The employer has the burden of proof in showing that it is entitled to relief pursuant to the safe harbor provision.

## 8670. How can an employer show that it had a reasonable basis for classifying its workers as independent contractors, rather than employees, in order to qualify for the Section 530 safe harbor?

An employer can avoid IRS reclassification of its independent contractors as employees if it is able to prove, among other requirements (see Q 8669), that it had a reasonable basis for its classification of workers.

The courts have found that the "reasonable basis" requirement is satisfied when the employer relies on one or more of the following:

(i) judicial precedent, published rulings or IRS letter rulings to the taxpayer (IRS rulings addressed to other taxpayers have been found insufficient);[3]

(ii) a past IRS audit of the employer where there was no assessment attributable to the treatment of individuals holding positions similarly situated to the individual at issue for employment tax purposes;

(iii) a longstanding recognized practice of a significant section of the industry in question;[4] or

(iv) as a catch-all, any other reasonable basis for not treating an individual as an employee.

1. See, for example, *303 West 42nd St. Enterprises, Inc. v. IRS*, 181 F.3d 272 (1999).
2. *Medical Emergency Care Associates v. Commissioner*, 120 TC 436 (2003).
3. See *Darrell Harris, Inc. v. United States*, 770 F. Supp. 1492 (1991) (in which the taxpayer was not entitled to rely upon a letter ruling to satisfy the reasonable basis requirement because it was not issued directly to the taxpayer).
4. See *Nu-Look Design v. Commissioner*, 356 F.3d 290 (2004), *Greco v. United States*, 380 F. Supp. 2d 598 (2005).

The courts have found the reasonable basis requirement to be satisfied even in cases where the employer relied upon an IRS audit of one class of workers to justify independent contractor status for a second class. For example, the courts have allowed an employer to rely upon an audit of the classification of its landscaping staff in order to provide a reasonable basis for that same employer's treatment of its janitorial staff as independent contractors.[1] The relevant inquiry was into the relationship between the employer and the workers, in terms of control and supervision, rather than the actual type of work that was being performed.

An employer can also rely upon a "longstanding" custom used by a "significant section" of the industry to establish a reasonable basis for the workers' classification. The practice must be longstanding, and, under Section 530, an industry practice is longstanding if it has been in existence for at least 10 years (the statute does not *require* that the custom be in use for 10 years, but does preclude the courts from requiring a longer time period).[2]

A "significant section" of the industry means 25 percent of the industry, excluding the employer in question, though a lower percentage may apply if the facts and circumstances of the particular case show that such percentage is appropriate.[3] The taxpayer is not required to look to the practices in the industry on a nationwide basis. Instead, the courts have permitted taxpayers to look to the segment of the industry in which they practice, using factors such as the size of the employer and the geographic region in which it operates to determine the relevant comparison.[4]

Even if the employer has no precedential opinion, past IRS audit or industry custom to rely upon, it can still establish that it had a reasonable basis for classifying its workers as independent contractors if it can show that it had some *other* reasonable basis for the classification.[5] For example, employers who have relied upon professional advice (such as from an accountant or attorney) in classifying workers as independent contractors may be able to use this advice as a reasonable basis for the classification.[6]

Some courts have also found that a reasonable basis for the classification existed when the common law factors (see Q 8662) weighed in favor of independent contractor classification.[7]

**Planning Point**: An IRS determination of a particular classification, made in response to a request made by a firm or worker on Form SS-8 (see Q 8668), would also constitute a reasonable basis for the classification under "(i)" above. A determination letter applies only to a worker (or a class of workers) requesting it, and the decision is binding on the IRS.

Note that in certain cases a formal determination will not be issued. Instead, an information letter may be issued. Although an information letter is advisory only and is not binding on the IRS, it may be used to assist the worker to fulfill his or her federal tax obligations.[8]

1. *Lambert's Nursery and Landscaping, Inc. v. U.S.*, 894 F.2d 154 (1990).
2. Section 530(e)(2)(C)(i). See also, IRS Publication on the history of Section 530, available at: http://www.irs.gov/pub/irs-utl/irpac-br_530_relief_-_appendix_natrm_paper_09032009.pdf (last accessed May 28, 2014).
3. Section 530(e)(2)(C)(ii).
4. *General Inv. Corp. v. United States*, 823 F.2d 337 (1987), *J & J Cab Service, Inc. v. United States*, 75 AFTR 2d 618 (1995).
5. Rev. Proc. 85-18, 1985-13 IRB 27.
6. *Smoky Mountain Secrets v. United States*, 910 F. Supp. 1316 (1995).
7. *In re Critical Care Support Services, Inc.*, 138 BR 378 (1992), *American Institute of Family Relations v. United States*, 79-1 USTC 9364 (1979).
8. General Instructions to IRS Form SS-8.

**8671. Is a life insurance agent typically an employee or an independent contractor? How does this classification impact the agent's ability to deduct business expenses?**

The amount of the deduction for a life insurance agent's expenses is directly related to the agent's status either as an independent contractor or an employee. Typically, whether an insurance agent is considered an independent contractor or employee is determined on the basis of all the facts and circumstances involved. The IRS uses the same 20 factors discussed in Q 8662 in determining an individual's status as employee or self-employed person.[1]

Under the common law rules, most life insurance agents are self-employed individuals, and this is their status generally for tax purposes. Thus, in the usual case, a life insurance agent reports his income as an independent contractor, using Schedule C of Form 1040 for his business income and deductions. This means that he may deduct *most* of his business expenses directly from gross income.[2]

However, even a life insurance agent who is an *employee* under the common law rules may be permitted to deduct certain business expenses directly from gross income. This rule is limited to those expenses for which reimbursement has been included in the agent's gross income. Work expenses which are not fully reimbursed are generally deductible as miscellaneous itemized deductions; thus, they are permitted only to the extent that the aggregate exceeds 2 percent of adjusted gross income.[3]

The IRS has ruled that a full-time life insurance salesperson is not an "employee" for purposes of IRC Sections 62 and 67, even though he is treated as a "statutory employee" for Social Security tax purposes.[4]

On the other hand, the IRS has found that a district manager of an insurance company was an employee of the company, and not an independent contractor.[5] The IRS found that regional and senior sales vice presidents of an insurance company (but who were not officers of the company) were independent contractors and not employees of the insurance company.[6]

The courts have also made decisions in various cases concerning an insurance agent's classification as an employee or independent contractor. As with other employment situations, where an employer has the right to control the manner and the means by which the agent performs services, an employer-employee relationship will generally be found.[7]

However, according to decisions from the Sixth and Eleventh Circuits, the fact that an insurance agent received certain employee benefits did not preclude his being considered an independent contractor, based on all the other facts and circumstances of the case. The Sixth Circuit

1. Rev. Rul. 87-41, 1987-1 CB 296.
2. IRC Sec. 62(a)(1).
3. IRC Secs. 62, 67.
4. Rev. Rul. 90-93, 1990-2 CB 33.
5. TAM 9342001.
6. TAM 9736002.
7. See *Butts v. Commissioner*, TC Memo 1993-478, Let. Rul. 9306029.

rejected the IRS claim that a discharge provision in an agreement between agent and insurance company guaranteeing that the agent would not be fired for unsatisfactory performance unless he was first given notice that his work was unsatisfactory and his job in jeopardy, and was given the chance to bring his performance up to satisfactory levels, provided the company with the "right to control" the manner in which the agent performed his work. The court ruled that the provision simply reflected both the importance the company attached to sales productivity and its willingness to provide low -producing agents with a chance to bring productivity to acceptable levels before being terminated.[1]

**Planning Point**: Certain types of full-time insurance salesmen may qualify as "statutory employees" under IRC section 3121(d)(3), rather than "common law employees," and, as such, may use schedule C of form 1040 to determine net profit or loss.[2] To qualify as a statutory employee under section 3121(d)(3), the taxpayer must show: (1) that his entire or principal business activity was devoted to the solicitation of life insurance or annuity contracts; (2) that he did not have a substantial investment in the facilities used in connection with the performance of his services; and (3) that he is not a common law employee.[3]

## 8672. How are renewal commissions received by a life insurance agent taxed?

First year and renewal commissions are taxable to the agent as ordinary income. If the agent works on commission with a drawing account, the amount reported depends upon his contract with the insurance company. If the drawing account is a loan that must be repaid if he leaves, the agent reports only commissions actually received. If the drawing account is guaranteed compensation, he reports this compensation and any commissions received in excess of the amount that offsets his draw. This rule applies even if the agent uses the accrual method of accounting.[4]

Under certain circumstances an agent will not be required to recognize taxable income upon the sale of a life insurance policy. It has been held that an agent who is required to remit only "net premiums" (gross premium less the "basic commission" the company would allow him) to an insurance company, and who is under a contract with an insured to collect only an amount equal to the net premiums due, is not in constructive receipt of commissions usually earned on the sale of that policy. As a result, the agent is not taxed on the foregone commissions that would have been earned if a gross premium was collected.[5]

If the agent is not unconditionally obligated to repay advances, and any excess of advances over commissions earned would be recovered by the insurance company only by crediting earned commissions and renewals against such advances, amounts advanced to the agent are included in income in the year of receipt.[6] A life insurance agent's advance commissions received in previous years are taxable in the year the obligation to pay is discharged.[7]

1. *Butts v. Comm*, above. See also *Ware v. United States*, 67 F.3d 574 (6th Cir. 1995).
2. Rev. Rul. 90-93, 1990-2 CB 33.
3. *In the Matter of Appeal of M and L Tofig*, No. 91R-0742-JV (California Board of Equalization 10/28/1993.
4. Rev. Rul. 75-541, 1975-2 CB 195, *Security Associates Agency Insurance Corp. v. Commissioner*, TC Memo 1987-317, *Dennis v. Commissioner*, TC Memo 1997-275.
5. *Worden v. Commissioner*, 2 F.3d 359 (1993).
6. *George Blood Enterprises, Inc. v. Commissioner*, TC Memo 1976-102, Rev. Rul. 83-12, 1983-1 CB 99.
7. *Cox v. Commissioner*, TC Memo 1996-241.

With respect to commissions on credit life insurance, an accrual basis loan company which receives commissions on credit life insurance, but which may be required to refund a portion of the commission later if the loan is repaid and insurance coverage terminated before the end of the original term, includes the entire commission as income in the year the coverage was arranged. It may not spread the accrual over the term of the loan.[1]

When an agent purchases a policy for himself – on his own life or on the life of another – the agent must report the commissions as taxable income even though the commissions were never received. Such commissions are considered compensation and not a reduction in the cost of the policy.[2] This rule applies to brokers as well as to other life insurance salesmen. The agent or broker, or by whatever name he be called, is to receive or retain a percentage of the premiums on policies procured by him, called commissions, as compensation for his service to the company in obtaining the particular business for it. As such, the commissions were income within the meaning of IRC Section 61(a)(1).[3]

Similarly, if an agent sells a policy to a friend and waives his commissions, the agent must nevertheless report the commissions as taxable income.[4]

## 8673. How is the sale of a life insurance agent's renewal commissions taxed?

Generally, a bona fide, arm's length sale of a right to receive renewal commissions can successfully transfer the federal income tax liability on an insurance agent's renewal commissions to the purchaser. If an agent sells the right to renewal commissions, the agent must report the entire sale price as ordinary income in the year the sale is made.[5]

Renewals cannot be converted to capital gain by sale to a third party.[6] In addition, the Tax Court has held that amounts received by a district manager upon the termination of his agency contract are treated as ordinary income and not capital gain resulting from the sale of a capital asset, if the money received was compensation for the termination of the right to receive future income in the form of commissions.[7]

Apparently, the buyer must amortize his cost. In other words, the buyer can exclude from gross income in any year only that portion of the purchase price which the renewals received in that year bear to the total amount of anticipated renewals. The issue of whether the amount of deductible amortization is correctly determined requires consideration only of the contracts under which the buyer purchased the right to be general agent or purchased rights to renewal commissions.[8]

1. Rev. Rul. 75-541, 1975-2 CB 195.
2. *Ostheimer v. United States*, 264 F.2d 789 (1959), Rev. Rul. 55-273, 1955-1 CB 221.
3. *Commissioner v. Minzer*, 279 F.2d 338 (1960), *Bailey v. Commissioner*, 41 TC 663 (1964).
4. *Mensik v. Commissioner*, 37 TC 703 (1962), *aff'd*, 328 F.2d 147 (7th Cir. 1964).
5. See *Cotlov v. Commissioner*, 228 F.2d 186, *Turner v. Commissioner*, 38 TC 304 (1962).
6. *Remington v. Commissioner*, 9 TC 99 (1947), *Davidson v. Commissioner*, 43 BTA 576 (1941).
7. *Clark v. Commissioner*, TC Memo 1994-278.
8. *Latendresse v. Commissioner*, 243 F.2d 577 (1957).

## 8674. Are there any circumstances where an insurance agent's commissions may be taxable to a company rather than to the agent?

Where an individual agent owns or controls a corporation which is related to the agent's insurance activities, questions may arise as to the proper allocation of income and deductions between the individual and his corporation.

Typically, income is taxed to the individual who earns it, and the income earner cannot avoid the result by assigning income or the right to receive it either before or after the income has been earned.[1]

In one situation, a life insurance agent assigned his commissions to his wholly owned pension consulting corporation, for which he worked as an employee. He did not (could not, under the insurer's rules) assign his agency contract. Since neither the corporation nor any of its other employees were authorized under the contract to submit applications, none of them had the right under the contract to earn commissions. All applications developed through the sales efforts of all employees were submitted through the agent and the insurance company paid the commissions under the assignment to the consulting firm. The IRS considered the arrangement an assignment of future income and ruled that the commissions were includable in the agent's gross income.

However, the agent was allowed to deduct (as a business expense) a part of the assigned commissions. Since the services of other employees of the corporation helped produce the commissions, part of the assigned commissions was treated as compensation to the corporation for its services and taxed to the corporation. The balance of the assigned commissions was treated as contributions to capital instead of income.[2]

The IRS distinguished this situation from one in which the corporation was held to have earned the income,[3] because there the agreements between the agent and insurance company were assigned to the corporation.

In another case, a corporate life insurance agency tried to assign a contract to service a group medical insurance plan to its subsidiary, also an insurance agency. The parent corporation assigned the insurance commissions and service fees to the subsidiary, as well. However, the parent agency continued to perform all services to the group plan under the agreement, used its own office facilities and employees and paid all operating expenses. The subsidiary was unable to perform the agreement because of lack of staff, equipment and financing.

The Tax Court held that the parent earned the fees and commissions since it performed the services, and the subsidiary was unable to perform them. The parent agency argued that the assignment was of the agreement, as distinguished from the income. The argument failed because the parent was unable to submit proof. However, the court suggested that it would be hard to show an actual assignment of the agreement in view of the nature of the agreement,

1. *Helvering v. Horst*, 311 U.S. 112 (1940).
2. Rev. Rul. 77-336, 1977-2 CB 202.
3. Rev. Rul. 54-34, 1954-1 CB 175.

since it was one calling for performance of future services which the alleged assignee would be unable to perform.[1]

In *Davidson v. Commissioner*, the taxpayer was a successful salesman who specialized in estate planning sales. He formed a corporation to which he sold his insurance business, including all assets and good will, and provided in the instrument of transfer that all business done by him thereafter would be done for the benefit of the corporation. The taxpayer was to turn over to the corporation all of his first year commissions, keep his renewal commissions and be paid a salary as general manager of the corporation. The corporation carried on estate planning services acting through agents and employees other than the taxpayer, though the taxpayer worked jointly with some of these agents and personally received all commissions not retained by the other agents. The taxpayer endorsed over to the corporation commissions received by him pursuant to his agreement with the corporation, and did not include the commissions in his gross income, but did include them in the corporation's gross income in its return.[2]

Despite all these elaborate arrangements, the Tax Court held that all the commissions received by the taxpayer were taxable to him personally, not to the corporation. The court also rejected the taxpayer's argument that the commissions endorsed over to the corporation should be considered payments for services rendered by the corporation, and thus deductible as a business expense. The court held that the only amount deductible on such a basis would be an amount considered reasonable payment for such services had the taxpayer and the corporation bargained at arm's length.

In *American Savings Bank v. Comm.*, two individuals formed an insurance partnership authorized to solicit mortgage and credit life insurance in connection with loans made by banks in which they had interests. Insurance was sold on the bank premises primarily by officers of the banks who were individually licensed as insurance agents. By agreement between the partnership and the agents, commissions were divided 50-50 between the agents and the partnership. Later, the insurance business which, to that point had been conducted as a partnership, was transferred to a corporation formed by the two partners. Commissions thenceforth were divided between the corporation and the agents just as had been done between the partnership and the agents. The issue in the case was whether the commissions received by the corporation were taxable to the corporation or to the two individuals.[3]

The court examined all surrounding facts and circumstances, and concluded that control over the company's earnings rested with the corporation. The court noted that nearly all commissions were generated by other agents of the company and the contracts authorizing sales of insurance were with the corporation rather than with the individuals. Therefore, the commissions were taxable to the corporation rather than to the two individuals.

In *Shaw v. Comm.*, the taxpayer owned and managed two corporations. He was also licensed as an insurance agent to sell credit life and health insurance to customers of his companies.

1. *Millette and Associates, Inc. v. Comm.*, TC Memo 1978-180.
2. 43 BTA 576 (1941).
3. 56 TC 828 (1971).

Insurance was sold by employees to the corporations and applications were submitted in the taxpayer's name. Commissions on the insurance sold were paid to the taxpayer, who in turn endorsed the checks over to the corporations. In reaching its determination whether the commissions should be taxed to the taxpayer or to his corporations, the court first observed that the result would not be affected by the fact that, under state law, the corporations were prohibited from acting as insurance agents. Such a circumstance would not prevent the court from finding that the corporations should be taxed on the commissions if it determined that the corporations were actually in control of the insurance-selling enterprise. However, the court believed the facts of the case indicated that the taxpayer "was himself in the insurance business (admittedly to benefit his corporations) and used the corporations as his agents in the carrying out of the business of selling insurance." The court found, therefore, that the taxpayer, not his corporations, had earned the commission income and was liable for the taxes associated with it. However, the court recognized the fact that the corporations had performed services and expended funds in producing the insurance, and so allowed the taxpayer to deduct a large part of the commissions turned over to the corporations as a business expense.[1]

## 8675. Are partners and members of LLCs considered independent contractors or employees?

A general partner is treated as self-employed and income received from the partnership is, accordingly, treated as self-employment income.[2] Income received by a *limited* partner, on the other hand, is generally not treated as self-employment income *unless* that income represents a guaranteed payment to the limited partner within the meaning of IRC Section 707(c).[3] A payment will be considered "guaranteed" under Section 707(c) if it is made without regard to the income of the partnership.[4]

If an LLC is taxed as a partnership, its members are treated as partners for tax purposes (including determining whether their income represents self-employment income).[5] Despite this, in the case of an LLC member, if a member who has contributed both services and capital to the organization receives a distribution, the distribution should represent self-employment income insofar as it relates to the *services* contributed by the member. The difficulty arises in determining whether a distribution relates to the services or a return of capital.

The Tax Court recently held that payments received by a taxpayer through his LLC were guaranteed payments, rather than partnership distributions, that gave rise to ordinary income tax liability because the payments were made without regard to the partnership's income and were made in exchange for the taxpayer's services, not as a return of partnership capital.

In this case, after the taxpayer's employer refused to treat him as an independent contractor, the taxpayer resigned and formed an LLC through which he could perform the same services as a subcontractor for his former employer. The taxpayer received all payments for these services

1. 59 TC 375 (1972).
2. See IRC Sec. 1402(a).
3. IRC Sec. 1402(a)(13).
4. IRC Sec. 707(c).
5. Let. Rul. 9432018.

through the conduit LLC, which was taxed as a partnership, and labeled them as partnership distributions—arguing that the payments were made in exchange for the use of capital.

The IRS disagreed with this characterization and instead reasoned that these payments represented guaranteed payments for services under IRC Section 707(c) and, therefore, generated ordinary income tax liability. The Tax Court agreed with the IRS, finding that the taxpayer here performed all services on behalf of the LLC, employed no employees and could not present any evidence that the payments, which were determined without regard to the partnership's income, were made in exchange for the use of partnership capital. As a result, the taxpayer was required to include the payments in calculating his ordinary income tax liability.[1]

While the IRS proposed regulations on the issue (see below), in 1997 Congress provided that the regulations would not be made final and the IRS has not proposed further regulations.[2] Because of this, it is uncertain whether a distribution to an LLC member will be subject to the self-employment tax (see Q 8663) in a situation where the distribution cannot be apportioned to show whether it relates to the member's services or capital contribution. Even in such a situation, the members of an LLC may still qualify as owner-employees for purposes of retirement plan qualification under the rules discussed in Q 8665.

**Planning Point**: Proposed Treasury Regulation section 1.1402(a)-2 was originally issued by the IRS in 1997. However, because of controversy over the self-employment tax treatment of limited partners who are active in a partnership's business, Congress prohibited the IRS from making the regulations final before July 1, 1998, believing instead that Congress should formulate such rules. Since the expiration of the moratorium, neither Congress nor the IRS has acted to clarify the self-employment tax treatment of LLC members, leaving the proposed regulations as the only administrative guidance on the matter. Thus, while the proposed regulations are not precedential, they can be relied on to avoid a penalty under IRC section 6406(f). There is also judicial precedent, in *Elkins* 81 T.C. 669 (1983), to reasonably conclude that the courts will sustain the position of a taxpayer who relies on proposed regulations.

1. *Seismic Support Services v. Comm.*, TC Memo 2014-78.
2. TRA 97, Sec. 935.